ARBITRAGE

Characteristics of Risk and Return in Risk Arbitrage

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After the announcement of a merger or acquisition, the target company's stock typically trades at a discount to the price offered by the acquiring company. The difference between the target's stock price and the offer price is known as the arbitrage spread. Risk arbitrage, also called merger arbitrage, refers to an investment strategy that attempts to profit from this spread.

If the merger is successful, the arbitrageur captures the arbitrage spread. However, if the merger fails, the arbitrageur incurs a loss, usually much greater than the profits obtained if the deal succeeds. In this paper, we provide estimates of the returns to risk arbitrage investments, and we also describe the risks associated with these returns.

This paper analyzes 4,750 mergers from 1963 to 1998. Results indicate that risk arbitrage returns are uncorrelated with market returns in flat and appreciating markets. However, during market downturns, the correlation between market returns and risk arbitrage returns increases.

Transaction costs account for most of the difference between the estimates in this paper and those obtained in other studies. Although the authors' estimate is far less than estimates reported in other studies, it is still substantial. The paper postulates that this excess return reflects a premium paid to risk arbitrageurs for providing liquidity.

eliminate the risk of experiencing investment losses.

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