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On its own course: merger arbitrage as an intelligent diversifier

The following publication is part of the Berenberg Funds and Solutions series.

Insights provides a better understanding of our investment philosophy and thought process.

Beyond stocks and bonds – merger arbitrage as a strategic building block

More opportunities for diversification, stability and independence from the market in the portfolio

In a world in which geopolitical tensions have become normalised, equities and bonds are increasingly moving in lock-step and the effects of inflation can be felt on a daily basis, it has become a necessity to search for resilient, market-neutral sources of returns. This is where merger arbitrage comes in as a liquid, defensive and **market-neutral yield component in the portfolio**. It has one clear goal: stability, diversification and attractive returns – all with a consistently manageable risk.

The investment strategy is based on a simple principle: when a listed company is taken over, arbitrageurs realise what is known as a spread as compensation. The performance of the market is of little importance in this context. Merger arbitrage works in bull markets, sideways trends and recessions.

Unlike traditional asset classes, merger arbitrage does not depend on corporate earnings, economic growth, interest rates or inflation data. The yield is determined solely by the circumstances of the takeover, and not by micro or macro factors. This makes the strategy particularly valuable in the present day: it provides an opportunity for largely uncorrelated, stable income, not only complementing equities and bonds, but actually relieving the pressure on them in the context of the portfolio.

Whether as a partial replacement for bonds, a stability anchor when valuations are tough or a strategic diversifier, merger arbitrage is ideal for modern portfolios structured for returns, risk control and reliability.

That the strategy works is no mere theory. **Warren Buffett himself once used merger arbitrage extensively** – with half of his managed assets at times – disciplined, selective and independent of the market.
In light of the turbulence of 2025 with its dramatically heightened volatility, sensitive markets and not wholly convincing valuation levels, merger arbitrage is once again highly relevant. Although not a magic bullet, it is a stable, liquid component for investors who do not merely want returns at all costs, but rather structure and reliability – this is where merger arbitrage can represent a new, proven alternative pillar for the portfolio.

'I've probably participated in about 300 arbitrage situations at least in my life, maybe more.'

Warren Buffett

A strategic component for modern portfolios

Despite its long history stretching back to the 60s and 70s and its widespread use by institutional Anglo-Saxon investors, the potential of merger arbitrage remains largely untapped in Europe, especially Germany, Austria and Switzerland. This alternative strategy has advantages to offer, especially in a challenging market landscape – for investors from private investors to institutional funds:

- **Attractive, risk-adjusted yield opportunities** – with low volatility and greater planning reliability
- **Market-neutral structure** – independent of economic cycles and macro or interest rate scenarios
- **Real diversification** – with extremely low correlation to equity and bond markets

This Berenberg Insight shows how merger arbitrage can be incorporated into strategic asset allocation as a liquid, robust portfolio component for greater stability, less dependence on market movements and calculable returns.

What is merger arbitrage – in simple terms

The term sounds more technical than the underlying idea actually is: Merger arbitrage refers to a specialised investment strategy that focuses on public acquisitions and mergers. It's not centred on a single M&A deal, but rather a highly diversified portfolio of active transactions in their final stages.

'Merger arbitrage produces more steady absolute profits from year-to-year than the more general equity investments do. In years of market decline, it piles up to a big edge for us.'

Warren Buffett

When a public merger or acquisition is announced, the pattern is almost always identical – the share price of the target company rises in the direction of the agreed purchase price, although it normally remains slightly below it. The reason: opportunity costs and risk. The market prices in potential residual risks, such as regulatory approvals, shareholder approvals or unanswered financing questions. The difference between the current share price and the acquisition price – the **spread** – is the source of income in the merger arbitrage strategy.

Example: A buyer offers 100 euros per share, the market price is 96 euros. The arbitrageur buys the share and holds it until the transaction is concluded – realising the price difference as profit. If these 4 euros are earned in six months, this equates to an annualised return of around 8% (see fig. 1). Regardless of how the markets as a whole perform.

The structure of a merger arbitrage portfolio is reminiscent of a rolling bond portfolio, but **without the interest rate risk**. In each case, capital is only tied up for the relatively short duration of individual transactions. Once a deal is closed, the investor invests in the next merger. This makes the strategy particularly attractive in periods of higher interest rates or market volatility. There is also a **liquidity premium**: many traditional equity funds or index trackers sell their positions immediately after the announcement of a merger. Ultimately, they have done their job well in that case. Arbitrageurs acquire these shares on the finish line and provide liquidity – and are rewarded with an additional premium.

