



# Capital Perspectives

Monthly investment analysis and insights from Wilmington Trust Investment Advisors

ON THE RECORD

## Economy and Earnings: Swinging for the Fences

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Tony Roth

Earnings season is a key time for market participants. Even for long-term investors like us, who are not in the practice of aggressively trading securities before or after earnings announcements, it is an informative few weeks. The microeconomy meets the macro, and companies either confirm or challenge what we’re seeing from other economic data. Direct commentary from management is critical, particularly at watershed moments in the business cycle.

### Riding the rising tide

We have held an overweight to equities since November 2020, and continue to find the return vs. risk profile for stocks more compelling than bonds or other defensive assets. The U.S. economy is growing at the fastest rate in decades, with potential for economic growth and earnings that surprise to the upside. The magnitude of growth figures for 2020 makes it such that the margin of error—more likely increasing the upside—could be quite significant.

That thesis is playing out in the latest slew of macroeconomic data and corporate earnings reports. U.S. GDP for the first quarter of 2021 grew 6.4% quarter over quarter annualized, with real GDP staging a massive comeback since the second quarter of 2020 and now sitting just 1% below pre-pandemic levels on an annualized basis. (Figure 1). In addition, U.S. personal income grew by 21%—the most in the 75 years that data have been recorded, according to the Bureau of Economic Analysis.

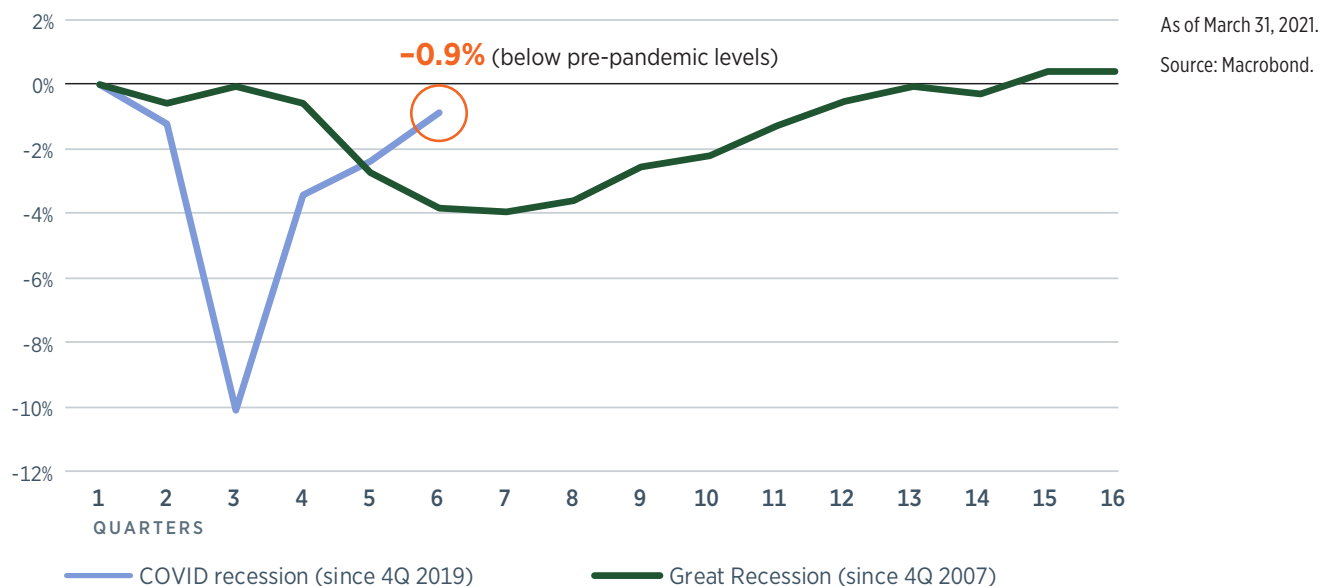
S&P 500 earnings for 1Q 2021 are projected to grow a whopping 46% year over year, the highest rate of growth since the first quarter of 2010. And 2Q 2021 is expected to deliver growth of more than 58%. While earnings growth was certainly expected to be large given year-over-year comparisons to the 2020 pandemic lows in economic

Continued

Figure 1

**U.S. economy quickly making up lost ground**

(Cumulative percent change in real GDP in quarters after start of recession)



**One of the most exciting areas of first-quarter GDP was business capital expenditures on equipment and intellectual property products, with growth in information-processing equipment and software of 26% and 10%, respectively, from pre-pandemic levels.**

activity, 1Q 2021 earnings surprises—at 3.7% and 22.8% above estimates, respectively (according to Factset)—are either at or near record-high levels.

Some of the biggest earnings beats have been delivered by the market’s mega-cap growth darlings in tech, communication services, and internet retail. We believe these companies can continue to grow after the pandemic, as new business creation drives cloud adoption, tech investment and, to a material degree, permanent changes in consumer behavior. One of the most exciting areas of first-quarter GDP was business capital expenditures on equipment and intellectual property products, with growth in information-processing equipment and software of 26% and 10%, respectively, from pre-pandemic levels.

Despite this historic report card, the market response has been measured, with those U.S. large-cap stocks beating estimates and delivering price appreciation in line with historical averages (Figure 2). This may be an indication that equity valuations have priced in quite a bit of good news already, or it could be a sign that the direction of future policy—as it relates to the Federal Reserve or President Biden’s tax agenda—is giving investors pause. Nonetheless, the S&P 500 has climbed 11.8% year to date as of April 30. These strong gains could set up the market for a period of consolidation as more policy details come to light. Ultimately, though, we believe the strength of the underlying economy will propel further market gains despite the clear monetary and fiscal risks on the horizon.

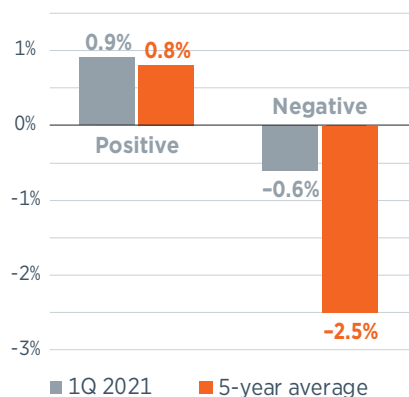
We are overweight equities across all major asset classes: U.S. large cap, U.S. small cap, international developed, and emerging markets. Of these regions, U.S. equities both large and small are, in our view, most exposed to short-term monetary and fiscal policy pressures. Higher corporate and capital gains tax rates are clear

Continued

Figure 2

**Average price reaction despite historic earnings beats**

(S&P 500 average price change for positive and negative earnings surprises)



Data as of April 30, 2021.

