SEVENS REPORT *alpha*

October 17, 2017

In Today's Issue

- Merger Arbitrage—The absolute return strategy for an increasingly risky market.
- Gabelli ABC Fund (GABCX/GADVX)—A long-standing, actively-managed mutual fund with a top-notch skipper at the helm.
- IQ Merger Arbitrage ETF (MNA)—An ETF with a mechanical approach that has outperformed in recent years.

Merger Arbitrage Funds—The Absolute Return Strategy for Increasingly Risky Stock and Bond Markets.

The current bull market for the S&P 500—103 months in length—is the second-longest bull market for the domestic index since 1950. It's up 353%, in terms of total return, since its bottom in March 2009.

The widely followed index is on pace for its ninth consecutive year of positive returns, which would tie the longest streak on record (1991-1999).

And the market isn't showing any signs of slowing down.

The S&P 500 just finished its eight-consecutive quarter (eleventh months in a row) in the green. Its last 5% drop was 20 months ago.

Virtually all major US equity indexes (S&P 500, Dow Jones Industrial Average, Dow Jones Transportation Average, Nasdaq Composite, NYSE Composite, S&P MidCap 400 and Russell 2000) recently closed at all-time highs.

International equity markets, while cheaper, have been even hotter than domestic equities of late.

Plenty of risks are mounting, including impending interest rate hikes, Fed balance sheet unwind plans, political gridlock on tax reform and geopolitical issues such as North Korea.

While there's no telling when this bull market will end, it's certain to not last forever.

If you're considering rebalancing portfolios, or even taking profits off the table, where do you reposition those assets?

The conventional answer is fixed income. But, bonds have an incredible bull run, as well. It's even arguable that bonds are more expensive than stocks. Then there's the current ultra-low yields; a rising rate environment for the foreseeable future, and most model portfolios already have significant fixed income allocations in place (especially, if your book is full of retired/senior clients).

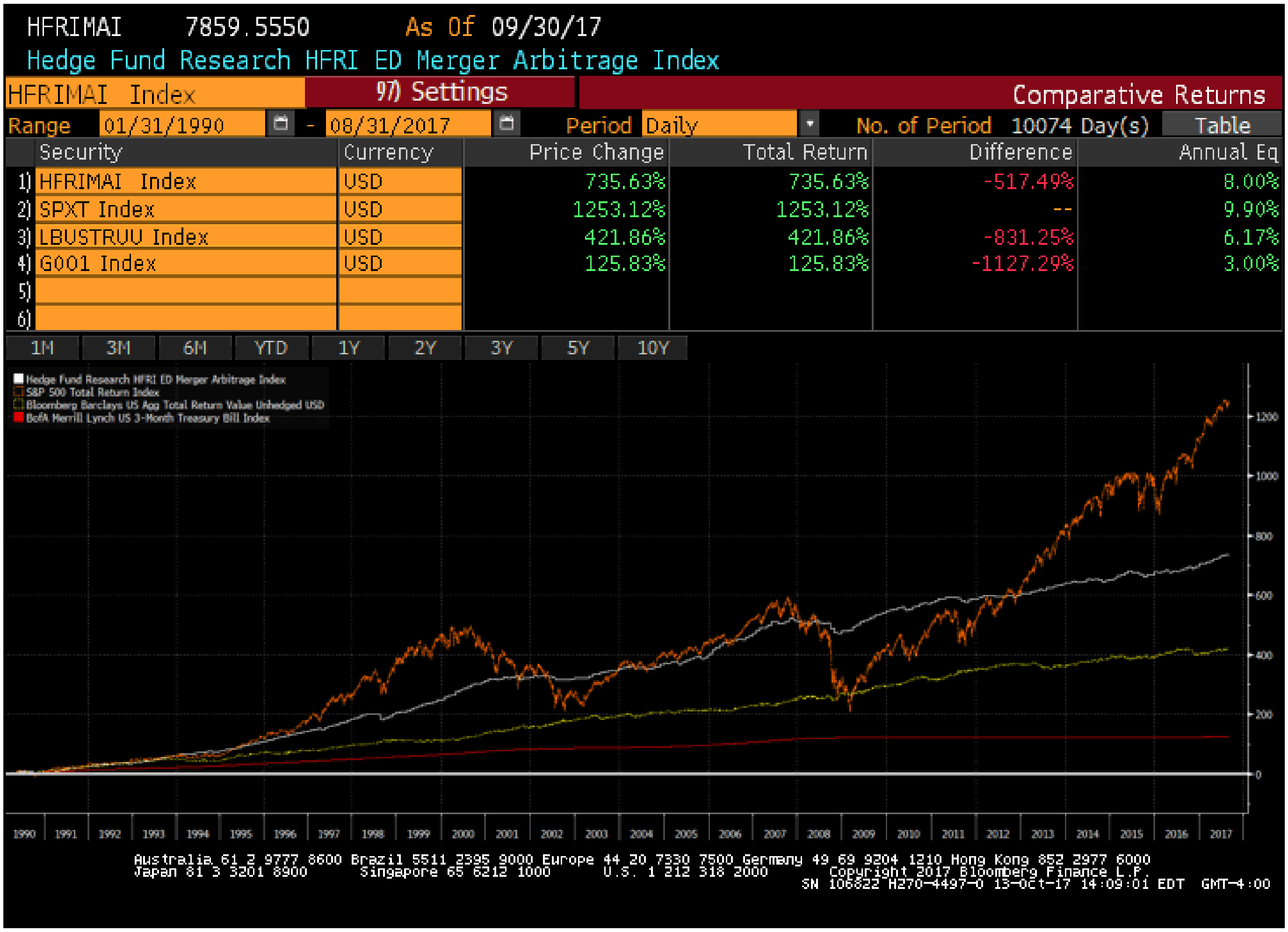
One alternative asset class to consider to potentially mitigate risk, provide downside protection and diversify returns is merger arbitrage.

