



Boost Returns by Easily Recognizing What's Beneath the Surface of a Stock

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Profit from Special Situations – Risk Arbitrage

November 12, 2008

In part five of the series on special situations, I'll briefly present the idea of risk (or merger) arbitrage.

*This series is based on the book *You can be a stock market genius!* so for additional information, be sure to read it yourself.*

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so for additional information, be sure to read it yourself.

New here? Catch up on the series.

Part 1: Odd Lot Tenders (http://www.oldschoolvalue.com/blog/special_situation/profit-from-special-situations-stock-tenders/)

Part 2: Book review (<http://www.oldschoolvalue.com/blog/book-review-and-readings/you-can-be-a-stock-market-genius/>) on *You can be a stock market genius!*

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Part 3: Spinoffs (http://www.oldschoolvalue.com/blog/special_situation/profit-from-special-situations-spinoffs/)

Part 4: A Look at Dr Pepper Snapple (<http://www.oldschoolvalue.com/blog/stock-analysis/dr-pepper-snapple-dps-spinoff/>)

Quick Brush Up

There is no point in buying a stock speculating that the company will be taken over. Risk arbitrage, which I will just refer to as arbitrage, involves the purchase of a stock *after* the merger announcement.

The book quickly gets to the point and tells the reader to avoid arbitrage because of the high levels of uncertainty involved in the process. However, I would like to add that by waiting and choosing wisely, you will be able to make very good gains off low risk.

The basics and overview can be found in an earlier post here

(<http://www.oldschoolvalue.com/blog/investing-strategy/arbitrage-rundown/>). It covers topics such as why you should consider arbitrage in your investing strategy, the types of homework you

should do, what to look for and the risk involved.

Previous Arbitrage

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technologies (http://www.oldschoolvalue.com/blog/special_situation/new-merger-arbitrage-with-jaz/) and currently Puget Energy (http://www.oldschoolvalue.com/blog/special_situation/update-puget-energy-psd-arbitrage/). I eeked out a tiny profit (<http://www.oldschoolvalue.com/blog/investing-strategy/aquila-great-plains-merger-review-ila-gxp/>) with Aquila and documented a vital mistake with this transaction, successfully did not partake in the Jazz merger due to the illiquidity and stock for stock condition, and would like to see the Puget Energy merger close out soon.

Keep Things Simple

There are also different forms of arbitrage.

- Cash only transactions where stock is paid for in cash
 - Stock for stock where the shareholders are given stock of the other company
 - Partial stock where a percentage of the share is converted to stock and cash
 - Purchase merger securities (the Greenblatt recommends looking into warrants)
-

Focus On This Checklist

Before you invest any cash, you should be able answer all the items below.

1. Make sure both parties have done their due diligence
 2. Check management of both parties are trustworthy
 3. Financing and regulator approval is complete
 4. Get preliminary shareholder sentiment or controlling shareholder approval
 5. Obtain regulator (SEC, FCC, any and all) approval
 6. Get final shareholder approval at a meeting called for that purpose
 7. Check to see that insiders are continually vesting or buying shares
 8. Verify upside and downside risk is asymmetric by assigning potential upside to downside returns
-

Risks to Think About

- Calculate the potential upside and downside vs time. In the PSD merger, I've given the chance of success 90% with a gain of around 25% within 1 month. This is excellent odds.
- Unpredictability: Anything can happen in mergers. Financing can break down at the last

minute, the market can go crazy and take everyone with them, earthquakes could ruin the operation of the business etc etc.

- Allocate assets accordingly depending on your odds.

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But most of all, stick to investing in solid companies if you are unsure or feel uneasy with the whole notion.

Disclosure: Long PSD

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(<http://www.oldschoolva.com/bullet-checklist/>)



How to Analyze and Profit off Going Private Transactions
(<http://www.oldschoolva.com/going-private-transactions/>)




What to Do with Your Stock Tender Offer
(<http://www.oldschoolva.com/stock-tender-offer/>)



ROI Alert: Details Behind Why I Bought PATH
(<http://www.oldschoolva.com/path/>)



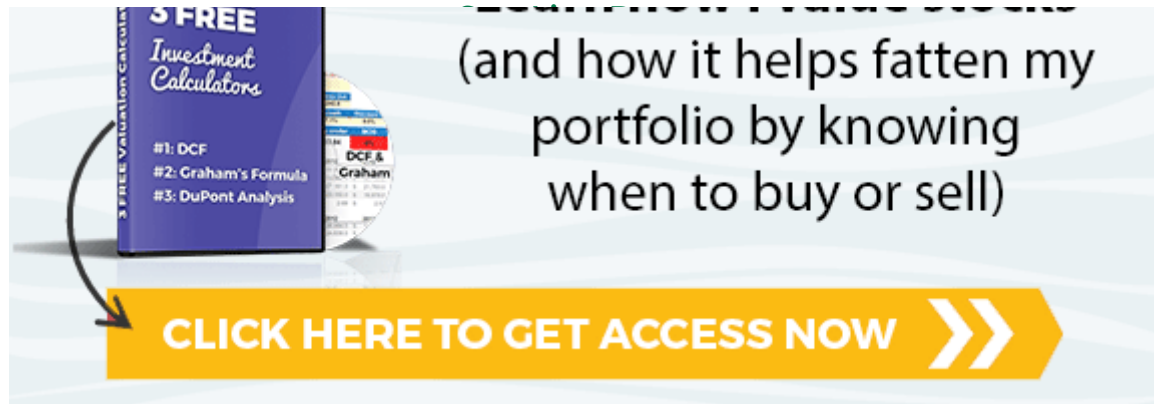
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(<http://www.oldschoolva.com/infu-update-and-some-wise-rules/>)



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Jae Jun · 8 years ago

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Ben · 7 years ago

Nice written post!

