DECEMBER 2024 COMMENTARY

Oak Hill NexPoint Global Merger Arbitrage Fund

Market Comments

The U.S. equity markets demonstrated remarkable resilience in Q4 2024, building on a strong year of performance. The S&P 500 posted an impressive annual gain of 25.02%, marking its best two-year streak since 1998. This robust performance was largely fueled by significant advancements in artificial intelligence (AI) technologies and consistent economic expansion. The technology sector, spearheaded by companies like Nvidia and Tesla, was a standout performer, driving a substantial portion of the market's gains.

Investor sentiment received an additional boost following the re-election of President Donald Trump. Expectations of pro-business policies, including potential tax cuts and deregulation, created a favorable environment for equities. However, the market's gains were not uniformly distributed. As of year-end, the ten largest stocks in the S&P 500 represented 38% of the index and 34% of the Russell 1000, reflecting an unprecedented level of concentration. This poses challenges for active portfolio managers attempting to replicate the index within the bounds of diversification regulations.

There are signs that market breadth may be improving, though disparities remain. While the S&P 500 market-cap-weighted index was up 25.02%, the equal-weighted index rose just 12.78% for the year. This uneven performance underscores systemic risks associated with high concentration in a few dominant companies, complicating risk mitigation strategies for passive and active investors alike. A broader market would support both business confidence and consumer sentiment, providing a solid foundation for economic growth.

Investment-grade bonds faced a challenging landscape in 2024, with the Bloomberg U.S. Aggregate Bond Index delivering a modest 1.25% return for the year. After peaking at over 5.0% mid-year, performance waned due to a significant rise in the 10-year Treasury yield, which ended the year at 4.57%. Notably, this marked an unprecedented rise in government bond yields following a 100 basis point cut in the federal funds rate since September 2024.

Looking ahead, market analysts expect the U.S. economy and corporate earnings to continue growing, supporting positive equity performance. However, potential risks include rate volatility and inflationary pressures, exacerbated by uncertainty surrounding fiscal policies under the Trump administration. Fed expectations have shifted significantly over the past three months. The market now anticipates a more modest path of rate cuts, with the federal funds rate projected at 3.75% by December 2025, compared to earlier expectations of 3%.

A policy misstep, such as unexpected Fed rate hikes, could trigger a more negative scenario for risk assets. Nonetheless, we expect technology to remain a key driver of profit margin improvements and earnings growth as AI adoption accelerates. AI's transformative impact is expected to surpass previous technological revolutions, including the internet and mobile computing, delivering productivity gains across all sectors.

While we maintain a structurally positive view of the U.S. economy and equity markets heading into 2025, extended valuations warrant caution. The S&P 500's lack of a significant drawdown in 2024 underscores the potential for increased volatility in 2025. Surprisingly, the elevated forward price-to-earnings (P/E) ratios are not limited to the "Magnificent 7" but are observed across the broader market. This highlights the need for earnings growth to sustain further stock price appreciation. While we remain optimistic about U.S. stocks in 2025, bolstered by anticipated solid GDP growth, accommodative financial conditions, and resilient consumer spending, investors should remain vigilant about potential risks such as inflationary pressures, policy uncertainties related to Trump, and economic imbalances in China.

M&A Update

Momentum in North American and European M&A activity observed in the first half of 2024 has persisted into the fourth quarter despite slightly softer deal volume associated with the uncertainty surrounding U.S. elections. North America recorded over $2 trillion in announced M&A volume in 2024, making its second-highest level in the last five years. Announced M&A volume was steady across both halves of 2024 with the first half tilted more towards mega-deals ($10B+) and the second half leaning more towards mid-cap deals ($1B-$10B). Globally, M&A activity increased 12% year-over-year, surpassing $3.5 trillion, with consistent growth across all regions. North America remained the largest contributor, accounting for 58% of global deal volume.

Stock consideration gained prominence in 2024 as many acquirers' shares traded near 52-week highs. All-stock transactions represented one-third of all deals valued at over $200 million, with a significant uptick in the latter half of the year. Rising interest rates, coupled with strong equity markets driving elevated acquirer share prices, made stock an attractive currency for dealmaking. This trend is expected to continue in 2025, supported by market strategists' forecasts of positive absolute returns in equities, further reinforcing stock-based deal activity.

North American transactions valued between $1 billion and $5 billion saw notable growth in the second half of 2024, increasing 22% over 2023 levels. This resurgence spanned diverse sectors, with six out of nine industries reporting year-over-year increases in M&A volume. Among the top ten announced deals in North America in 2024, the technology, media, and energy sectors were particularly prominent, with significant growth in $1 billion+ deal announcements. Notably, $1 billion+ announcements in the technology and healthcare sectors reached near-record levels, trailing only the peak observed in 2021.

Financial Sponsors activity increased significantly with announced deals worth nearly $700 billion in 2024. The second half ended noticeably stronger, with a greater volume compared to the preceding 4 half-year periods. Financial sponsors were highly active in the public markets which led to 34 targets larger than $1 billion being taken private in 2024, a 17-year high in North America. With the potential for additional interest rate cuts and improving market sentiment in 2025, Financial Sponsors are well-positioned to push transaction volumes higher.