Merger arbitrage is an absolute return strategy that seeks to profit from the timely completion of pending mergers, takeovers and other corporate reorganizations. Primarily, it makes money off the discrepancy between the acquisition price and the price at which a company's stock trades before the consummation of a merger.

Generally, when a takeover deal is announced, the stock price of the acquisition target spikes. However, it doesn't jump all the way to the offer price until the transaction is complete (or just before). The main reasons it doesn't are there's a risk that the deal could fall through, and the time value of money.

Merger arbitrage is one of the oldest hedge fund strategies—and for good reason.

It's low risk (volatility like bonds instead of stocks), and it has a high success rate (over 90% completion rate on announced deals, historically). It also offers steady, sin-



gle-digit returns (and has held up very well during past bear markets and corrections).

While merger arbitrage isn't an income solution, its returns are competitive—and higher—than most fixed income options. Over the long term, its returns have fallen between the returns of stocks and bonds.

A merger arbitrageur goes to work after an M&A deal is announced.

Here are two examples of how a merger arbitrage strategy would have worked on actual announced deals:

1) **Cash deal**. Mead Johnson Nutrition is a consumer health company based in Glenview, Illinois. The company is best known for its infant formula product, Enfamil. On February 10, 2017, Reckitt Benckiser Group entered into an agreement to acquire Mead Johnson Nutrition for $90 cash per share in a $17.9 billion merger. The deal closed on June 15, 2017.

An illustration of how a merger arbitrage investment would have worked:

Cost on 2/10/17:	**$87.40**
Closing deal price on 6/15/17:	**$90.00**
Gain:	**$2.60**
Net Gain:	**2.98%**
Annualized RoR:	**8.70%**

2) **Cash and stock deal**. St. Jude Medical is a Saint Paul, Minnesota-based medical device company. On April 28, 2016, St. Jude Medical agreed to be acquired by Abbott Laboratories for $46.75 per share in cash and 0.8708 shares of Abbott Laboratories' stock—representing roughly $25 billion of value. The transaction closed on January 4, 2017.