In spite of these structurally beneficial characteristics, merger arbitrage is still often misunderstood and some prejudices persist:

Myth 1 : 'Too risky, many deals fail'
Reality: >95% of all deals close successfully. Experienced arbitrageurs select safe transactions and diversify.

Myth 2: 'Yields too low'
Reality: Stable, risk-adjusted returns. Spreads per deal: 2-5%, portfolios often >7-10% p.a. thanks to deal turnover (as at April 2025)

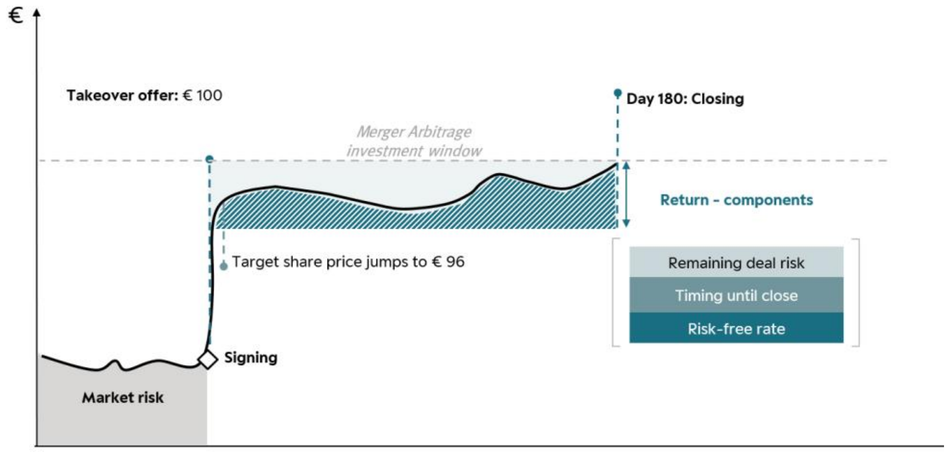
Myth 3: 'Only hedge funds profit'
Reality: International pension funds, endowments and even sovereign wealth funds use merger arbitrage for diversification & portfolio stabilisation

Myth 4: 'Not enough attractive deals'
Reality: Constant M&A activity on average 800 public deals/year -> diversified portfolios with 30-40 lucrative transactions

Myth 5: 'Only works in certain market phases'
Reality: Resilient in every phase of the cycle. M&A remains central - takeovers and mergers take place in every market phase.

In a nutshell: Contrary to all the myths, merger arbitrage is a clear, repeatable strategy based on clear processes, economic logic and selective risk management; one that has proven to be a stable, liquid yield component in portfolios for decades.

Fig. 1: How merger arbitrage works



Source: own depiction

Practical examples: Merger arbitrage in action

The acquisition of **Activision Blizzard** by **Microsoft** in the **USA** is one prominent example out of hundreds of M&A transactions, from which arbitrageurs selectively identify the most attractive opportunities each year. **Microsoft** announced its acquisition of the video game developer for USD 95.00 per share. The share price rose following the announcement, but remained significantly lower – at around USD 80.00 intermittently – for a long time. This was due to excessive regulatory concerns, especially from the USA, which the market viewed as a potential deal-breaker.

A classic situation arose for merger arbitrageurs: an arbitrageur who entered at around USD 80.00 and bet on the successful closing of the deal could realise a difference of USD 15.00 per share. The operational performance of Activision was excellent at the same time, which increasingly limited the downside. Upon the closing of the transaction, investors realised a high double-digit annualised return that surpassed the share level – including Warren Buffett, who was heavily invested in the deal through **Berkshire Hathaway**. Even if his vehicle is too large for systematic merger arbitrage, the case shows that the Oracle is still active from time to time. Highly publicised examples like this are rare. Most M&A arbitrage situations are much less exciting, and the returns tend to be on a high yield level.