Source: Factset.

Shows the average price increase of S&P 500 companies that reported quarterly EPS above (positive) or below (negative) consensus estimates from two days before the earnings release date through two days afterwards.

Indices are not available for direct investment.

headwinds for U.S. equities. Net profit margins for the S&P 500 are elevated (Figure 3), and investors expect them to stay at these levels despite the possibility of rising input costs (including wages), higher rates, and the near certainty of higher taxes. And recently, Treasury Secretary and former Fed Chair Janet Yellen publicly expressed her view that policy rates may need to rise to keep the economy from “overheating.”

Nevertheless, we continue to find value in U.S. equities over a 12- to 24-month horizon. Overall, we assess the U.S. economy as more early cycle than any other stage. Also, investors continue to be keen to buy the dip on market pullbacks, which has prevented the S&P 500 from correcting more than 9.5% since March 2020. We expect the reflation trade (which aims to halt the decline in prices for goods and services, and is typically accompanied by extended reacceleration in economic prosperity) to resume—lifting growth, inflation, interest rates, and value, or more economically sensitive, stocks. Additionally, we are positioning portfolios with more value exposure and a higher commodity weight than the benchmark. Sectors that often hold larger weights in value-biased strategies, like financials, materials, and energy, are trading at attractive levels (though industrials have become a bit stretched). We have not given up on mega-cap growth, and maintain a market-weight exposure to growth along with a significant exposure to the quality factor, which is represented by metrics like stable earnings growth, low leverage, and high return on equity. Growth and value have both performed nicely over the past year, and adequate exposure to both is prudent.

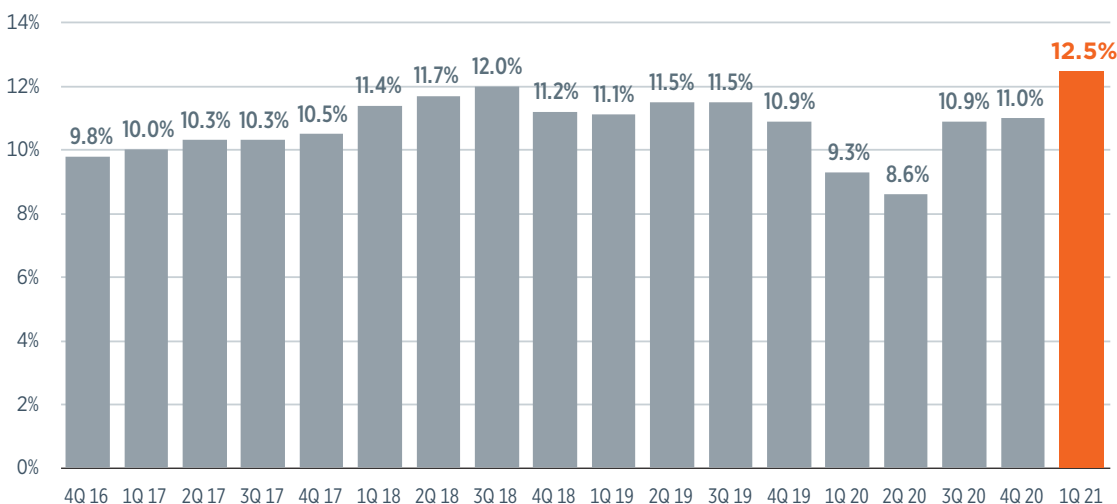
**Opportunities in less loved places**

International equities also continue to provide opportunity and have been underloved, so to speak, by investors for years. Europe, Japan, and emerging economies are lagging the U.S. as it relates to the timeline for virus control and vaccinations. However, we are already noting dramatic improvement in case

Figure 3

**Profit margins are elevated, leaving future earnings growth at risk**

(S&P 500 net profit margin by quarter)



Data as of April 30, 2021.

Source: Factset.

Shows historical net profit margin of all S&P 500 companies combined by quarter, and the blended net profit margin for 1Q 2021 (blend of actual results for those that have already reported, estimates for those yet to report).

Indices are not available for direct investment.

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**Current tactical asset allocation**

	Tactical tilts	-	NEUTRAL	+	Positioning
<b>Equities</b>	U.S. Large Cap	○ ○ ○ ○ ● ○ ○ ○			Overweight
	U.S. Small Cap	○ ○ ○ ○ ● ○ ○ ○			
	International Developed	○ ○ ○ ○ ● ○ ○ ○			
	Emerging Markets	○ ○ ○ ○ ○ ○ ● ○			
<b>Tax Exempt Fixed Income</b>	Investment Grade	○ ● ○ ○ ○ ○ ○ ○			Underweight
	High Yield	○ ○ ○ ○ ● ○ ○ ○			
<b>Real Assets</b>	Inflation-linked Bonds	○ ○ ● ○ ○ ○ ○ ○			Overweight
	Global REITs	○ ○ ○ ● ○ ○ ○ ○			
	Other/Commodities	○ ○ ○ ○ ● ○ ○ ○			
<b>Alternatives</b>	Equity long/short hedge	○ ○ ● ○ ○ ○ ○ ○			Underweight
<b>Cash</b>		○ ○ ● ○ ○ ○ ○ ○			Underweight

**We are already noting dramatic improvement in case growth and vaccination rates for non-U.S. developed countries, and expect the growth rate between the U.S. and the rest of the world to begin converging in the second half of this year.**

growth and vaccination rates for non-U.S. developed countries, and expect the growth rate between the U.S. and the rest of the world to begin converging in the second half of this year. The MSCI EAFE index, a proxy for international developed equity markets, is trading within the second percentile versus the S&P 500 on a 12-month-forward-looking price-to-earnings basis, and emerging markets are trading within the seventh percentile. This means these markets are cheap compared to the U.S. Consequently, we expect these regions to prosper over the next year.

