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The Merger Fund I MERIX

Experienced managers executing a sound approach to merger-arbitrage investing.

Morningstar's Take MERIX

Overall Morningstar Rating™	★★★★		
44 US Fund Event Driven (29 Feb 2024)			
	3 Yr 44 funds	5 Yr 41 funds	10 Yr 32 funds
Morningstar Rating™	3★	3★	4★

Morningstar Medalist Rating™	Bronze
Analyst-Driven %	100.00
Data Coverage %	100.00

Morningstar Pillars	
Process (21 Mar 2023)	Above Average
People (21 Mar 2023)	Above Average
Parent (8 Mar 2024)	Average
Performance (21 Mar 2023)	
Price (21 Mar 2023)	

21 Mar 2023 | by Adam Millson

The Merger Fund benefits from an established investment process led by two industry veterans. The strategy continues to earn a Morningstar Analyst Rating of Bronze for both its share classes.

Comanagers Roy Behren and Michael Shannon have led this strategy together for more than 15 years and average 26 years of event-driven investing experience at the firm. They receive support from a five-person research and trading staff. The team suffered its first departure to an outside opportunity, losing a senior trader, in May 2022. The firm quickly hired a trader to fill the void. And though the loss is a hit to the team's hallmark stability, it remains an experienced and tightly aligned group averaging 15 years with the firm.

The managers take a focused approach, allocating to global merger-arbitrage deals and eschewing exposure to more-speculative, soft catalyst events. Merger deals spanning all-cash, stock-for-stock, and mixed (cash and stock) transactions are usually the bulk of the portfolio. As of December 2022, nearly all the portfolio's deal exposure sat with all-cash deals (92.3%) compared with 58.6% 12 months prior, a product of the deal environment. Fundamental analysis is core to evaluating deals, and the investment team leans heavily on its experience to quickly synthesize new deal information and identify opportunities based on a variety of deal-related factors like timeline, regulatory barriers, and potential for shareholder disapproval. A proprietary risk system accompanies the team's fundamental research by aggregating deal-specific information for ongoing analysis and portfolio-level risk calculations. It's a sufficient tool given the focused approach here.

The team will also allocate to other arbitrage opportunities like buying a target's bonds or investing in special-purpose acquisition companies. The team has significantly increased the portfolio's exposure to SPACs, more than quadrupling the exposure from early 2020 to 35.8% as of December 2022. Compelling return characteristics based on both the return to trust value and accrued interest (trust cash is invested in short-term rates) drove the investment.

The strategy's consistent returns—only four down years since its 1989 inception—coupled with minimal sensitivity to the returns of equity and bond markets, and a below 0.15 beta to both the S&P 500 and Bloomberg US Aggregate Bond Index, make it a sound diversifying exposure in a multi-asset portfolio.

Process Above Average | Adam Millson | 21 Mar 2023

Strong fundamental research and deep industry expertise are the foundation for this established approach to merger-arbitrage investing. It continues to earn an Above Average Process rating.

This team employs a merger-arbitrage strategy, focusing on publicly announced mergers, acquisitions, and other corporate reorganizations. In general, the team aims to capture the spread between a target company's stock price after a deal is announced and the announced acquisition price. Fundamental, bottom-up research informs all investments made within the portfolio. The team's strength stems from its members' experience—both comanagers have analyzed announced deals for more than two decades—and multidisciplinary backgrounds. Such deep and broad-based expertise helps inform their views on the numerous elements specific to each deal that drive their estimate for the transaction's successful closure.

To support the team's fundamental analysis, the managers layer on an in-house quant optimization tool that incorporates the qualitative analysis underpinning each deal's risk/reward profile. All active positions sit within the tool and allow for the calculation of portfolio-level risk analytics like liquidity and value-at-risk. Though the tool itself isn't overly robust compared with more deeply resourced peers, it is sufficient given this team's focused approach, which relies heavily on the managers' experience and the team's bottom-up research.