One less well-known example from **Europe** is the acquisition of **Va-Q-Tec** by **EQT. Va-Q-Tec**, a company that focused on temperature-sensitive packaging for the pharmaceutical and biotech industries and was one of the largest beneficiaries of the pandemic, was taken over by the Swedish private equity investor as part of a buyout. EQT offered EUR 26.00 per share – an attractive premium over the market price. Whereas long-only investors were quick to exit, an interesting spread opened up for arbitrageurs. The market priced regulatory risks in – especially relating to **Envirotainer**, another EQT portfolio company. However, the detailed analysis quickly showed that the concerns of the broad market were exaggerated. The fields of business did not materially overlap and the deal went ahead as expected. Once again, the result was double-digit annualised returns – regardless of the overall market.

These are just two examples of many, but they show that merger arbitrage is not speculation, but rather a question of analysis. If you are prepared to look deeper than passive trackers and traditional funds, you can strategically turn structural market inefficiencies in M&A situations into returns – especially in the final months of a stock's life on the stock exchange, where other factors are decisive. The majority of transactions take place in an extraordinarily mundane fashion, and that is a good thing.

Warren Buffett, the merger arbitrageur:

- **More than just value –** Buffett's early success in the 60s and 70s was down to merger arbitrage in no small part: 'I've probably participated in about 300 arbitrage situations at least in my life, maybe more.'
- **Merger arbitrage allocation** – 'At one time, 30-40% of Buffet's partnership was invested in merger arbitrage on a regular basis.'
- **Selective deals even now** – Although Berkshire Hathaway has grown too large for systematic merger arbitrage, Buffett's team still invests in selected mega-deals, such as Monsanto (2016), Red Hat (2018) and Activision (2022).

'Charlie and I, fifty years ago, we used to do a lot of merger arbitrages …] and we spent a lot of time analysing the probability of announced deals going through. And we called them workouts, and now the term became merger arbitrage.'

Warren Buffett

Why merger arbitrage?

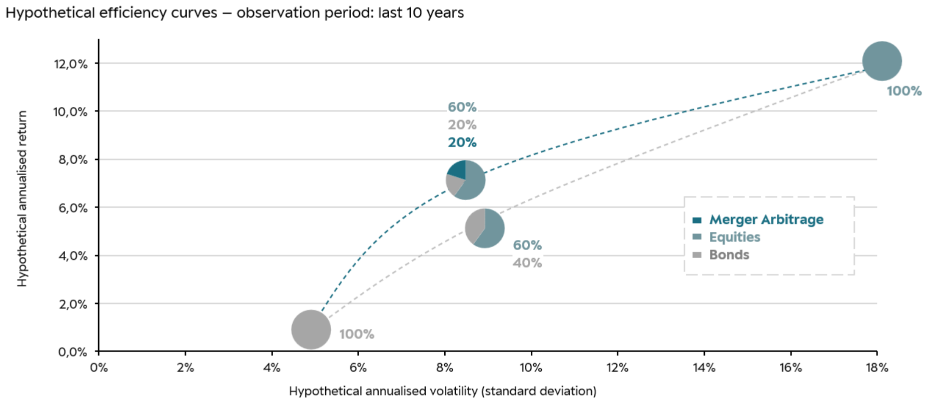
Merger arbitrage per se is not a new strategy, but it has rarely been as relevant as it is today. Once used extensively by Warren Buffett, it offers an impressive combination of diversification, stability and reliability for investors who want to make their portfolio more resilient today.

Merger arbitrage as a diversifier for portfolios

The classic combination of shares for growth and bonds for stability has worked for decades – today it is less and less effective, especially when it matters. In an environment where asset classes increasingly react in the same way, we need components that are as uncorrelated as possible, work differently and provide diversification. Merger arbitrage is exactly that: a liquid, **market-neutral** strategy whose returns are determined not by macro trends, but rather business events – regardless of interest rate policies, economic activity or the geopolitical situation.

Merger arbitrage makes for an impressive **strategic portfolio component** thanks to its high absolute and risk-adjusted yield expectations as well as advantageous correlation characteristics. Even a moderate allocation can noticeably improve the risk/return structure of strategic asset allocation (SAA).

