Constantia Capital Merger-Arbitrage Strategy
May 2023 Commentary

Our composite returned -0.37% in May, bringing year-to-date returns to 0.66%, 3.88% annualized for the past 5 years and 4.88% annualized in 11 1/2 years since inception.

The S&P 500 posted positive results for the month thanks to Nvidia, which rose more than 25% after reporting strong sales buoyed by sales of chips that can support Artificial Intelligence (AI) applications. Many other stocks related to the AI theme, including Microsoft and Google, also rose. However, most other equity indices struggled and the MSCI World Index returned -1.0%, despite having a 60% weight in US equities. The US debt ceiling crisis appears to have been averted for now, but inflation fears persist, causing US government bond yields to rise for the month. The Bloomberg Aggregate Bond Index returned -1.1%. The classic 60/40 Equity/Bond benchmark (All World Index, Bloomberg US Aggregate Bond Index) returned -1.04% for the month.

The goal of Merger-Arbitrage is to post returns above the risk-free rate, with low volatility. With short-term rates on US Government bonds yielding close to 5%, we had been expecting above average returns for the year. (Looking forward, we still believe that goal is attainable, especially given the recent high rate of deal announcements). Our returns for the first five months of the year, at less than 1%, are disappointing. Much of the blame is due to the current anti-trust environment in the US, UK and China. Microsoft's acquisition of Activision is the most high-profile deal that may not be approved. This month saw two other high-profile anti-trust actions (see below). Those same deals are gaining approvals in other countries, which makes the case that US and British anti-trust authorities are outliers. US anti-trust laws are much more objective than the regulators, and the US government regulators have been losing most cases recently that end up in court. Meanwhile, deal announcements continue at an above average rate, with the vast majority of deals do being approved reasonably quickly.

Despite our disappointing performance relative to our cash benchmark, it is important to note that our returns are significantly ahead of our peers. An index of 10 Merger-Arb mutual funds and ETF's that we track returned -1.77% for May and -1.51% year-to-date. A separate index of Merger-Arb hedge funds maintained by an independent third-party that we regard as the Morningstar of hedge funds, was down 1.70% for the first four months of 2023 (results for May will be available shortly).

For our Merger-Arb strategy, some of the highlights and lowlights of the month were:

- The highest profile merger-arb announcement for the month was that TD Ameritrade and First Horizon Bank terminated their merger. When the dust settled, it turned out that TD Ameritrade was not able to satisfy the Federal Reserve that their anti-money laundering procedures were satisfactory – it is not clear to us why that problem was not flagged years ago. The negative impact was 31 bps for the month and 65 bps since deal announcement.

- Apollo Global had made a proposal to acquire British oil-field services company John Wood Group. As usual for proposed (as opposed to definitive) deals, our position was reasonably small, but the stock dropped 34% when Apollo withdrew the proposal, resulting in a loss of 16 bps.
- Horizon Pharmaceutical, being acquired by Amgen, saw their deal blocked by US anti-trust authorities on the basis that the acquisition would allow Amgen to entrench Horizon's existing monopoly on two medications. We agree with various commentators that this action has no basis in law, and believe that Amgen will prevail in court, which is scheduled for September. The negative impact was 15 bps. Further, that announcement had the spillover effect of causing the spread of most pharmaceutical deals to widen.
- The saga of JetBlue's acquisition of Spirit Air continues. During the month, the US government prevailed in court in their decision to block an existing code sharing deal between JetBlue and American Airlines. That ruling could ultimately end up being beneficial to the JetBlue/Spirit deal, but for now the market perception has been negative. We had reduced our position in Spirit Air to below 50 bps, and the resulting negative impact was 5 bps.
- The best contributing deal was Office Properties Income Trust's acquisition of Diversified Healthcare Trust. Both companies are REITs. The deal is trading well above the deal price possibly based on a shareholder of Diversified saying they would not support the deal (implicitly holding out for a higher price). The positive contribution was 12 bps.
- Moneygram International, the international payment processor being acquired by private equity firm Madison Dearborn, had been waiting for approval by Indian authorities. That approval was finally granted this month, resulting in a contribution of 7 bps.
- Prometheus Biosciences is being acquired by Merck. The target company has two primary drugs both with many competitors, and not surprisingly the deal gained anti-trust clearance, contributing 5 bps. But coming after the Horizon announcement, the merger-arb market gave a collective sigh of relief, and spreads on other pharmaceutical deals returned to more normal levels.
- Our composite benefited by 35 bps from a Contingent Value Right (CVR) being paid out. Progenics was acquired by Lantheus back in 2020 and their prostate cancer imaging agent achieved its revenue target. The CVR had been marked at zero.

New deal announcements were 32 for the month, while 16 closed and three were terminated. Diversification remains high and the number of deals has risen back to approximately 100. The portfolio is back to zero leverage (approximately $100 of long positions for every $100 of capital).

Constantia Capital Merger-Arbitrage: Performance as of May 31, 2023

Benchmark	Reporting Period	Returns (Net)[2] [3]	Bench-Mark[2]	Excess (Net)	Volatility	Sharpe Ratio
LIBOR/SOFR 3-month USD	Year-to-date	**0.66%**	2.04%	-1.38%	N/A	N/A
	Latest 3 Years	**5.17%**	1.60%	3.57%	3.01%	1.19
	Latest 5 Years	**3.88%**	1.80%	2.08%	5.32%	0.39
	Latest 10 Years	**4.10%**	1.26%	2.83%	4.55%	0.62
	Since Inception[1]	**4.88%**	1.15%	3.74%	4.47%	0.84

[1] Returns annualized, since inception date 11/1/2011
[2] Returns annualized for periods in excess of one year
[3] Net returns after performance fee, which three qualified clients have elected as of the date above

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