The M&A market is experiencing both cyclical and structural recovery, with expectations of a multiyear rebound supported by record-high stock market levels, a solid economic backdrop, lower interest rates, open capital markets, increased corporate confidence, and growing pressure on private equity to deploy capital and monetize investments. For the first time in decades, central banks are cutting rates due to declining inflation rather than economic slowdowns, creating a favorable environment for M&A. Lower debt financing costs in a soft-landing scenario should encourage sponsors to deploy dry powder and corporates to utilize excess capital. The conclusion of the U.S. elections is an additional positive catalyst.

A Trump presidency, coupled with a Republican-controlled Senate, has resulted in regulatory personnel changes that increase the likelihood of transactions being approved without undergoing a second request, potentially boosting corporate appetite for larger deals. Additionally, the extension of the Tax Cuts and Jobs Act would provide clarity on corporate tax rates—an essential factor in deal valuation. Morgan Stanley's base case projects a 50% increase in M&A announcements for 2025, with its bull case suggesting a more substantial 78% rise.

"The table is pretty much set for a robust 2025," said Dan Grabos, head of Americas M&A at Barclays Plc in New York. "We're past the U.S. election, and there's underlying optimism about a pro-growth, less-regulated environment. I expect transactions across the spectrum, from transformational $10 billion-plus deals to increased mid-cap activity." Tom Miles, global co-head of M&A at Morgan Stanley, echoed this sentiment, stating, "We anticipate a more favorable regulatory environment under a Trump administration, encouraging companies to revisit larger, transformational mergers and revitalizing that segment of the market."

Regulatory Update

The fourth quarter was marked by substantial regulatory activity in M&A, including the closure of several high-profile transactions, a DOJ antitrust lawsuit, two blocked mergers, and a controversial decision by the Committee on Foreign Investment in the United States (CFIUS). Specifically, five deals under "second request" review successfully closed during the fourth quarter with no enforcement action. The Federal Trade Commission (FTC) approved ConocoPhillips' $22.9 billion acquisition of Marathon Oil Corp, Walmart's $2.3 billion purchase of Vizio Holdings Corp, and Novo Holdings' $16.2 billion acquisition of Catalent Inc. Additionally, the DOJ cleared First Advantage's $2.0 billion acquisition of Sterling Check, which was finalized in November, and Waste Management's $7.7 billion acquisition of Stericycle Inc. Despite these closures, five additional deals under late-stage second requests remain pending, with outcomes—either clearance or litigation—expected in Q1 2025.

In November, the DOJ, in collaboration with attorneys general from Maryland, Illinois, New Jersey, and New York, filed a civil antitrust lawsuit seeking to block UnitedHealth Group's proposed $3.3 billion acquisition of Amedisys Inc., a leading home health and hospice services provider. The DOJ argued that this merger, combined with UnitedHealth's 2023 acquisition of LHC Group, would solidify UnitedHealth's dominance in these markets, potentially controlling over 30% of services in several states. This, the DOJ contends, would reduce competition, increase costs, and lower the quality of care. UnitedHealth and Amedisys have extended their merger agreement deadline to December 31, 2025, with a regulatory breakup fee of $275-$325 million contingent on specific asset divestitures by May 1. Both companies have expressed a firm intention to contest the lawsuit, asserting the transaction's pro-competitive and innovative benefits. Optum, UnitedHealth's subsidiary, stated that the transaction "would be pro-competitive and further innovation," and plans to "vigorously defend against the DOJ's overreaching interpretation of the antitrust laws.“

In April 2024, the FTC filed a lawsuit to block Tapestry, Inc.'s proposed $8.5 billion acquisition of Capri Holdings. The FTC argued that merging Tapestry's brands—Coach, Kate Spade, and Stuart Weitzman—with Capri's brands—Michael Kors, Versace, and Jimmy Choo—would significantly reduce competition in the accessible luxury handbag market, potentially leading to higher prices and fewer choices for consumers. In October, U.S. District Judge Jennifer Rochon granted the FTC's request for a preliminary injunction, effectively blocking the merger. The court agreed that the merger would lessen competition in the accessible luxury handbag market. Following the court's decision, both companies initially planned to appeal. However, in November, Tapestry and Capri mutually agreed to terminate the merger agreement, citing the legal uncertainties and the unlikelihood of resolving the regulatory challenges before the deal's deadline of February 10, 2025.

The FTC secured another victory in December when Judge Adrienne Nelson ruled against Kroger's $24.6 billion merger with Albertsons. The court determined that the merger would significantly reduce competition in the traditional supermarket sector, even after Kroger's proposed divestiture of 579 stores to C&S Wholesale Grocers. Judge Nelson emphasized that antitrust laws should not allow otherwise unlawful mergers simply to enable smaller firms to compete with industry giants. In the aftermath, Albertsons filed a lawsuit against Kroger, alleging a failure to use "best efforts" to secure regulatory approval and seeking billions in damages.