An illustration of how a merger arbitrage investment would have worked:

Cost on 4/28/16:	**$77.40**
Price to sell short	**0.8708 ABT**
shares per share of STJ:	**$40.25**
Cash received on deal closure:	**$46.75**
Total value of cash + stock:	**$81.80**
Gain:	**$4.40**
Net Gain:	**5.69%**
Annualized RoR:	**8.28%**

Tender offers (target shareholders are allowed to tender their shares without a vote) generally average one to two months in duration. Mergers tend to take three months or more. Of course, regulatory frameworks can affect the timeline of deal closing.

Now, not every deal is completely successfully. But, the combinations of the amount of deals available, the high win rate, the average returns and short duration of trades results in a bona fide absolute return strategy.

But it's important to mention, although the concept of merger of arbitrage—picking up the spread—is very simple, the part that can be complicated is assessing the risks associated with the spread.

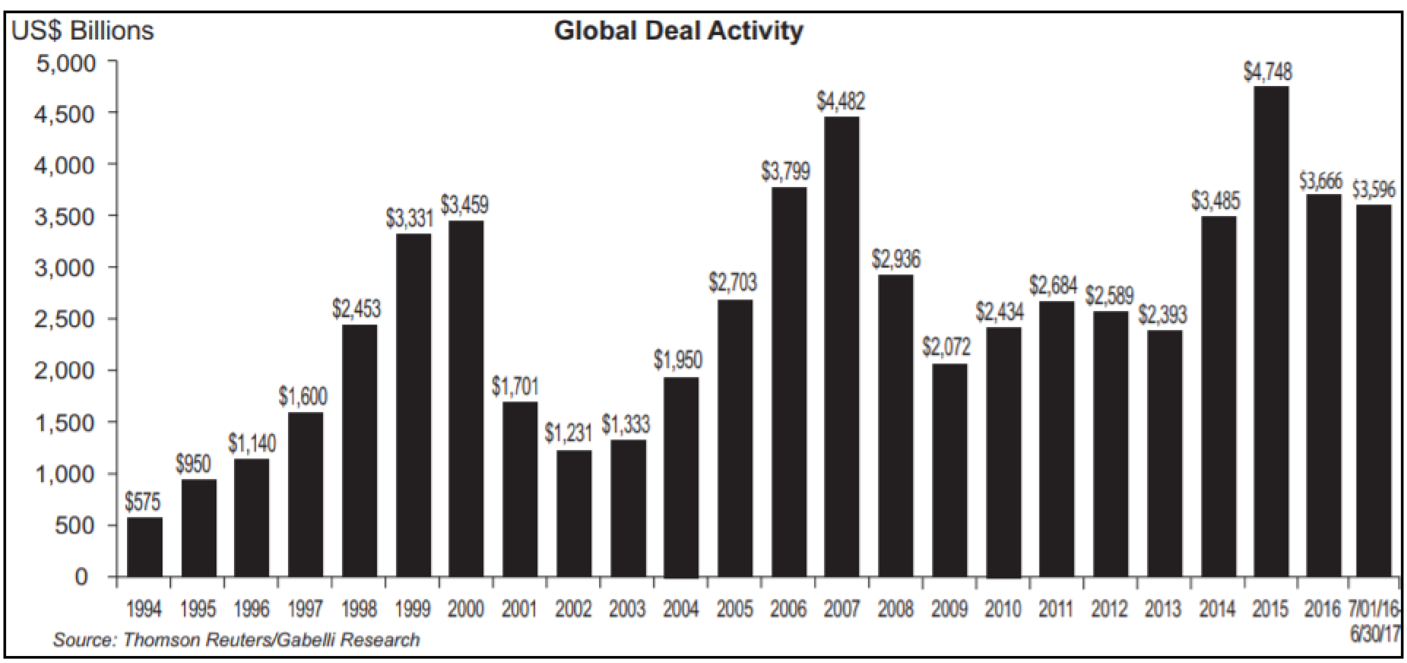
- Will they get the vote?
- Will they get the financing?
- Will regulators let the deal go through?
- Is the valuation fair?