**“Sell in May?”**

The financial media chorus is now calling for a correction and it may well prove right. Positioning has become somewhat stretched. Higher interest rates, virus variants, Fed tightening, and higher taxes all provide possible triggers for an equity pullback. However, in our view, even if we get a correction, it will simply provide a new level from which stocks will rise to new records later in the year. Indeed, when not coinciding with a recession or dramatic economic slowdown, equity market corrections tend to be short lived. We believe it is best to stay invested, be patient, and remain poised to potentially reap the rewards later in the economic cycle.

Be sure to read on for an “In Focus” primer and our take on one of the most talked about, but possibly least understood, areas of the market today: SPACs (special purpose acquisition companies), by Research Analyst Evan Kurinsky and Senior Portfolio Manager Jordan Strauss.

Until next month,

Tony

## Special Purpose Acquisition Companies— A Blank Check for Success?



**Evan Kurinsky**  
Research Analyst



**Jordan Strauss, CFA**  
Senior Portfolio Manager

### At a glance:

- SPACs, which have been around since the 1990s, initially earned a less-than-savory reputation, but regulatory change helped legitimize the structure
- In 2020, 248 new SPACs came to market, encompassing 53% of all IPOs for the year; through April 7, 2021 has already exceeded that number
- A SPAC sponsor team, as compensation for the risk capital assumed, typically receives private warrants with similar terms to those issued to unitholders
- SPAC sponsors must find and win over targets that shareholders will vote for—or face losing contributed risk capital and potential reputational damage
- Returns for SPACs from IPO through acquisition have had a pronounced positive skew; from 2017–2020, the median annualized return was 6.1%

Special purpose acquisition companies (SPACs) have been around for decades, but in the spring of 2020, they became an extremely popular alternative route for private companies to go public. The subsequent record-breaking surge in SPAC issuance and merger activity that followed was astounding and could reasonably lead one to describe 2020 as “the year of the SPAC.” These vehicles also garnered an enormous amount of attention due to volatile trading activity across several high-profile targets, raising the question of whether SPACs represent a dangerously speculative asset, or if investors can turn to them as part of a legitimate portfolio investment strategy.

In our view, investing in SPACs may provide a differentiated return stream depending on risk–return objectives, and can be accessed through either a low-risk, consistent return or high-risk, high-potential reward strategy. However, as with any investment, it’s important to understand the key features and complexities before diving in headfirst. In this paper, we break down the basics of the SPAC structure and the reasons behind its sudden rise to prominence, as well as review how we believe investors should be thinking about SPACs. First, let’s get the lay of the land.

### What is a SPAC?

- A SPAC is a “blank check” company—one in the development stages whose business plan is to raise capital in an initial public offering (IPO) with the sole purpose of merging with an unspecified private firm, thereby taking it public. Following the IPO, SPACs have a specified timeframe, typically two years, to find a target firm and, pending majority shareholder approval, consummate a merger or otherwise liquidate and return cash plus accrued interest to investors.
- SPACs have been around since the 1990s as an alternative channel to public markets. However, they initially earned a less than savory reputation and were viewed as more of a backdoor option for smaller, less established firms, to whom the traditional IPO process was inaccessible. Loosely regulated at first, SPACs were frequently associated with fraudulent activity, which brought about a wave of regulatory change, thereby helping to legitimize the structure for sponsors, investors, and target companies alike.

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**In 2020, 248 new SPACs came to market, encompassing 53% of all IPOs for the year, and raising a cumulative \$83 billion, more than five times the volume of the previous year.**

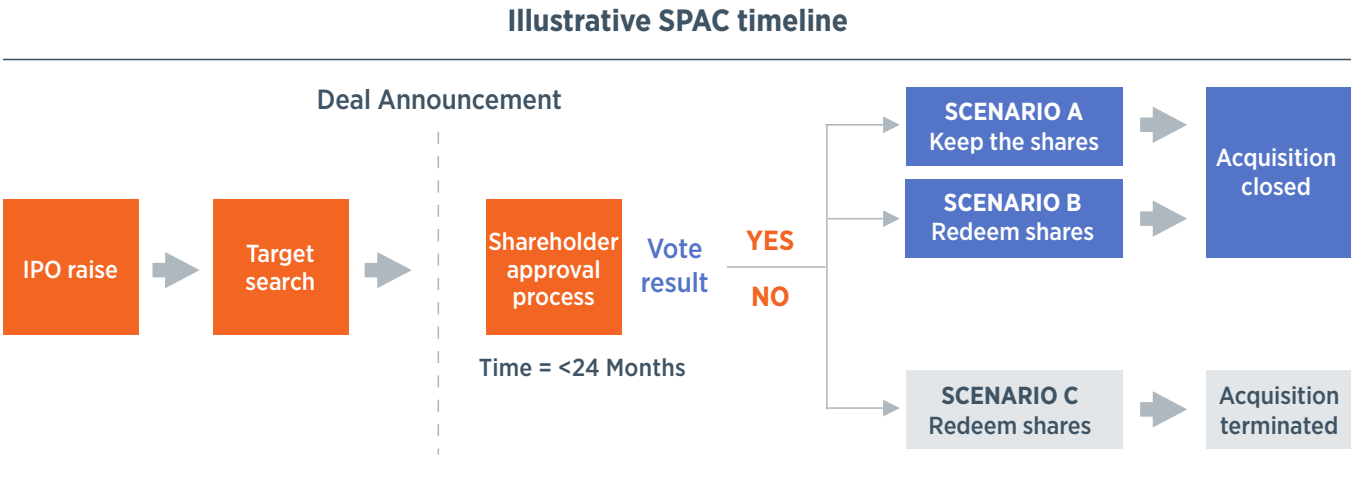
- Even before the pandemic, SPACs had seen an uptick, public evidenced by strong IPO activity in January and February of 2020. Soon thereafter, a confluence of factors that began during the market meltdown in March 2020—including a temporary freeze in the IPO market, growing support from high-quality sponsors, and a surge of interest from retail investors—helped usher in a surge of SPAC IPOs and mergers. In 2020, 248 new SPACs came to market, encompassing 53% of all IPOs for the year, and raising a cumulative \$83 billion, more than five times the volume of the previous year. And 2021 has started off with a bang as well, with more SPAC IPOs in 2021 (through April 7) than all of 2020 combined.<sup>1</sup>

**Basic structural features for investors:**

- **Units:** In the primary offering, a SPAC raises capital by selling units to participants, typically a mix of hedge funds and other institutional investors. The units are usually composed of one common share and some amount of fractional “warrants,” which give an investor the right to purchase common stock of the newly public target firm after the business combination. Following the IPO, units can be purchased by retail investors on the secondary market, until roughly 50–60 days thereafter, when shares and warrants begin to trade separately.