On January 3, 2025, President Joe Biden blocked the proposed $14.9 billion acquisition of U.S. Steel by Japan's Nippon Steel, citing national security concerns. When the deal was announced in December 2023, opposition to Nippon Steel's acquisition of U.S. Steel never made much sense on the merits. Economically, the deal was relatively small—involving just the nation's third-largest steelmaker—and early indications were that its Japanese purchaser would help the long-suffering U.S. Steel modernize plants. The national security justifications were similarly empty: Japan is one of the United States' closest allies, and even if Nippon Steel were to shutter all of U.S. Steel's factories, that impossibly insane move wouldn't affect the United States' defense-related steel needs in the slightest. So, a CFIUS approval was a no-brainer until politics took over. Unfortunately, Biden's decision exposes the CFIUS process as a permanent tool of politicians, unreasonably expands the scope of what is considered national security and forces the U.S. to put in writing that a Japanese buyer of a steel company on U.S. soil is a national security threat, which is simply untrue and detrimental to American security. It is noteworthy that Japanese companies operate numerous steel assets on U.S. soil prior to this deal. Nippon Steel and U.S. Steel criticized the move as a violation of due process and are considering legal action.

Regulatory Update (Continued)

In December, President-elect Donald Trump tapped Gail Slater, an antitrust veteran and economic adviser for JD Vance, to lead the Department of Justice's antitrust division and take charge of a full docket of blockbuster monopoly cases against companies including Google, Visa, and Apple. Slater is expected to continue the department's crackdown on Big Tech, including cases brought during Trump's first term in the White House. Slater was an antitrust attorney at the FTC, an advisor to the Democratic FTC Commissioner Julie Brill (appointed by Obama), and a member of Trump's former White House Economic Counsel.

Trump filled his last major antitrust position by appointing current FTC Commissioner Andrew Ferguson as Chair in December. We think this selection settles some lingering questions about how populist antitrust enforcement will be in Trump 2.0, and the signals are constructive for dealmaking. Trump will designate him as Chairman on day 1, although Republicans will not take a 3-2 majority at the agency until the confirmation of Mark Meador for Lina Khan's seat as a commissioner. Our expectation heading into the election was that Trump would take antitrust in a traditional Republican pro-business direction, seeking to eliminate the headwinds from the Biden Administration's approach and unleash pent-up deal flow.

Ferguson's agenda has some populist elements, but they are very much confined to issues around speech, content moderation, and alleged censorship by Big Tech. Meanwhile, his views on competition policy and FTC regulatory questions are more clearly and traditionally conservative. The major points of his agenda, in his own words, are to "reverse Lina Khan's anti-business agenda" and specifically "stop Lina Khan's war on mergers," "hold big tech accountable and stop censorship," "protect freedom of speech and fight wokeness," and "fight the bureaucracy to implement President Trump's agenda."

Outside of big tech, we believe that the pendulum is swinging back in a more pro-business direction on antitrust, and that Trump's enforcers will try not to chill dealmaking activity. This doesn't mean that there will be no resistance to deals—Biden's antitrust enforcers have brought some tenuous challenges, but they've also prevailed in court on challenges to mergers including Spirit-Jet Blue, Tapestry-Capri, and most recently Kroger-Albertsons. Where there are real competition concerns and winnable cases, Ferguson and Slater won't necessarily sit on their hands, and Ferguson has voted in favor of some merger challenges this year. But they are expected to avoid discouraging unproblematic deals.

The US is not alone in its more pro-business regulatory environment with the UK and EU announcing more constructive regulatory environments. In the UK, the Competition & Markets Authority ("CMA") is looking at ways to clear more deals without harming consumers and forcing divestitures after Prime Minister Keir Starmer called on regulators to cut red tape to spur growth. The CMA said that it will review whether it can use a broader range of behavioral remedies during its merger review process to avoid a forced sale of parts of businesses. The move would mark a break from the past, which focused primarily on forcing companies to make significant structural changes before clearing a deal. Sarah Cardell, the CMA's chief executive officer, said in a speech in November that "only a truly problematic merger, where the harm to businesses and consumers cannot be effectively addressed through remedies, should not proceed." Furthermore, in her speech, Cardell talked about merger enforcement making room for "UK Champions." Her language echoes the European Commission's plans to elevate European champions for the same purpose. Regulators in Europe and the US recognize that companies need scale to compete in global markets and are positioned to approve mergers that benefit local rivals.

The Fund maintains a high level of confidence in its investment strategy, designed to deliver investors low-volatility returns that are uncorrelated with broader fixed-income and equity markets. By prioritizing deals with appealing spreads, regulatory obstacles that can be managed effectively, and shorter expected closing timelines, the Fund strives to provide investors with a favorable risk-reward profile. We want to express our sincere appreciation to our shareholders for their ongoing support.

Risks & Disclosures

Market commentary contains information about prior investments made by the Portfolio Manager of the Fund. This information was prepared by the Portfolio Manager based on its experience in the industry and on assumptions of fact and opinion as to future events which the Portfolio Manager believed to be reasonable when made. There can be no assurance that the Portfolio Manager and/or the Fund will be as successful as these earlier investments. Prior investment returns are not indicative of future results. It should not be assumed that investment recommendations made in the future will be profitable or will equal the performance of the securities included herein.

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