All these different factors need to be considered so that a merger arbitrageur can evaluate if an investment is warranted given the risk/reward.

Merger arbitrage transactions are designed to be as market-neutral as possible. Generally, the result of a transaction is dependent on whether the specific corporate event occurs, not general market direction.

In my estimation, there are several reasons why merger arbitrage should continue to be a viable strategy for financial advisors—and their clients—going forward.

Robust deal activity. Per Bloomberg, there have been over 21,800 announced global deals totaling $3.6 trillion. This represents a 25% increase on dollar value on a year-over-year basis. North America has greater deal value than Europe ($1.6T vs. $1.2T). However, the percentage increase in Europe has been gaining ground (5% for US vs. 105% for Europe) and provides another stream of growing deal activity.



Low interest rates and lots of cash on corporate balance sheets also support deal activity.

Corporate cash stash. According to S&P Global Ratings, US corporate cash was at a record $1.9 trillion at the end of 2016. Meaning, many US companies are armed with large stockpiles of buying power.

Low-rate world. Interest rates on bonds and loans are at historically low levels. So, if a company isn't flush with cash, it can borrow cheaply to finance a deal at attractive rates. With the low cost of capital, there's a low barrier to make a deal attractive.

Okay if interest rates rise. Historically, merger arbitrage returns and spreads have had positive correlations with interest rates. This is due to the fact that the spread is driven by the risks inherent to a particular deal as well as the risk-free rate. Generally, as the risk-free rate rises, so too do annualized spreads.

So, as the Fed continues to raise rates, bonds stand to get killed, but merger arbitrage becomes more attractive.

Low-growth environment. Companies are struggling to grow organically. So, there's an appetite to grow inorganically.

Corporations are utilizing M&A activity to increase sales, decrease costs (through synergies) and for strategic purposes such as industry transformation. The Time Warner/AT&T deal and the Amazon/Whole Foods are two prime examples of the latter.

Plus, the asset class has volatility much closer to bonds than stocks.

Aging bull market. As mentioned earlier, this bull market is long in the tooth. US equities sport some of the highest valuation in history.

While I'm not proclaiming equites are a massive bubble ready to burst, I do think some of the market's extremes—high equity valuations, one of the lowest VIX readings in its 27-year history and ultra-low yields in fixed income—make it an opportune time to explore the value of alternative investments and portfolio diversifiers.

The beauty of merger arbitrage is that you can avoid big down years, which helps with capital preservation over the long run.

Now, let's review two of my favorite ways to get exposure to merger arbitrage...

Idea #1: GABCX/GADVX—Gabelli ABC Fund

Nicknamed "Super Mario" for his stock-picking prowess, Mario Gabelli is a legend in the investment world.

Mario's firm GAMCO has compounded client assets at 15%-plus over the last 40 years. GAMCO has $41 billion in assets under management.

Mario attributes much of his success to sticking to his "core competency." That is, he has specialized in a distinct group of industries—namely, autos, media and conglomerates—for 50 years (another 10 as an analyst before starting his own firm). Basically, Mario knows these industries inside and out.

There's another area of the markets that qualifies as one of his core competencies: merger arbitrage. Mario and his team have compound accumulated knowledge in the M&A space, too. The firm's first hedge fund in merger arbitrage was started in the 1980s.

Mario Gabelli launched "The Deal Fund" (Gabelli ABC Fund) in May 1993.

As quoted in some of the fund's literature, Warren Buffett once said:

"Give a man a fish and you feed him for a day. Teach him to arbitrage and you feed him forever."

Mario has been the lead portfolio manager of the fund the entire time. He's still very involved in running the fund, today.

The Gabelli ABC Fund was created for conservative investors desiring to participate in the equity markets without assuming the risks of portfolios fully invested in equities. By focusing on absolute returns, the fund aims to achieve positive returns in various market conditions without excessive risk of capital.