The strategy's primary exposure sits within merger-arbitrage deals. In most instances, the managers either buy the target only (all-cash transactions) or short the acquisitor (stock-for-stock transactions). As of December 2022, the portfolio's exposure to all-cash deals stood at 92.3% of the long exposure. That's well above the fund's typical mark—it stood at 58.6% at year-end 2021—but it is representative of the deal environment. Its four largest positions sat with targets involved in all-cash deals: First Horizon Corporation FHN (3.4%), Horizon Therapeutics PLC HZNP (2.8%), Store Capital Corporation STOR (2.7%), and LHC Group LHCG (2.7%). The latter two deals closed in February 2023.

Consistently buying, and in some instances shorting, companies that go through successful mergers is the managers' primary focus, but they can also invest across the capital structure and into other arbitrage-related investments, provided they can structure the trades to hedge out market sensitivity. For instance, they will allocate to SPACs, which have become a sizable piece of the portfolio in recent years. Since early 2020, the portfolio's SPAC exposure has more than quadrupled: to 35.8% as of year-end 2022 from 7.9%. That rise has made SPACs a more influential piece of the fund's performance. In 2022, the basket of roughly 200 positions was the second-largest contributor to results (it added 0.58%). However, it hasn't affected the fund's equity sensitivity. Its sensitivity to changes in the S&P 500, as measured by beta, has remained below the event-driven Morningstar Category average, an important metric when considering this type of strategy for a diversified portfolio.

People Above Average | Adam Millson | 21 Mar 2023
Two veteran managers helm this strategy with the support of a small but experienced investment team. Despite a recent departure, the team remains well-positioned and continues to earn an Above Average People rating.

Comanagers Roy Behren and Michael Shannon took the lead on this strategy in December 2010 following the retirement of Westchester Capital Management's founder Frederick Green. They were both named to the strategy alongside Green in January 2007. Both managers joined Westchester more than 25 years ago; the firm is now an affiliated manager of Virtus Investment Partners following its October 2021 acquisition. In addition, each brought notable expertise prior to joining the firm. Behren spent the beginning of his career with the U.S. Securities and Exchange Commission as an enforcement attorney, while Shannon graduated from Boston College with a finance degree, then focused on mergers and acquisitions at JPMorgan and D.E. Shaw & Company.

The investment team's stability was this strategy's hallmark for years. However, in May 2022, the team experienced its first departure for an outside opportunity. Benjamin Kunofsky, a senior trader who joined the firm in 2010, exited. The firm backfilled his role with the addition of a trader. Despite the loss, the team's overall experience—averaging 15 years with the firm and 21 years of industry experience—remains strong.

Parent Average | Adam Millson | 8 Mar 2024
As Virtus Investment Partners evolves its investment affiliate roster and fund lineup, it retains an Average Parent rating.

The publicly traded firm uses a multimanager approach. It fully owns all but one of its 14 affiliated asset managers and also uses subadvisors. Since 2020, it purchased six affiliates, expanding its alternative offerings through its 2021 Westchester Capital Management acquisition and its 2023 purchase of AlphaSimplex. In 2022, Virtus combined its three fixed-income affiliates—Newfleet, Stone Harbor, and Seix—into one legal entity, Virtus Fixed Income Affiliates, though each affiliate maintains its brand and continues to manage money independently.

Virtus has also made some changes to its investment lineup. Voya became a meaningful subadvisor for Virtus, after Voya bought the US business from Allianz Global Investors, which was banned by the SEC from running registered funds in the US for 10 years. Virtus maintained some of the portfolio management teams that moved to Voya but hired affiliates for most of the 17 mandates that AGI ran. More recently, Virtus announced in November 2023 it was moving on from longtime subadvisor Vontobel in favor of affiliate Sustainable Growth Advisors.

Virtus offers distribution and back-office strength, while allowing affiliates investment autonomy. Some managers are strong, such as equity specialist Kayne Anderson Rudnick.

