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Hard-Hit Hedge Funds Sense Brighter Future After Election

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It has been a rough year for betting on big takeovers. Now, some in the hedge-fund industry hope President-elect Donald Trump could breathe new life into the business, by giving U.S. corporations more freedom to pursue major deals.

The optimism is already evident in surging stock prices for some companies, like Discover Financial Services, that are pursuing combinations. It is part of an optimism across Wall Street about potentially lucrative opportunities under a second Trump term.

In recent months, numerous high-profile acquisitions have either struggled to close or failed, including a plan to unite Tapestry and Capri Holdings, the companies behind Coach and Michael Kors. The pileup has ripped through the hedge-fund world, leading to unexpected losses and several top traders losing their jobs.

Now, the incoming president's pro-business, lighter-regulation agenda "means a pro-merger environment that will embolden companies to get bigger through acquisitions; it is as simple as that," said Orkun Kilic, a London arbitrager. "I am very excited for the next four years."

A hostile deal environment largely kept Kilic on the sidelines since December, he said, and he expects to become more active with Trump, a Republican, taking office.

Trump-related euphoria quickly fed into the shares of Capital One Financial and Discover Financial Services, which soared on renewed bets their $35 billion merger will pass regulatory muster.

The market is assigning an 80% probability the deal closes, up from 70% before the election, according to MKP Advisors, which specializes in mergers-and-acquisitions transactions.

A gauge of so-called merger-arbitrage performance is up 4.6% this year through October after fees, data from the hedge-fund research firm PivotalPath shows. That compares with an 8.5% rise for the firm's broad hedge-fund industry index.

"They're not only underneath the industry average -- I think this year they might not even beat Treasurys," said Omar Sayed, a merger-arb trader who left Millennium Management this year. The yield on a low-risk 10-year U.S. Treasury note is about 4.3%.

Sayed said he plans to launch his own merger arbitrage-focused firm, but will wait until conditions improve and he can deliver the kinds of returns that investors want.

Merger arbitrage was made famous by the likes of billionaire investor John Paulson -- now a candidate for Treasury secretary -- and Robert Rubin, a former holder of that role and Goldman Sachs executive. It appeals partly because returns aren't usually linked to broader market moves.

But this year, dealmaking encountered regulatory and political pushback in Europe, the U.S. and elsewhere. In the U.S., Federal Trade Commission Chair Lina Khan has taken an unusually tough stance against mergers. FTC challenges to many deals, including Tapestry's bid for Capri, made it riskier to bet on takeovers closing.

Further complicating matters is a drop-off in deal numbers, which hit their lowest level since 2015 in the first 10 months of this year, LSEG data show. And higher interest rates helped make it more expensive to use debt to boost deal returns.

Trump's credentials as pro-merger will be tested early with his decision over the fate of Khan. Many investors expect her removal as FTC chair because of her record of challenging many deals and wariness of big **technology** companies.

This year brought a string of busted or challenged mergers, including Amazon.com's bid for robot-vacuum maker iRobot, and a failed $3.8 billion union between JetBlue Airways and Spirit Airlines.

This rough ride harks back to 2014 when merger arbs suffered a one-day shellacking some dubbed "Arbageddon," as two huge deals collapsed and then-President Barack Obama, a Democrat, said his administration would revisit rules on tax-driven mergers.

Last month, merger investors suffered two major setbacks. The first drubbing resulted from the collapse of a bid for Hong Kong-listed China Traditional Chinese Medicine Holdings, after the $2 billion deal unexpectedly failed to win timely approval from Chinese regulators. Days later, a U.S. judge blocked Tapestry's bid for Capri, siding with the FTC and arguing the deal would raise prices for more-affordable handbags. The companies plan to appeal. Shares in China TCM and Capri suffered one-day drops of 35% and 49%, respectively, after the deals collapsed.

Izzy Englander's Millennium Management ranked among China TCM's biggest shareholders before the deal broke down, owning a more-than-5% stake worth about $135 million, filings show. Hong Kong-based Athos Capital owned more than 4%, another filing showed.

Millennium was a shareholder in Capri, as was London-based Melqart Asset Management, FactSet data as of June shows. The firms each owned more than 2 million shares at the time.

The setbacks left some money managers struggling to hang on to their jobs.

At least 10 merger-arb investors and analysts since April have been fired, left or are planning to leave their jobs following underperformance, according to people familiar with the matter.

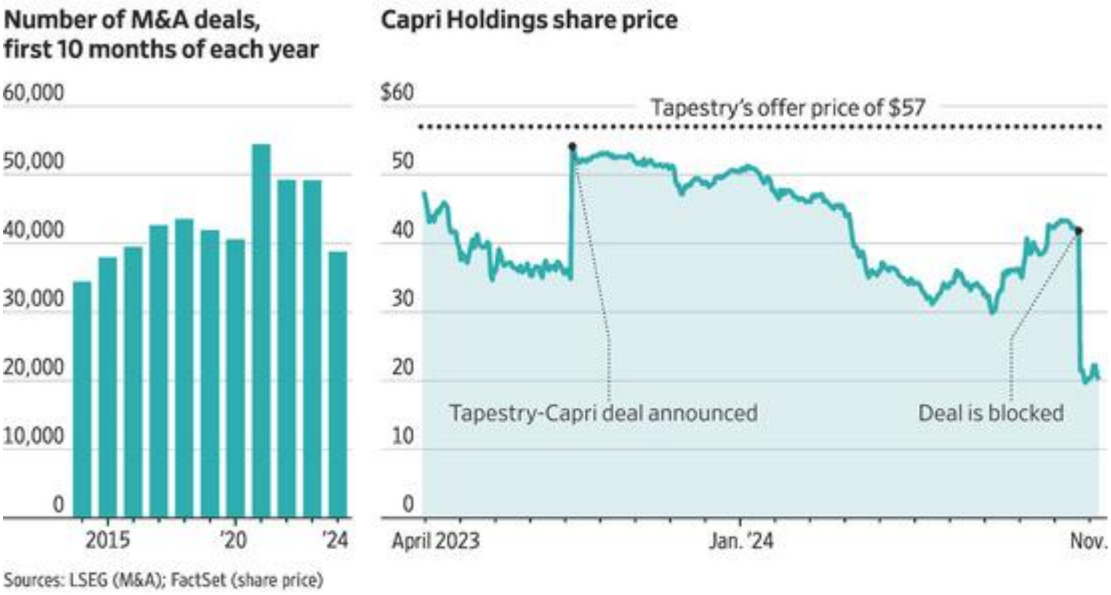
Among those who left their roles: Ed Cooper and Laurent Pujade-Lauraine at Millennium Management, Eric Fritz at Schonfeld Strategic Advisors, Adam Schwartz at Balyasny Asset Management and Neel Gupta, who worked at Soros Fund Management.

The managers and their firms either declined to comment or couldn't be reached for comment.

The Tapestry-Capri deal had been a popular target for merger arbs. Manuel Blanco, a portfolio manager at Maven Securities, touted the deal's merits at a June conference. That included an option strategy to mitigate potential losses if the deal failed, and the possibility of still making money if that scenario led to a breakup of Capri, according to a copy of his presentation seen by The Wall Street Journal.

Blanco is in the process of leaving Maven. He said his departure has nothing to do with his Capri investment and is driven by his plans to set up a new fund.

Despite the changing atmosphere, there is one big deal that many traders view as a lost cause even under a Trump administration: Nippon Steel's high-profile and controversial $14.1 billion deal for U.S. Steel. Trump came out against the tie-up during the campaign, amid opposition to the Japanese takeover from the United Steelworkers union and local politicians.



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