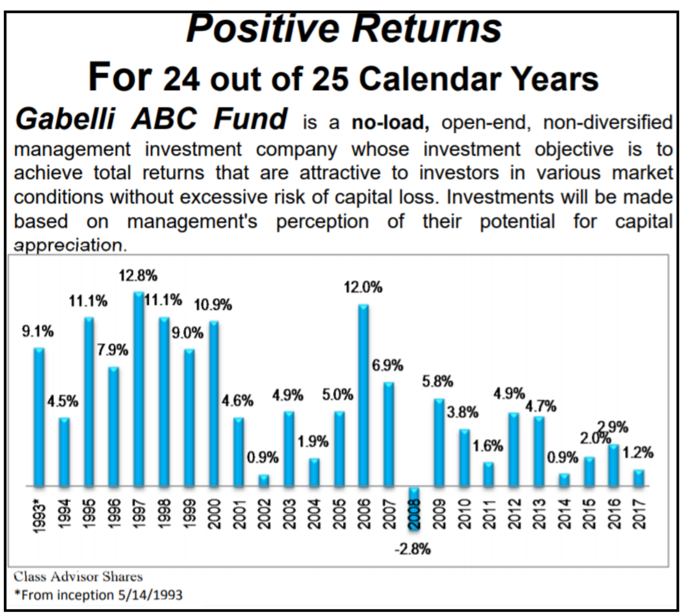
The fund's guidelines include:

- Attempts to earn consistent, risk-adjusted, nonmarket correlated returns

- Invests in announced M&A transactions with a concentration on cash transactions
- Looks for well-financed, strategic buyers
- Offers diversified, global exposure across all market capitalizations and market sectors
- Focus on industries where the team has strong analytical foundations (fully utilizing the resources of the Gabelli organization, including 40-plus sector-specific analysts)
- Average holding period between 45-90 days
- Avoid overall market risk

The investment process timeline: transaction announced… fundamental research, risk analysis… determine transaction timing and approvals… establish trading strategy… and earn spread and reinvest.

The fund has a remarkable history of employing this



strategy and cranking out positive returns year after year. It has recorded positive returns in 24 of the last 25 years.

The one year it was down (2008), it was only down 2.8%. The S&P 500 plummeted 37% that year.

Over the last 15 years, the fund's standard deviation is 2.78. In contrast, the Bloomberg Barclays US Aggregate Bond Index had a standard deviation of 3.38 and the S&P 500 had a standard deviation of 10.07.

Since its inception on May 14, 1993, the longest-dated

GABCX Facts	
Inception Date:	5/14/93
Assets:	$1.4B
Expense Ratio:	0.60%
Mstar Category:	Market Neutral
Mstar Rating:	5 Star

"Advisor" share class (GADVX) has an annualized return of 5.62% through June 30, 2017. For comparison, the fund's benchmark, the Lipper UST Money Market Average, has an annualized return of 2.19%.

The fund targets a return of 3-4% over the risk-free rate (short-term Treasuries).

As of June 30, 2017, the fund has a market capitalization breakdown of 23% large cap, 47% mid cap and 30% small cap. Geographically, it has roughly 75% North America and 25% Europe.

Top Ten Holdings (%)

Panera Bread	3.2
C.R. Bard Inc.	3.0
Westar Energy Inc.	1.9
Spectranetics Corp.	1.4
VCA Inc.	1.4
Parmalat SpA	1.3
Kate Spade & Co.	1.3
Time Warner Inc.	1.3
Level 3 Communications Inc.	1.1
Abertis Infrastructure	1.0

If M&A activity takes a turn for the worse—deal activity dries up or more deals go bust, having a seasoned management team could prove to be beneficial.

Note: The Gabelli ABC Fund is available through multiple custodians. The fund is eligible at Schwab, Fidelity and TD Ameritrade through their transaction fee platforms.

And the fund is available through broker dealers including Morgan Stanley, Merrill Lynch, UBS and Wells Fargo Advisors (to name a few) on their fee-based platforms.

The fund's Advisor share class (GADVX) is available through broker dealers or other financial intermediaries that have entered into appropriate selling agreements with the distributor. GADVX has an expense ratio of 0.85%. Minimum initial investment for both Advisor and AAA (GABCX) share classes is $10,000.