I really like your checklist, it's very good to see the important points at one place! I will bookmark this page to use it later on! Thanks!

..= Ben´s last blog ..Betting Arbitrage without any risk with the Boss Buster! updated Wed Oct 7 2009 2:56 pm CDT =-.

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Jae Jun · 8 years ago

Fat Pitch Financials also has a special situations section (you have to pay) that has lots of information on the latest tenders.

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Sivaram Velauthapillai · 8 years ago

Thanks for the suggestion



THANKS for the suggestion...

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Sivaram Velauthapillai • 8 years ago

Do you know how to go about finding odd-lot tenders? Any thoughts?

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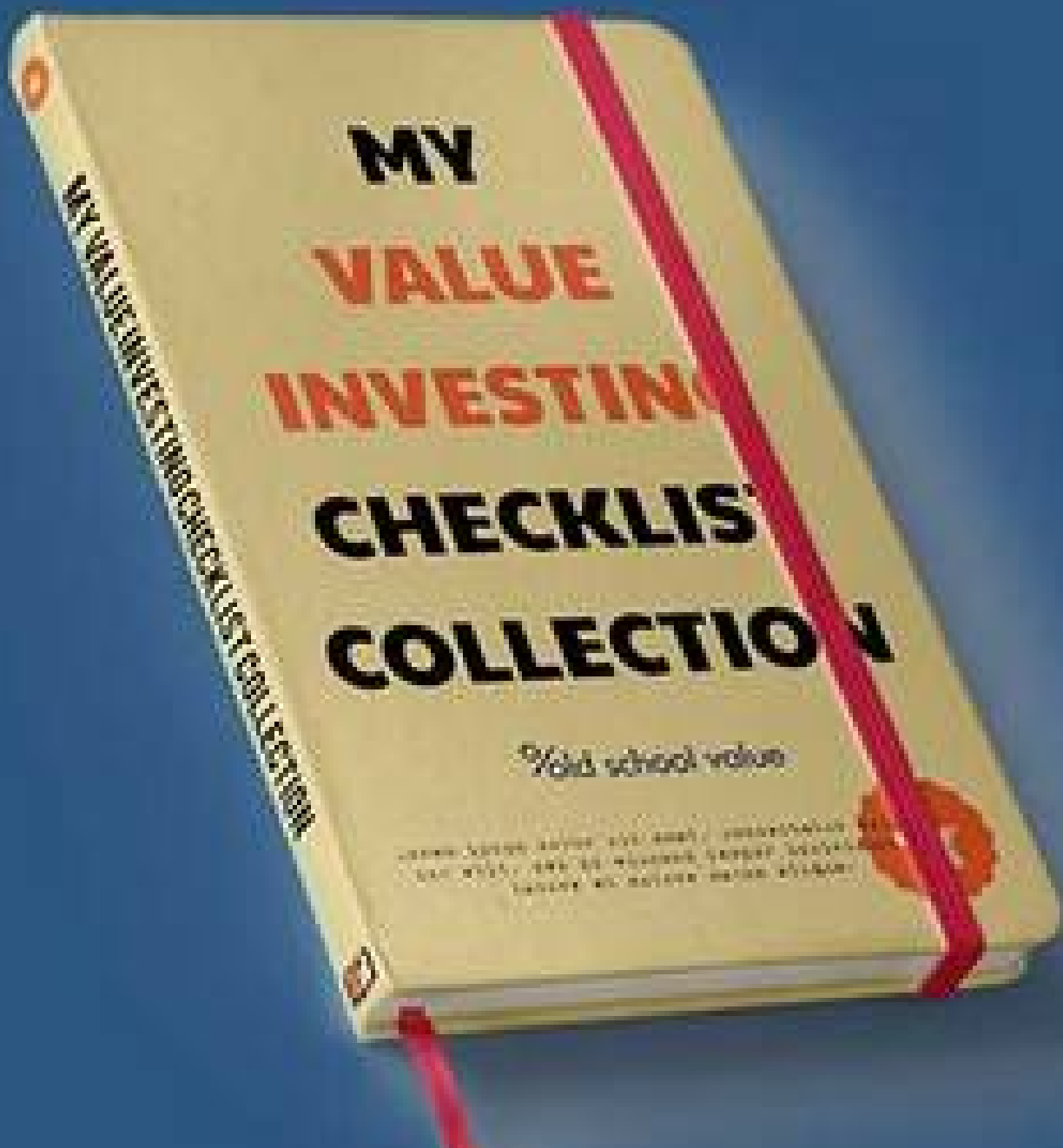
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Our Mission



(<http://www.oldschoolvalue.com/about.php>)
My wife and I are Christians and our focus is to love God and love people. We are proud supporters of Compassion and are grateful to be sponsoring 8 children.

We are just two ordinary people and understand that we cannot change the world. However, that doesn't mean we can't try. Call me crazy, but our dream is to one day sponsor 1,000 children around the world. Thank you for helping us achieve this one child at a time.

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