**Redeemable common shares:** Typically priced at \$10/share, each share represents \$10 of cash deposited in a blind trust and kept in short-term Treasury or money market securities to be allocated toward a merger if consummated. Shareholders have the option to redeem shares for the initial \$10 apiece plus interest once a SPAC announces a merger target, and they can also sell shares in the open market at any point. If the sponsor team fails to secure a business combination in the specified timeframe, shareholders receive their pro rata share of cash from the trust account, plus interest accrued.

Figure 1  
**Timeline of SPAC process from IPO to post merger**



**Timeframe: up to 24 months**

Continued

**To compensate for the associated opportunity cost (versus investing in equities or bonds that may generate higher returns), investors receive fractional warrants as a sweetener, enhancing potential upside if the merger is a success.**

**Detachable warrants:** Usually warrants give the holder the option to purchase shares at a value 15% above the IPO price (\$11.50) by a specified maturity date, typically a few years in the future. Unitholders can keep the warrants even if they sell the common shares.

### **The hub among the spokes**

#### **SPAC sponsor**

- **Role:** The leadership team that sets up a SPAC raises funds and is responsible for its success or failure in acquiring a target. SPAC sponsor teams are typically led by former CEOs, private equity or venture capital executives, or prominent investment bankers, with significant expertise in a particular industry or a strong history of deal making. Sponsors contribute “risk capital” to the transaction, which is typically 2% of the IPO size to cover the bank fees, plus an additional \$2 to \$4 million to cover operating expenses. For this risk capital, sponsor teams typically receive private warrants with similar terms to those issued to unitholders.
- **Incentives:** In the common SPAC structure, the sponsor receives “founder shares” (otherwise known as a “promote”), representing up to 20% ownership of the post-combination company if a merger is successfully closed—a potentially lucrative payout over a relatively short time span.
- **Risks:** While running a SPAC can ultimately yield a lofty payout, it is by no means a free lunch. The sponsor needs to find and win over a target that shareholders will feel comfortable voting for, and faces the loss of the contributed risk capital and potential reputational damage if they fail to do so. Founder shares retire worthless if the sponsor fails to close a deal.

### **Who are the primary investors in SPACs, and what are their key risks and incentives?**

#### **Public shareholders**

- **Role:** Shareholders provide the sponsor with the necessary capital to take the SPAC public. Mostly institutional investors take part in the IPO and public investors can buy in via the secondary market. Holders of shares vote on whether to approve or reject a merger with the target company.
- **Incentives:** Investors face the potential of muted returns in the interim while the sponsor seeks out a private company merger target. To compensate for the associated opportunity cost (versus investing in equities or bonds that may generate higher returns), investors receive fractional warrants as a sweetener, enhancing potential upside if the merger is a success. Investors can also capture meaningful upside if the market is receptive to the target company. The perceived quality of a deal can be measured by the degree of appreciation in shares after the merger announcement, which can be substantial. In 2020, investors were well compensated from the “pop” in shares seen after the merger announcement, with an average price gain of 13.6% on the day of announcement compared to only 2.5% in past years, according to Barclays Research.<sup>2</sup>

Continued

Before announcement, investors have little visibility of the company they may eventually own and are putting their faith in the sponsor to execute. In that sense, there is no fair value to estimate for an unknown eventual target.

Returns for SPACs from IPO through acquisition have been solid, and with a very pronounced positive skew—from 2017–2020 the median annualized return was 6.1%, with no instances of return less than 0% for holders who redeemed.<sup>2</sup>

- **Risks:**

**Pre merger:** In theory, risks are relatively low for investors that acquire shares at or near the IPO price during the pre-merger period, which are comparable to a convertible bond in combining bond-like downside with equity upside. The redemption option provides \$10/share downside protection and shares typically trade close to that value before merger announcement. According to Bank of America, the median SPAC searching for a target in mid-February 2021 was priced at \$10.50.<sup>3</sup> Investors are putting their faith in the sponsor to get the target approved, and warrants retire worthless if they fail to do so.

**Post merger:** The redemption option concludes at merger completion and post-merger performance has been historically poor, with the median company trailing the S&P 500 index by substantial margins over all timeframes, including trailing by roughly 27% for the six months following the transaction.<sup>5</sup>

**Lack of visibility:** Before announcement, investors have little visibility of the company they may eventually own and are putting their faith in the sponsor to execute. In that sense, there is no fair value to estimate for an unknown eventual target.