Idea #2: MNA—IQ Merger Arbitrage ETF

The IQ Merger Arbitrage (MNA) launched on November 17, 2009. The fund seeks to track the performance of the IQ Merger Arbitrage Index. MNA has the longest track record and largest asset base of any merger-related ETF on the market.

Per its prospectus:

The underlying index seeks to employ a systematic investment process designed to identify opportunities in companies whose equity securities trade in developed markets and which are involved in announced mergers. Acquisitions and other buyout-related transactions.

The underlying index seeks to capitalize on the spread between the current market price of the target company's stock and the price received by the holder of the stock upon consummation of the buyout-related transaction. In addition, the underlying index includes short exposure to the US and non-US equity markets.

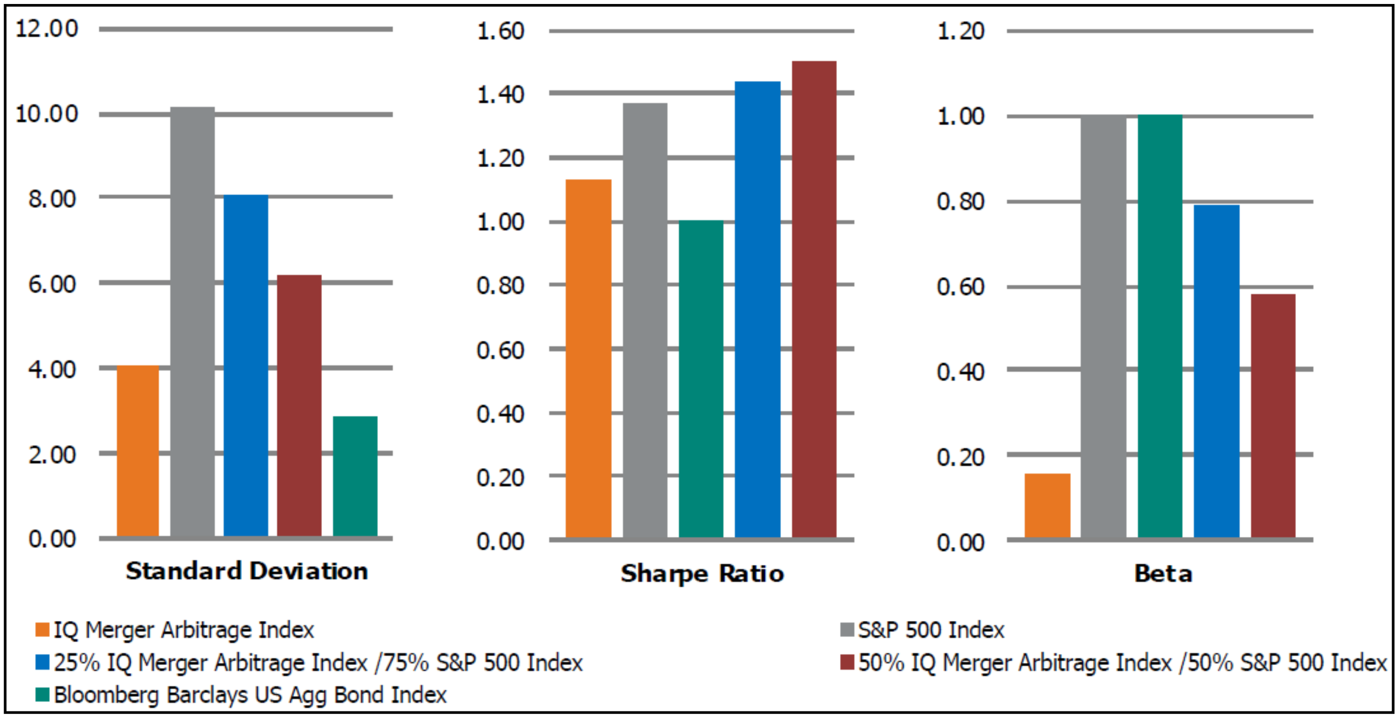
As CIO of IndexIQ Advisors Sal Bruno told us:

"While not a new strategy, offering merger arbitrage in an ETF affords investors easy access to this potent portfolio tool in a cost-effective, transparent and tax-efficient vehicle.