Fig. 2: Merger arbitrage as a stabilising portfolio component

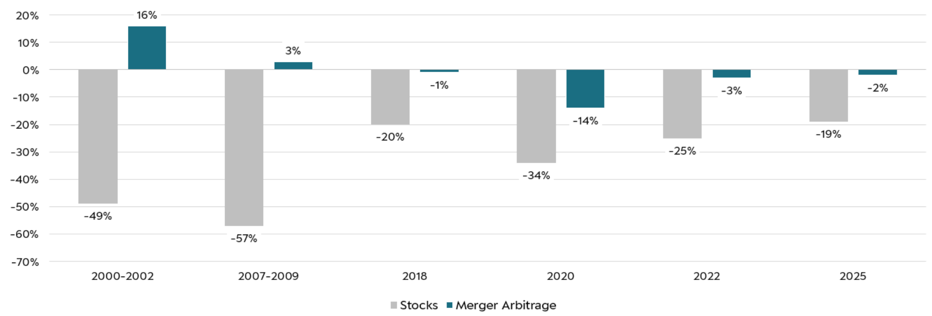


Source: Bloomberg, Berenberg. Note: The hypothetical performance depicted is not the actual performance of an investor. Hypothetical performance data are naturally subject to limitations and are not a reliable indicator of future results. Past performance, simulations or forecasts are not reliable indicators of future development. The allocations depicted are meant for illustrative purposes only and are not to be taken as a recommendation or an offer to invest. Calculation with Bloomberg data, period: 30/04/2015 – 31/03/2025. Shares are presented by the S&P 500 Index, bonds by the Bloomberg Global Aggregate Total Return Index, and merger arbitrage by the HFRI ED Merger Arbitrage Index.

Stability in volatile times

As described, the source of income lies in the difference between the market price and the acquisition price of a company. This mechanism works even if markets are fluctuating, as companies merge out of strategic necessity, not emotion. Consequently, the strategy has proven robust with low downside capture in previous market phases, especially in 'traditional' crises.

Fig. 3: Lower losses in periods of crisis



Source: Bloomberg, drawdown data from 01/01/2000 to 30/12/2022. Shares = S&P 500 Index, merger arbitrage = HFRI Merger Arbitrage Index.

Established. Event-driven. Lucrative – merger arbitrage in strategic asset allocation

International institutional investors have been using merger arbitrage as a strategic diversifier for many years. In the current market environment, the strategy is among the preferred components in the alternatives bucket of many insurers and pension funds.[1]

- **Stable, predictable income** independent of market phases
- **Low correlation with equities and bonds** – real diversification
- **Attractive risk-adjusted returns** with a manageable volatility level

[1] Barclays Capital Solutions: Outlook 2025

Merger arbitrage strategically complements traditional allocations beyond the limits of other asset classes.

Advantage	Description	Relevance
Stable income	M&A spreads are a reliable source of returns, regardless of macro trends.	Predictable income not only for investors focused on asset preservation.
Market-neutral structure	Almost no beta, no dependence on economic activity – income from M&A transactions.	Reduces fluctuations in the overall portfolio – especially valuable in volatile periods.
Attractive Sharpe ratio	Significantly higher than with bonds, with limited risk.	Increases efficiency in the portfolio.
Low correlation	Almost zero with bonds, low with equities – real diversification.	Complements existing portfolios with no cluster risks.
Crisis resistance	High deal closure rates and stable spreads even in stressful periods.	Anticyclic component to smooth the overall performance in crises.
Interest advantage	Arbitrage spreads rise with the interest level, no duration risk.	Relevant partial substitute for bonds when interest rates rise or fluctuate.
Liquidity	Can be traded daily through UCITS structures, no lock-ups.	Suitable for flexible, actively managed portfolios – complete transparency.
Easily scalable	Rolling model, continuous reinvestment process.	Operationally efficient – can even be implemented with larger allocations.

Why now?

The **conditions** in the current market environment are good for merger arbitrage: looser regulations, higher interest rates and a volatile capital market are an attractive framework for a strategy that largely works independently of market trends. The relevant competition authorities are taking an increasingly pragmatic stance – this is advantageous. Approval procedures are becoming more efficient and deal uncertainties are falling. For arbitrageurs, this means higher closure rates, shorter holding periods and faster capital rotation.

At the same time, spreads profit directly from higher interest rates – they are structurally linked to the risk-free rate. The typical holding period of 3-6 months also makes it possible to adapt dynamically to changing interest rates. Whereas traditional asset classes suffer in the face of **geopolitical tension** and falling company profits, merger arbitrage remains largely unaffected. As mentioned above, the income is isolated, originating from M&A transactions and not market movements. In turbulent periods, the demand for low-correlation strategies with plannable risk therefore rises.