#### Private investment in public equity investors

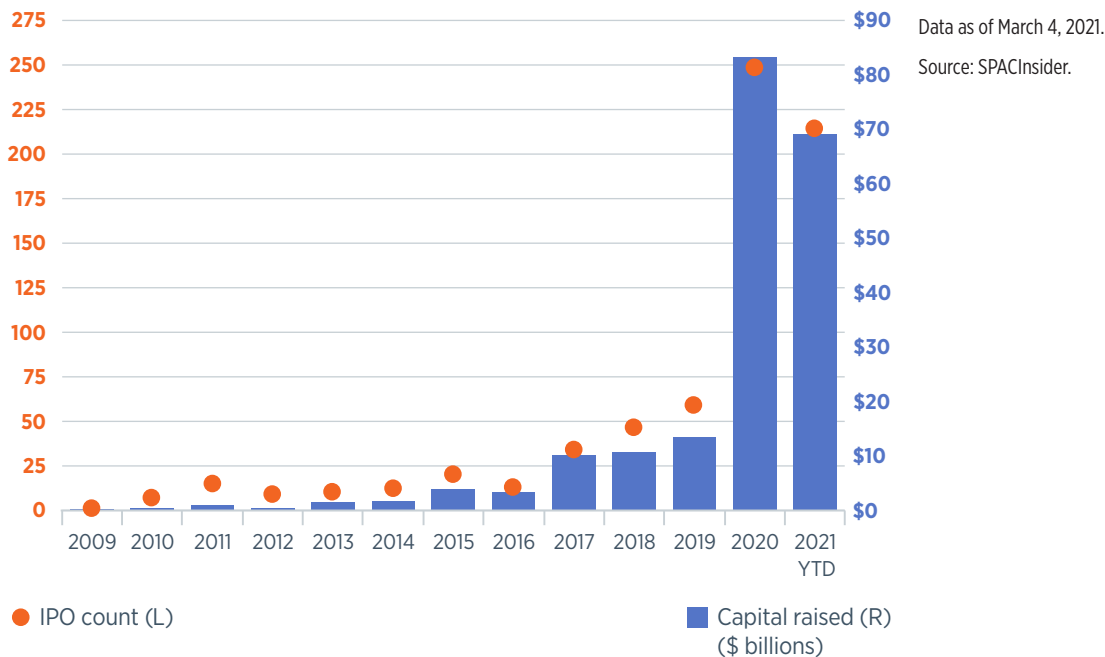
- **Role:** SPACs typically make acquisitions that are two to five times the size of the SPAC IPO. While much of this amount is equity rolled over from the private owners of the company, sponsors often supplement SPAC IPO proceeds with a private investment in public equity (PIPE) to cover the remaining cost. In PIPE transactions, institutional investors receive the SPAC units via a private placement, typically at a price equal to (and sometimes less than) the SPAC IPO price. During this marketing process, prospective PIPE investors receive material non-public information regarding the potential transaction the SPAC is pursuing. PIPE operations in SPACs has been evolving and growing in importance; targets and investors often view securing PIPE capital as a vote of confidence in the sponsor and deal, which has been reflected in the performance of the SPAC stock.
- **Incentives:** PIPE investors typically receive their shares at the IPO price or lower, often at a significant discount to the trading price of the security.
- **Risks:** While the shares PIPE investors receive are similar to those issued in the IPO, they are unregistered and cannot trade until registered with the Securities and Exchange Commission, which can take weeks or months. Although this is usually well before the SPAC sponsor or the target company can sell shares, PIPE investors are exposed to market movements during that time and often there is a significant drop in price on the day PIPE investors can ultimately sell.

Continued



Figure 2

**SPAC IPO count and gross proceeds raised by year**



**SPAC sponsors can present financial forecasts to potential investors, creating a major selling point for earlier-stage businesses with limited financial history.**

**For a private company, what are some of the unique features of going public via SPAC versus the traditional IPO process?**

- **Speed to market:** For a target acquired by a SPAC, the process from private to public markets can take as little as five to six months, versus the IPO process, which can take one to two years from start to finish.<sup>4</sup>
- **Certainty of pricing:** For IPOs, the offering is announced months ahead of when the deal comes to market, and prices are highly influenced by market conditions and investor demand. Additionally, newly issued shares often see a tremendous first day price pop. This benefit goes to the investors lucky enough to receive an allocation of IPO shares at the expense of the company that issued those shares at prices well below what the market would bear. In contrast, terms of the SPAC merger with a target, including price and valuation, are negotiated between the sponsor and target before the transaction is announced.
- **Lower cost:** In a traditional IPO, the fees associated with the offering (underwriting, legal, auditing, etc.) are the responsibility of the company and reduce the proceeds. In a SPAC merger, those costs are typically born by the SPAC shareholders at the time of the merger, rather than the company.
- **Ability to present forward projections:** For legal reasons, companies don't typically provide forward-looking statements and financial projections when marketing an IPO. SPAC sponsors do not face the same hurdle and can present the target's financial forecasts to potential investors. This feature can be a major selling point for earlier-stage businesses with limited financial history, since it allows them to walk investors through strategic growth plans and how they intend to allocate capital.

Continued

**SPAC structures have become more shareholder friendly, making the SPAC route an increasingly viable choice, even for companies that have the option of a traditional IPO.**

- **Strategic partnerships:** Beyond providing a path to public markets, SPAC sponsors often join the target company's board as strategic advisors, supporting the new public firm with industry expertise, connections, and credibility. It is hence no surprise that former Fortune 500 CEOs, venture capitalists, and prominent bankers are frequently at the helm of SPAC management teams.

#### **Why did SPAC transactions surge in 2020?**

- **A ballooning supply of mature private companies:** With steady inflows into private markets over the past decade and no shortage of financing options, companies have been staying private for longer and private markets have expanded relative to public. According to the Milken Institute, up until 2007 there were more publicly listed firms than private companies backed by private equity (PE) in the U.S., but the ratio flipped that year and, by 2018, there were just under 8,000 PE-backed private companies versus roughly 3,400 public companies.<sup>6</sup> All the while, private equity and venture capital firms have extended their hold periods, with the median time to exit tripling between 2005–2018. As the pandemic took hold, the IPO market temporarily closed down, PE firms' attention shifted to stabilizing the companies that were already a part of their portfolios, and SPACs provided a convenient and relatively quick way to provide liquidity to mature portfolio investments.
- **Broad acceptance of SPACs as a legitimate path to public markets for high-quality companies:** SPACs have historically had a less than pristine reputation as a vehicle that allowed shady financial sponsors to earn returns by bringing low-quality companies public at the expense of unsuspecting retail investors. As a result, companies that could gain liquidity through the IPO market did not view SPACs as a viable option. So, what's changed?

**The quality of SPAC sponsors has improved,** and SPAC structures have become more shareholder friendly, making the SPAC route an increasingly viable choice, even for companies that have the option of a traditional IPO. A growing crowd of experienced financiers have entered and lent credibility to the space, which has helped form a positive feedback loop, attracting more high-quality sponsors, attractive innovative companies, and in turn, enticing more institutional and retail investment.

**The pandemic made features of SPACs appealing for prospective targets and investors:** With unnerving market volatility and an uncertain path forward in the worst of the pandemic, SPACs provided an avenue to public markets with greater certainty of execution and pricing. For investors, the option to redeem shares for their initial cost and additional warrants embedded in SPAC units provided institutional investors with an easy return on investment with minimal downside risk, which became desirable in a highly volatile and low-rate environment. Extremely strong market activity and rising valuations in the second half of the year made the prospect of going public increasingly attractive, and SPACs provided an abbreviated method of doing just that.