We have seen a big uptick in fund inflows as advisors are taking advantage of the fund's consistent positive returns, coupled with its low volatility and low correlation to broad equities and bonds, to improve the efficiency of their clients' portfolios.

With merger activity continuing to remain robust, the positive environment for a merger arbitrage strategy should continue."

Of the most popular merger arbitrage funds in the marketplace, MNA has been the top performer in recent years. Over the last five years, it's easily outpaced its three actively-managed peers (Note: The Gabelli ABC Fund has narrowly outperformed MNA since its November 17, 2009 inception).



The cumulative returns in the chart convert to these five-year annualized returns: MNA (4.89%), GABCX (2.99%), ARBFX (1.91%) and MERFX (2.11%). And throw in the five-year annualized returns of the Bloomberg Barclays US Treasury Bill 1-3 Month Index (0.19%) and Bloomberg Barclays Aggregate Bond Index (2.06%) for good measure.

Top Fund Equity Holdings[5] - 6/30/17		
C. R. Bard, Inc.	Health Care	8.98%
Huntsman Corporation	Materials	8.58%
Time Warner Inc.	Consumer Discretionary	8.13%
NXP Semiconductors NV	Information Technology	6.90%
Akorn, Inc.	Health Care	6.61%
Panera Bread Company Class A	Consumer Discretionary	4.86%
Level 3 Communications, Inc.	Telecommunication Servi	4.20%
Swift Transportation Company Class A	Industrials	3.27%
Kate Spade & Co	Consumer Discretionary	2.73%
Brocade Communications Systems, Inc.	Information Technology	2.36%

An allocation to MNA—in this case, looking at the statistics of the IQ Merger Arbitrage Index—can improve the risk/return profile of a traditional portfolio. The performance is generally not highly correlated to other asset classes over time and has a lower beta sensitivity to the broader market.

MNA's index has exhibited a low correlation to both stocks and bonds over time. It has a 0.40 correlation to the S&P 500 Index and a -0.08 correlation to the Bloomberg Barclays US Aggregate Bond Index.

Additionally, MNA hasn't paid out a capital gain distribution since 2011—making it a tax efficient way to get exposure to merger activity.

MNA Facts	
Inception Date:	11/17/09
Assets:	300M
Avg Daily Vol:	68K
Expense Ratio:	0.77%
Mstar Rating:	5 Star

Note: MNA trades commission-free at Schwab and E-Trade.

Judging by the $6.4 billion in combined assets of the top four merger arbitrage funds, it's evident that most investors aren't aware of this strategy's value.

For those financial advisors that do allocate to merger arbitrage, it is used as an effective strategy in various ways. Some use it as an equity allocation. Some put it in their fixed income bucket. Some substitute it for cash. And others slot it as a liquid alternative.

As an equity allocation, merger arbitrage makes for a nice hedge in a bear market. Treated as a fixed income substitute or supplement, merger arbitrage stands a good chance at outperforming traditional fixed income securities in the low-yield environment. Used as a cash equivalent, it provides extra juice. And utilized as an alternative, it can generate consistent absolute returns that fall somewhere between stocks and bonds over the long term.

An analyst friend of mine even tells me that one particular merger arbitrage fund's employees buy their own fund on margin as a safe way to leverage their returns.

Simply put, a merger arbitrage strategy is a good tool to have in your investment arsenal, and a good way to show your clients you can provide them with ideas that represent a diversified hedge regardless of market conditions.