Additionally, private equity with record-high dry powder has become a driving factor in the M&A market. Favourable share valuations in broad parts of the market and overwhelming investment pressure are favouring public-to-private transactions, often with attractive premiums and clear sources of finance. Additional opportunities arise for arbitrageurs in the form of bidding processes, earn-outs and variable structuring.

In summary: Merger arbitrage is more than just a **defensive component** in turbulent times; it is a strategy that can turn structural advantages into returns, especially now.

Implementation: three principles for optimal allocation

A successful merger arbitrage strategy requires precision, regulatory expertise and the ability to make strategic use of structural inefficiencies. The key lies not in the breadth, but rather the quality of the selection and risk management: capital is ideally used where spreads are attractive, the probabilities of closing are high and competitive pressure is low. Three strategic focal points are in the spotlight: Europe, mid caps and the fight focus.

I. Europe – An M&A market with untapped alpha potential

The European M&A market continues to offer structurally undeveloped opportunities for arbitrageurs. Whereas some US markets are still characterised by high valuations and intense competitive dynamics, many European companies are trading on historically attractive valuation levels – especially in the mid and small-cap segment. Public-to-private transactions are therefore rising noticeably, including in the industry, healthcare and technology sectors.

Another advantage: Europe's regulatory fragmentation creates natural inefficiencies. Different M&A regulations, national antitrust authorities and diverging approval processes make the structure more complex, but also more lucrative for experienced arbitrageurs with local networks.

Example: Germany's M&A law is one of the strictest in Europe, characterised by pronounced minority protection, clear regulations on deadlines and formalised bidding processes. It is often daunting to market participants without deeper local and linguistic anchors. Yet if you are familiar with the regulatory framework and are able to actively navigate it, you will find wider spreads and more calculable probabilities of closing.

For reasons relating to efficiency and currency, many international arbitrage funds focus solely on US deals with high liquidity and standardised regulatory processes. The European opportunity is left underutilised – a structural advantage for specialised managers with regional know-how and a flexible set-up.

II. Small and mid-cap deals – the undervalued arbitrage source

Whereas large and mega-cap transactions are under increasing regulatory pressure, small and mid-cap M&A deals (SMID) are becoming a more efficient alternative in terms of both risks and returns. It is in this segment that the most attractive spreads at times often arise, as many extremely large arbitrage funds eschew these transactions for liquidity reasons or are unable or unwilling to model them structurally (see point I).

The advantage of smaller deals is clear to see: shorter approval processes, smaller antitrust hurdles and higher closure rates allow for more calculable income. At the same time, the legal structure is identical to larger transactions – the same legally binding purchase contracts and the same protection for investors.

The spreads are often wider because major market participants are less focused on these deals, which means they are priced less efficiently. This is where the alpha arises for specialised managers with a flexible set-up.

The SMID category remains a largely unexplored niche with above-average potential, especially for funds that can operate independently of minimum volumes, index membership or trading liquidity. In a landscape of growing regulatory complexity in major transactions, however, it is becoming a strategically relevant source of income.

Factor	European merger arbitrage	US merger arbitrage
Complexity and valuation errors	More frequent regulatory requirements, cross-border approvals and special shareholder requirements lead to structural inefficiencies and wider spreads.	A higher degree of standardisation, faster processes and low regulatory complexity lead to narrower spreads and faster spread reduction.
Inefficiencies in small and mid-caps	Larger price inefficiencies, as risks are often priced incorrectly – especially in smaller-scale transactions.	Larger deals dominate and the market reacts efficiently – arbitrage windows close faster.
Private equity as a driver of M&A	Favourable valuations make European targets attractive to private equity, and the arbitrage potential does not disappoint.	Larger US transactions are more often strategically motivated (group consolidation) with fewer valuation anomalies.
Market density and competition	Lower hedge fund penetration in Europe, less competition – structural spreads remain in place for longer.	High market participation by specialised US hedge funds – inefficiencies are exploited faster.

III. Pure-play merger arbitrage – focus creates stability

Merger arbitrage works best when it is clearly focused and implemented systematically. A pure-play approach focuses solely on M&A transactions that have already been announced and deliberately avoids hybrid forms as well as the inclusion of special situations, distressed debt and pre-deal speculation.