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**Buying SPACs pre merger provides retail investors with a unique opportunity to capture upside comparable to that of the pros following a merger announcement.**

**Retail investors:** SPACs have become a hit with retail investors. According to Bank of America, 40% of SPAC trading on its platform from July to December 2020 was driven by retail, relative to just 21% of each S&P 500 and Russell 2000 stock trading.<sup>3</sup> In 2020, SPAC targets were highly concentrated in exciting industries popular with the retail crowd, including clean energy, biotech, and space travel. Virgin Galactic, a commercial spacecraft and spaceflight company under the Virgin Group, was one of the first SPAC targets to drum up significant retail interest, following its announced merger with Chamath Palihapitiya's Social Capital Hedosophia in October 2019. Retail investors have typically been shut out of IPO allocations in the primary market, excluding them from participation in the often sizeable first-day pop. In contrast, buying SPACs pre merger provides retail investors with a unique opportunity to capture upside comparable to that of the pros following a merger announcement, when a good portion of SPAC alpha (competitive returns) is generated.

#### **What are some potential risks/concerns relating to SPACs?**

- **Streamlined due diligence process:** This removes layers of scrutiny included in the typical IPO process, which raises the risk of a target providing misleading information to investors.
- **Potential misalignment between the sponsor and other stakeholders:** Sponsors have a tremendous economic incentive to close SPAC transactions and avoid losing their promote. Not finding a target during the specified time horizon means sponsors lose time, effort, and opportunity cost, and it can sully their reputations. In fact, of all the U.S. SPACs currently outstanding, 82% are still searching for a merger.<sup>3</sup> Pressure to close could incentivize settling for lower-quality deals or paying higher prices, leaving less upside for investors.
- **Reliance on forward projections:** The ability to sell a forward-looking story may risk bringing early-stage, lower-quality companies to public markets before they are truly ready. Forward projections can also be used to overemphasize a potential turnaround, and disguise trailing numbers for a declining business.
- **Dilutive structure and sponsor compensation:** SPAC sponsors receive 20% of the equity of the vehicle (which results in immediate dilution for the target-company shareholders) irrespective of post-transaction share price performance, which may contribute to the historically lackluster performance and cost born by public investors in the post-merger period.

#### **What we believe the future holds for SPACs**

Competition among outstanding SPACs has led to evolution of the structure, to better align the interests of all stakeholders. Bill Ackman's Pershing Square Tontine Holdings is a prime example, which notably does not include founder shares for sponsors—a key source of dilution that allocates asymmetric windfall to SPAC management teams. Similar to public shareholders, Ackman's profit opportunity relies on performance of the warrants and shares issued. In a similar vein, Morgan

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**While a market dislocation or underperformance of SPAC acquisitions could subdue the enthusiasm of targets or investors, SPACs will likely remain a viable alternative to IPOs**

Stanley has developed a new structure, called a “Stakeholder Aligned Initial Listing,” which ties compensation directly to post-merger performance, and aims to better align compensation with shareholders and limit post-merger dilution. Given the abundance of SPACs searching for targets and continuous flow of new IPOs, we would expect to see the structure continue to transform in ways that accrue greater benefit for the target and shareholders.

While the media has increasingly focused on the high number of SPACs searching for targets, and questioned whether the market is overly saturated with potential acquirers, we believe the environment remains conducive for continuing activity given the large number of private companies that is continually being refreshed. While a market dislocation or underperformance of SPAC acquisitions could subdue the enthusiasm of targets or investors from current levels, it seems likely that SPACs’ positioning as a viable alternative to IPOs is here to stay.

### **How to invest in SPACs**

The risk–return profile of a SPAC investment can vary widely depending on when in the timeline an investor buys and sells, as well as which security or securities are involved. Participating in the IPO or buying units (and warrants) near the IPO price and selling at or before the business combination has historically produced very consistent returns with very limited downside. Given that the ability to redeem SPAC units at the IPO price plus interest remains, it appears reasonable that pre-merger returns will continue to be on par with history. Nevertheless, getting involved around the time of merger has seen more volatile results, where the average company underperforms broad equity markets, but certain companies dramatically outperform. While this pattern is similar to that of traditional IPOs, SPACs have historically performed somewhat worse on average. However, as the makeup of companies going the SPAC route has begun to include more high-quality firms with compelling growth prospects that could very easily have undergone traditional IPOs, performance could improve on average and potentially include some very successful investments.

### ENDNOTES

- <sup>1</sup> <https://spacinsider.com/stats/>
- <sup>2</sup> M Venu Krishna, Barclays Research, “SPACS enter 2021 on a high note,” January 29, 2021
- <sup>3</sup> Bank of America Global Research, “The rise of SPACs–A primer on SPAC structures and impact to capital markets,” February 19, 2021
- <sup>4</sup> “Mike Bellin, PWC, ”Why companies are joining the SPAC boom,” September 22, 2020, <https://www.pwc.com/us/en/services/deals/blog/spac-boom.html>
- <sup>5</sup> Allison Nathan, Gabriel Lipton Galbraith and Jenny Grimberg, Goldman Sachs Global Macro Research, “The IPO SPAC-tacle,” January 28, 2021, <https://www.goldmansachs.com/insights/pages/top-of-mind/the-ipo-spac-tacle/report.pdf>
- <sup>6</sup> Jakob Wilhelmus and William Lee, Milken Institute, “Companies Rush to Go Private,” August 2018, <https://assetslb.milkeninstitute.org/assets/Publication/Viewpoint/PDF/WP-083018-Companies-Rush-to-Go-Private-FINAL2.pdf>



## ASSET CLASS OVERVIEW

# Hedge Funds

**Jordan Strauss, CFA**, Senior Portfolio Manager  
**Jessica Blitz**, Research Analyst

AS OF MARCH 31, 2021

	Month	YTD	Trailing 12-month return
Global	-0.06%	1.29%	9.32%
Equity Hedge	0.87%	2.65%	12.01%
Event Driven	-0.24%	1.71%	10.78%
Macro	-0.18%	0.52%	5.23%
Relative Value	-0.82%	-0.09%	7.32%

Sources: FactSet, Bloomberg, HedgeFundResearch Indices. Investing involves risks and you may incur a profit or a loss. Past performance cannot guarantee future results. Indices are not available for direct investment.

### What we are seeing now

Hedge funds started 2020 strong and navigated the pandemic-induced volatility late in the first quarter, providing strong capital protection during the drawdown. Unsurprisingly, hedge funds failed to keep up during the ferocious rally in risk assets that followed but ended the year with solid positive returns.