Performance | Adam Millson | 21 Mar 2023
The managers aim to deliver consistent low- to mid-single-digit returns over the risk-free rate with limited volatility and minimal sensitivity to broader equity and bond markets. Over the past decade through February 2023, the team has delivered on that objective. The strategy's A share class posted a 2.9% annualized return versus 0.8% for the ICE BofA US 3-Month Treasury Bill Index while maintaining a 0.10 beta relative to the S&P 500 and 0.03 beta to the Aggregate Index over that period.

The team's ability to identify successful mergers and acquisitions while avoiding deal breaks (the biggest risk to a merger-arbitrage strategy) will drive results. Though they haven't been immune to such scenarios, holding sizable exposures to recent breaks like Willis Tower Watson/Aon PLC in 2021 and Rogers Corp/Dupont de Nemours in 2022 (both were substantial detractors to the year's results), they maintain a strong and consistent record identifying, sizing, and managing through successful deals. This is evident in the fund's consistent execution, delivering positive returns over 30 of the 34 calendar years since launch.

The strategy's low-volatility profile and tendency to hold up well through periods of market stress, make it a solid diversifier for multi-asset portfolios. For instance, despite broad market volatility and deal spreads widening in 2022, the fund posted a 0.7% gain for the year relative to substantial losses for broad equity and bond market indexes; the S&P 500 and Aggregate Index posted 18.1% and 13.0% losses, respectively.

Price | Adam Millson | 21 Mar 2023
It's critical to evaluate expenses, as they come directly out of returns. Based on our assessment of the fund's People, Process, and Parent pillars in the context of these expenses, we think this share class will be able to deliver positive alpha relative to the category benchmark index, explaining its Morningstar Analyst Rating of Bronze.

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The Analyst-Driven % data point displays the weighted percentage of a vehicle's pillar ratings assigned directly or indirectly by analysts. For example, if the People and Parent ratings are assigned directly or indirectly by analysts but the Process rating is assigned algorithmically, the Analyst-Driven % for an actively managed vehicle would disclose that 55% of the pillar weight was assigned by analysts and the Analyst-Driven % for a passively managed vehicle would disclose that 20% of the pillar weight was assigned by analysts.

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Bonds are subject to interest rate risk. As the prevailing level of bond interest rates rise, the value of bonds already held in a portfolio declines. Portfolios that hold bonds are subject to declines and increases in value due to general changes in interest rates. Portfolios that invest in lower-rated debt securities (i.e., "junk bonds") involve additional risks because of the lower credit quality of the securities in the portfolio. The investor should be aware of the possible higher level of volatility, and increased risk of default. Tax- free municipal bond funds may be subject to state and local taxation and the Alternative Minimum Tax.

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Equities are typically subject to greater fluctuations in market value than other asset classes due to factors such as a company's business performance, investor perceptions, stock market trends and general economic conditions. Stocks of small or mid-sized companies involve additional risks; such companies may have a higher risk of failure, are not as well established as larger blue-chip companies, and have historically experienced a greater degree of market volatility than the overall market average.

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Market Risk
The market prices of securities can fluctuate as a result of several factors, such as security-specific factors or general investor sentiment. Therefore, investors should be aware of the prospect of market fluctuations and the impact it may have on the market price.

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Sector Strategies
Portfolios that invest exclusively in one sector or industry involve additional risks. The lack of industry diversification subjects the investor to increased industry-specific risks.

The Merger Fund® (MERIX)

As of 3/31/24	1-Year	5-Year	10-Year	Since Inception	Inception Date
MERIX	5.00	3.07	3.16	3.22	8/1/13

Performance data quoted represents past performance. Past performance does not guarantee future results. Investment return and principal value will fluctuate so that shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. Please visit virtus.com for performance data current to the most recent month end.

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The net expense ratio minus dividend and interest expense on short sales and indirect expenses incurred by the underlying funds in which the Fund invests is 1.17%.

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Average annual total return is the annual compound return for the indicated period and reflects the change in share price and the reinvestment of all dividends and capital gains. Returns for periods of one year or less are cumulative returns.

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