Have a good week,

Tom

Sevens Report Alpha ETF & Stock Ideas

ETF/Stock	Strategy	Date	Total Return	Benchmark Performance Since Issue Date
KWEB **(PGJ as an alternative if KWEB not available from your B/D).**	*KWEB (KraneShares CSI China Internet ETF) is a play on an index re-balance, where by Chinese "N" shares, which are ADRS of major Chinese companies like BIDU, WB, etc. will be added to MSCI Emerging Market Indices between now and June 2018.* ***What to do now: Buy.***	**Issue 1:** **8/17/17** **8/24/17**	**10.52%**	**5.55%**
RSP **(Guggenheim Equal Weight S&P: 500 ETF)**	*RSP has massively outperformed SPY as a core stock holding over longer-term time frames (314% vs. 112% over 17 years). In 2017, RSP has lagged (so far) due to significant tech sector outperformance, but we view this is a short-term distortion and an opportunity to buy this ETF at a discount compared to SPY.* ***What to do now: Buy.***	**Issue 2:** **9/7/17**	**4.02%**	**3.93%**
Self-Driving Car Basket. **SNSR (Global X Internet of Things ETF).** **ROBO (Global Robotics & Automation ETF).** **AMBA (Ambarella)** **QCOM (Qualcomm)**	*Massive changes to the auto industry, including self-driving technology, are closer to the mainstream than most investors think. We think the foundational changes to the auto industry could be the next investing "Mega Trend" that can provide outperformance for years to come.* *There is no pure play "self driving" ETF yet, but SNSR and ROBO offer exposure to a lot of the tech companies that are best positioned in the space.* *AMBA and QCOM also have unique exposure to the growing self driving car industry and represent two of the better "pure play" stocks on the industry.* ***What to do now: Buy as we remain long term bullish on each idea. However, if you are sitting on near 20% gains in AMBA and want to book some profits and re-enter later, that's certainly understandable.***	**Issue 3:** **9/21/17**	**SNSR:** **1.37%** **ROBO:** **3.51%** **AMBA** **17.98%** **QCOM** **0.58%**	**2.37%**
Electric Car Battery Plays. **LIT (Global X Lithium & Battery Tech ETF).** **ALB (Ablemarle Corp)**	*The trend towards the widespread adoption of electric cats is accelerating, with US auto companies planning massive roll out and China declaring all cars to be electric by the mid 2030's.* *There is no pure play "Electric Car" ETF but the key here is better technology, specifically lithium.* *LIT is a lithium ETF, while Albemarle Corp (ALB) is one of the leading lithium miners in the market today.* ***What to do now: Longer term investors can buy now, but as we said in the issue, both LIT and ALB ran up big time following the Chinese electric car decision. Both have digested those gains but remain over bought. Waiting for a lower enter point for shorter/ medium term investors is certainly understandable.***	**Issue 3:** **9/21/17**	**LIT:** **4.87%** **ALB:** **3.79%**	**2.37%**
Dividend Growth Strategy **DIVY (Reality Shares DIVS ETF)** **REGL (Proshares S&P Midcap 400 Dividend Artistocrats ETF)** **SMDV (Proshares Russell 2000 Dividend ETF)**	*Dividends are responsible for half of the market's total return over history—so they are an essential component of long term outperformance. But, while most investors simply go for high paying dividend stocks, our research shows that focusing on dividend growth can yield better long term returns.* *DIVY is the only ETF that isolates dividend grwoth of the S&P 500, and this fixed income alternative provides steady mid to high single digit returns with low volatility and true diversification.* *REGL and SMDV are ETFs that give us exposure to the "Dividend Aristocrats" of tomorrow.* ***What to do now: Buy.***	**Issue 4:** **10/4/17**	**DIVY:** **1.16%** **REGL:** **-0.04%** **SMDV:** **0.07%**	**AGG:** **-0.30%** **MDY:** **0.26%** **IWM:** **-0.30%**

Benchmark Information: KWEB, RSP, SNSR, ROBO, AMBA, QCOM, LIT, and ALB are all benchmarked to the SPY total return since the issue date. DIVY is benchmarked to the total return of AGG (IShares Core U.S. Aggregate Bond Fund). REGL is benchmarked to MDY (SPDR MidCap 400 ETF) and SMDV is benchmarked to IWM (IShares Russell 2000 Index ETF).