The first quarter of 2021 was the third consecutive quarter where hedge fund strategies generated positive absolute returns, though more muted across the board than in 4Q 2020. Returns were driven by equity hedge, event-driven, and merger arbitrage strategies. Relative to the broader market, hedge funds underperformed slightly. Early in the first quarter, during the meme stock craze encapsulated by Gamestop rising from under \$20 a share to nearly \$500 within four weeks, crowded shorts rallied, detracting from performance even as longs kept pace with market performance. Later in the same quarter, crowded longs detracted from performance, at least partially driven by growth's shift out of favor relative to value or cyclical names. The first quarter of 2021 represented the most challenging quarter for alpha for equity hedge funds since 2010, according to prime brokerage reports.

Overall, hedge fund asset under management (AUM) increased to an all-time high of \$3.80 trillion in 1Q 2021, driven both by positive performance and strong inflows. After reaching highs in 2018, the share of hedge fund investors who view the industry performance as disappointing has leveled out below 10%, helping to explain strong inflows in recent quarters. Flows have been net positive since 3Q 2020, reversing a long period of net outflows, favoring equity long/short, event driven, and multi-strategy funds, while equity market neutral/quant funds continued to see outflows. As we've seen in the past, the majority of inflows benefited the largest hedge funds, with over \$5 billion in assets. They now comprise just under 70% of total industry assets.

### What's changing

Equity long/short results were extremely volatile in the first quarter of 2021, with the spread between the two (i.e., returns on long book minus returns on short book) ending each month either wider than 3% or less than -3%, levels unseen since 2009 during the recovery from the great financial crisis.

During 2020, hedge fund manager dispersion based on yearly returns reached a 75% spread between the top and bottom 5% of managers, the widest annual dispersion since 2009. The strongest performers, though, returned a more muted return versus 2009 numbers, while the weakest performers underperformed their 2009 peers.

As ESG/SRI (environmental, social, and governance/socially responsible investing) strategies gain traction across asset classes, hedge funds proved no exception. Allocations to new ESG-focused hedge funds as well as the percentage of overall hedge fund exposure that is ESG-focused increased year-over-year as of 2020 year-end.

### What we expect

We believe that major industry trends—fee compression, hedge fund market concentration, and manager dispersion—will continue for the foreseeable future. We think that with strong due diligence, investing in the right hedge fund can provide a diversified return stream for investors and downside mitigation as displayed during the height of the crisis in March and April 2020. Given record high valuations in the equity market today, hedge funds are well positioned to both benefit from upswings and protect capital during dips.

# Investment Positioning

Portfolio targets effective May 1, 2021, for high-net-worth clients with Hedge Funds

## Growth & Income

	Strategic Asset Allocation (long term)	Tactical Asset Allocation (short term)
<b>Equities</b>		
U.S. Large-Cap	31.5%	Overweight
U.S. Small-Cap	5.5%	Overweight
International Developed	16.0%	Overweight
Emerging Markets	5.5%	Overweight
<b>Fixed Income</b>		
U.S. Investment Grade-Tax-Exempt	28.5%	Underweight
High-Yield-Tax-Exempt	2.0%	Overweight
<b>Real Assets</b>		
U.S. Inflation-Linked Bonds	1.0%	Underweight
Global REITs	1.5%	Neutral
Other	1.5%	Overweight
<b>Nontraditional Hedge</b>	5.0%	Underweight
<b>Cash &amp; Equivalents</b>	2.0%	Underweight
<b>Total</b>	<b>100.0%</b>	

Note: Totals may differ slightly from the allocation building blocks due to rounding.

**TAA**, or Tactical Asset Allocation, represents our *current recommendation* for each model strategy.

**SAA**, or Strategic Asset Allocation, represents our *current benchmark* allocation for each model strategy.

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For an overview of our asset allocation strategies, please see the disclosures.

Source: WTIA.

# Investment Positioning

Portfolio targets effective May 1, 2021, for high-net-worth clients with Private Markets\*

## Growth & Income

	Strategic Asset Allocation (long term)	Tactical Asset Allocation (short term)
<b>Equities</b>		
U.S. Large-Cap	24.3%	Overweight
U.S. Small-Cap	4.3%	Overweight
International Developed	11.6%	Overweight
Emerging Markets	4.1%	Overweight
<b>Fixed Income</b>		
U.S. Investment Grade-Tax-Exempt	24.7%	Underweight
High-Yield-Tax-Exempt	2.0%	Overweight
<b>Real Assets</b>		
U.S. Inflation-Linked Bonds	0.9%	Underweight
Global REITs	1.3%	Neutral
Other	1.3%	Overweight
<b>Nontraditional Hedge</b>	6.0%	Underweight
<b>Private Markets</b>	17.5%	Neutral
<b>Cash &amp; Equivalents</b>	2.0%	Underweight
<b>Total</b>	<b>100.0%</b>	

Note: Totals may differ slightly from the allocation building blocks due to rounding.

**TAA**, or Tactical Asset Allocation, represents our *current recommendation* for each model strategy.

**SAA**, or Strategic Asset Allocation, represents our *current benchmark* allocation for each model strategy.

\* Private markets are only available to investors that meet Securities and Exchange Commission standards and are qualified and accredited.

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For an overview of our asset allocation strategies, please see the disclosures.

Source: WTIA.

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Any positioning information provided does not include all positions that were taken in client accounts and may not be representative of current positioning. It should not be assumed that the positions described are or will be profitable or that positions taken in the future will be profitable or will equal the performance of those described.

Indices are not available for direct investment. Investment in a security or strategy designed to replicate the performance of an index will incur expenses, such as management fees and transaction costs that will reduce returns.

**An overview of our asset allocation strategies:** Wilmington Trust offers seven asset allocation models for taxable (high-net-worth) and tax-exempt (institutional) investors across five strategies reflecting a range of investment objectives and risk tolerances: Aggressive, Growth, Growth & Income, Income & Growth, and Conservative. The seven models are High-Net-Worth (HNW), HNW with Liquid Alternatives, HNW with Private Markets, HNW Tax Advantaged, Institutional, Institutional with Hedge LP, and Institutional with Private Markets. As the names imply, the strategies vary with the type and degree of exposure to hedge strategies and private market exposure, as well as with the focus on taxable or tax-exempt income.