The outcome is higher forecasting accuracy, lower market risks and even more clearly calculable returns. Whereas hybrid event-driven strategies are more heavily influenced by external factors, beta etc., a pure-play merger arbitrage strategy remains largely unaffected by macroeconomic developments.

As the positioning is on contractually secured transactions, the payout scenarios are structured with low volatility. The advantage of this disciplined approach is clear in volatile market phases in particular: legal clarity, regulatory structure and selective implementation make pure-play merger arbitrage a highly stable, market-neutral source of income – and a relevant alternative for investors.

In summary, a successful merger arbitrage strategy in 2025 follows three clearly defined principles:

- **Use Europe** – unlock market inefficiencies strategically through regulatory fragmentation and valuation haircuts.
- **Prioritise small and mid-cap deals** – less competition for higher closure rates and wider spreads.
- **Follow a pure-play approach** – avoid speculative risks and only rely on contractually secured transactions.

By pursuing or allocating this selective approach, it is possible not only to create stable, predictable yield opportunities, but also to unlock the potential for a structurally exceptional alpha in a challenging market environment.

Conclusion:

Crumbling correlations, geopolitical tension and sudden surges in volatility are making traditional 70/30 allocation structures increasingly vulnerable. Merger arbitrage is a robust alternative: market-neutral, low-risk yield opportunities based on M&A transaction structures instead of market forecasts – with high planning reliability, low volatility and **real diversification**.

There is a lot of catching up to be done here. The **conditions** are currently good for taking this step: attractive arbitrage spreads, looser regulations and persistent investment pressure from private equity investors are creating promising conditions, and not only for initial allocators. Although institutional investors in the USA and UK have long since established merger arbitrage as a solid allocation component, there is now an opportunity for family offices, funds of funds and wealth managers to follow suit.

Our Berenberg Insight clarifies: merger arbitrage is absolutely not just a tactical addition, but rather a strategic component for **resilient, forward-looking portfolios**. If you allocate today, you secure more than just returns – namely the opportunity for stability, structure and independence from the next market cycle.

'Merger arbitrage is more predictable than general stock market investments. The returns are limited, but so are the risks—if you know what you're doing.'

Warren Buffett

Key takeaways for allocators - why merger arbitrage is particularly relevant now:

- **Low correlation, low volatility:** Merger arbitrage has historically shown low correlation with bond and equity markets – while delivering more stable and predictable returns.
- **Attractive return potential:** The strategy offers systematic excess returns above money market levels – with clearly quantifiable risk and high replicability.
- **Beneficiary of rising interest rates:** Arbitrage spreads are positively correlated with interest rate levels – a structural advantage during periods of elevated inflation or tighter monetary policy.
- **Alternative to bonds:** As a market-neutral strategy, merger arbitrage offers a high-yielding complement to fixed income allocations – without duration risk and with daily liquidity.

Opportunities

- Attractive return potential for shares in M&A situations
- Share performance in M&A situations is more stable than the broader market
- Potential additional income through single-value and situation analysis and active management
- Systematic hedging of foreign exchange risks

Risks

- Share value may fall below the purchase price at which the customer purchased the share
- High volatility of shares, with possible losses
- Shares may sometimes perform below average during mergers and acquisitions
- No guarantee of success for single-value analysis and active management
- The use of derivatives to facilitate certain investment management techniques, including constructing long and synthetic short positions and creating a leverage effect to increase the economic engagement of a fund beyond the value of its net assets, can cause the overall risk profile of the fund to increase

- A positive return cannot be guaranteed. The performance of a merger arbitrage product can develop independently of general stock market trends, as both positive and negative changes in share price can influence the total value

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Publisher

Matthias Born
Head of Investments & CIO Equities
Berenberg Wealth & Asset Management

Author

Leonard Keller
Portfolio Manager
Merger Arbitrage
T.: + 49 89 25 55 12-117
E.: leonard.keller@berenberg.com

Author

Oliver Scharping
Portfolio Manager
Merger Arbitrage
T.: +49 89 25 55 12-126
E.: oliver.scharping@berenberg.com

Important notes

Joh. Berenberg, Gossler & Co. KG
Neuer Jungfernstieg 20
20354 Hamburg
Tel. +49 40 350 60-0
Fax +49 40 350 60900
www.berenberg.de/en
mergerarbitrage@berenberg.com