Model Strategies may include exposure to the following asset classes: U.S. large-capitalization stocks, U.S. small-cap stocks, developed international stocks, emerging market stocks, U.S. and international real asset securities (including inflation-linked bonds and commodity-related and real estate-related securities), U.S. and international investment-grade bonds (corporate for Institutional or Tax Advantaged, municipal for other HNW), U.S. and international speculative grade (high-yield) corporate bonds and floating-rate notes, emerging markets debt, and cash equivalents. Model Strategies employing nontraditional hedge and private market investments will, naturally, carry those exposures as well. **Each asset class carries a distinct set of risks, which should be reviewed and understood prior to investing.**

#### **Allocations:**

Each strategy is constructed with target weights for each asset class. Wilmington Trust periodically adjusts the target allocations and may shift away from the target allocations within certain ranges. Such tactical adjustments to allocations typically are considered on a monthly basis in response to market conditions. The asset classes and their current proxies are: large-cap U.S. stocks: Russell 1000® Index; small-cap U.S. stocks: Russell 2000® Index; developed international stocks: MSCI EAFE® (Net) Index; emerging market stocks: MSCI Emerging Markets Index; U.S. inflation-linked bonds: Bloomberg/Barclays US Government ILB Index; international inflation-linked bonds: Bloomberg/Barclays World exUS ILB (Hedged) Index; commodity-related securities: Bloomberg Commodity Index; U.S. REITs: S&P US REIT Index; international REITs: Dow Jones Global exUS Select RESI Index; private markets: S&P Listed Private Equity Index; hedge funds: HFRI Fund of Funds Composite Index; U.S. taxable, investment-grade bonds: Bloomberg/Barclays U.S. Aggregate Index; U.S. high-yield corporate bonds: Bloomberg/Barclays U.S. Corporate High Yield Index; U.S. municipal, investment-grade bonds: S&P Municipal Bond Index; U.S. municipal high-yield bonds: Bloomberg/Barclays 60% High Yield Municipal Bond Index / 40% Municipal Bond Index; international taxable, investment-grade bonds: Bloomberg/Barclays Global Aggregate exUS; emerging bond markets: Bloomberg/Barclays EM USD Aggregate; and cash equivalents: 30-day U.S. Treasury bill rate.

Continued



## Disclosures Continued

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**All investments carry some degree of risk.** Return volatility, as measured by standard deviation, of asset classes is often used as a proxy for illustrating risk. Volatility serves as a collective, quantitative estimate of risks present to varying degrees in the respective asset classes (e.g., liquidity, credit, and default risks). Certain types of risk may be underrepresented by this measure. **Investors should develop a thorough understanding of the risks of any investment prior to committing funds.**

**Quality ratings** are used to evaluate the likelihood of default by a bond issuer. Independent rating agencies, such as Moody's Investors Service and Standard & Poor's, analyze the financial strength of each bond's issuer. Ratings range from Aaa or AAA (highest quality) to C or D (lowest quality). Bonds rated Baa3 or BBB and better are considered **Investment Grade**. Bonds rated Ba1 or BB and below are **Speculative Grade** (also **High Yield**.)

### **Definitions:**

**Alpha** is a measure of performance on a risk-adjusted basis. The excess return of the fund relative to the return of the benchmark index is a fund's alpha.

**Equity risk premium** is the extra return that's available to equity investors above the return they could get by investing in a riskless investment like T-Bills or T-Bonds or cash.

**Event-driven hedge fund strategies** attempt to take advantage of temporary stock mispricing before or after a corporate event takes place. An event-driven strategy exploits the tendency of a company's stock price to suffer during a period of change.

**HFR® (HedgeFundResearch) Indices** are the established global leader in the indexation, analysis and research of the hedge fund industry.

**LIBOR** is the average interbank interest rate at which a selection of banks on the London money market are prepared to lend to one another.

**Macro hedge fund strategies** generally focus on financial instruments that are broad in scope and move based on systemic or market risk (not security specific). In general, portfolio managers who trade within the context of macro strategies focus on currency strategies, interest rates strategies, and stock index strategies.

**MSCI AC Asia ex Japan Index** captures large- and mid-cap representation across two of three developed markets countries (excluding Japan) and nine emerging markets countries in Asia. The index covers approximately 85% of the free float-adjusted market capitalization in each country.

**MSCI China Index** captures large- and mid-cap representation across China A shares, H shares, B shares, Red chips, P chips and foreign listings (e.g. ADRs). The index covers about 85% of this China equity universe. Currently, the index includes large-cap A and mid-cap A shares represented at 20% of their free float adjusted market capitalization.

**MSCI EAFE Index** is an equity index which captures large and mid-cap representation across 21 Developed Markets countries around the world, excluding the US and Canada. With 902 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

**MSCI EAFE Growth Index** captures large- and mid-cap securities exhibiting overall growth style characteristics across developed markets countries around the world, excluding the U.S. and Canada.

**MSCI EAFE Value Index** captures large- and mid-cap securities exhibiting overall value style characteristics across developed markets countries around the world, excluding the U.S. and Canada.

**MSCI Emerging Markets Index** captures large- and mid-cap representation across 26 emerging markets countries. The index covers approximately 85% of the free float-adjusted market capitalization in each country.

**MSCI Europe Index** captures large- and mid-cap representation across 15 developed markets (DM) countries in Europe. The index covers approximately 85% of the free float-adjusted market capitalization across the European DM equity universe.

**MSCI Japan Index** is designed to measure the performance of the large- and mid-cap segments of the Japanese market. The index covers approximately 85% of the free float-adjusted market capitalization in Japan.

**MSCI United Kingdom Index** is designed to measure the performance of the large- and mid-cap segments of the UK market. The index covers approximately 85% of the free float-adjusted market capitalization in the UK.

**Relative value hedge fund strategies** cover a variety of low-volatility trading strategies with the consistent theme of attempting to reduce market risk, i.e., the manager seeks to generate a profit regardless of which direction the markets are moving. All relative value strategies minimize market risk by taking offsetting long and short positions in related stocks, bonds, and other types of securities.

**S&P 500 index** measures the stock performance of 500 large companies listed on stock exchanges in the U.S. and is one of the most commonly followed equity indices.

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