2012 Research Report

Introduction to Activist Investing

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This report provides an overview of activist investing and also addresses the role of activist funds in investor portfolios and the associated risks of the investment strategy. Four appendices provide further detail on activist investing: case studies of four activist funds and their targets appear in Appendix A, Appendix B discusses some of the relevant rules and regulations in the United States, Appendix C presents data on activist managers from the Cambridge Associates database, and Appendix D summarizes some of the major findings of an academic study on hedge fund activism based on analysis of public filings. Though sections of this report discuss activities and regulations specific to the United States, similar considerations would apply in other countries.

What Is Activist Investing?

Activism is an investment strategy that looks to proactively improve shareholder value by influencing a company's corporate governance structure and/or corporate strategies. Activists look to extract value from companies in various ways, ranging from operational changes to the sale of a company division or even the company itself.

Activists are value investors in that they seek to identify companies that are rich in assets and have a sound underlying business model, but are for some reason trading below their "intrinsic value" and/or potential. However, unlike pure value investors that passively wait for the market to recognize the value of a stock, activists look to engage management and push for changes that will realize a stock's value over a more accelerated time horizon, thereby generating a higher internal rate of return. Although investments are typically minority holdings in traded equity and/or debt securities, this more "active" approach is in some ways similar to that of private equity investors that seek to control or influence a board's decisions on critical strategic and financial matters. This is especially true for activists pushing for operational improvements (see Figure 1 for a comparison of an operations-focused activist strategy and a generic leveraged buyout strategy on several metrics, as well as the case studies on Trian and Cevian in Appendix A). Activist managers can be broadly categorized in one or more of the following ways:

- **Operational.** Activists that focus on companies' income statements, looking to boost revenues and profit margins by, for example, improving operational efficiency, cutting costs, and re-directing resources toward higher margin projects.
- **Financial/Transactional.** Activists that focus on companies' balance sheets by effecting changes in capital structure through asset sales, spin-offs, and stock buybacks. In addition, they might attempt to pressure companies that they view as attractive acquisition candidates to proactively pursue opportunities to sell themselves.
- **Governance-Oriented.** Activists that tend to look for companies whose incentive structures and practices are sub-optimal with respect to shareholder interests by focusing on issues such as executive compensation and board elections.

Other contributors to this report include John Cornish and Karl Wichorek. Helpful context and background was provided by Jess Bolkcom and Brian Schorr of Trian Partners, Professor Alon Brav from Duke University's Fuqua School of Business, Dick Elden of Lakeview Investment Manager, and David Henderson of Cevian Capital Limited.

Figure 1. Comparison of Operations-Focused Activist Investing and Leveraged Buyout Investing

	"Operations-Focused" Activist Investment Strategy	Generic Leveraged Buyout Strategy
Opportunity Set	Thousands of public companies that can be bought opportunistically	Limited deals per year (~300) that require willing sellers and potentially an auction process
Valuation	No control premiums	Control premiums
Risk Management/ Leverage	Portfolio companies generally investment grade and low leverage is employed	Dependent on capital markets and can employ significant leverage
Liquidity	Can be highly liquid depending on manager terms; flexibility in exiting investments through public markets	Interim liquidity rare and exits generally depend on capital markets being open
Investment Horizon	Typically one to five years	Typically four to ten years
Control/Value Creation	Some board representation and influence	Full control and board representation: owner-operator partnership
Due Diligence	Extensive due diligence; access to insider information on occasion	Extensive due diligence and company access; access to insider information
Fees	Limited fees	Potential fees include deal fees, structuring fees and monitoring fees

Some of the most common activist targets include:

- Profitable companies with low debt levels and large cash reserves that are not being appropriately reinvested into the business or returned to shareholders.
- Companies with strong core businesses that have been pursuing value-destroying growth and acquisition strategies.
- Companies with excessive cost structures and inefficient operations relative to peers.
- Companies with distorted incentives such as excessive executive compensation packages.

Human capital–driven companies such as consulting or asset management firms are generally poor candidates for activism given the potential for a mass exodus of talent.

Fund Structure and Terms

Activist investment funds are usually modeled after the typical hedge fund structure in terms of fees and liquidity. In general, activist funds have a longer lock-up period than the average hedge fund to coincide with their relatively longer investment time horizons.

The hedge fund structure is conducive to activist investing for a number of reasons. First, hedge funds do not have portfolio diversification restrictions on position sizes. This flexibility is optimal for activist investors that often buy significant ownership stakes in a company. In addition, the hedge fund structure allows activists to constrain investor redemptions, giving the activist the security to pursue long-term investments. Moreover, the typical fee structure of hedge funds, in which the manager receives a performance fee on top of a management fee, is a valuable incentive for managers to invest the time and money required to carry out successful activist campaigns. It is important to note, though, that unlike many traditional hedge funds that trade in and out of numerous positions, activist funds often hold long positions for several years in a relatively concentrated portfolio. In addition, they tend to be long-only or long-biased investors with limited short exposure, often in the form of market indices.

In addition to hedge fund vehicles, activist managers sometimes offer private equity–style drawdown types of vehicles, but investor demand for such structures has been limited so far. Finally, activist managers often raise single-company investment pools to increase buying power in companies where they see very significant upside potential.

Investor Base

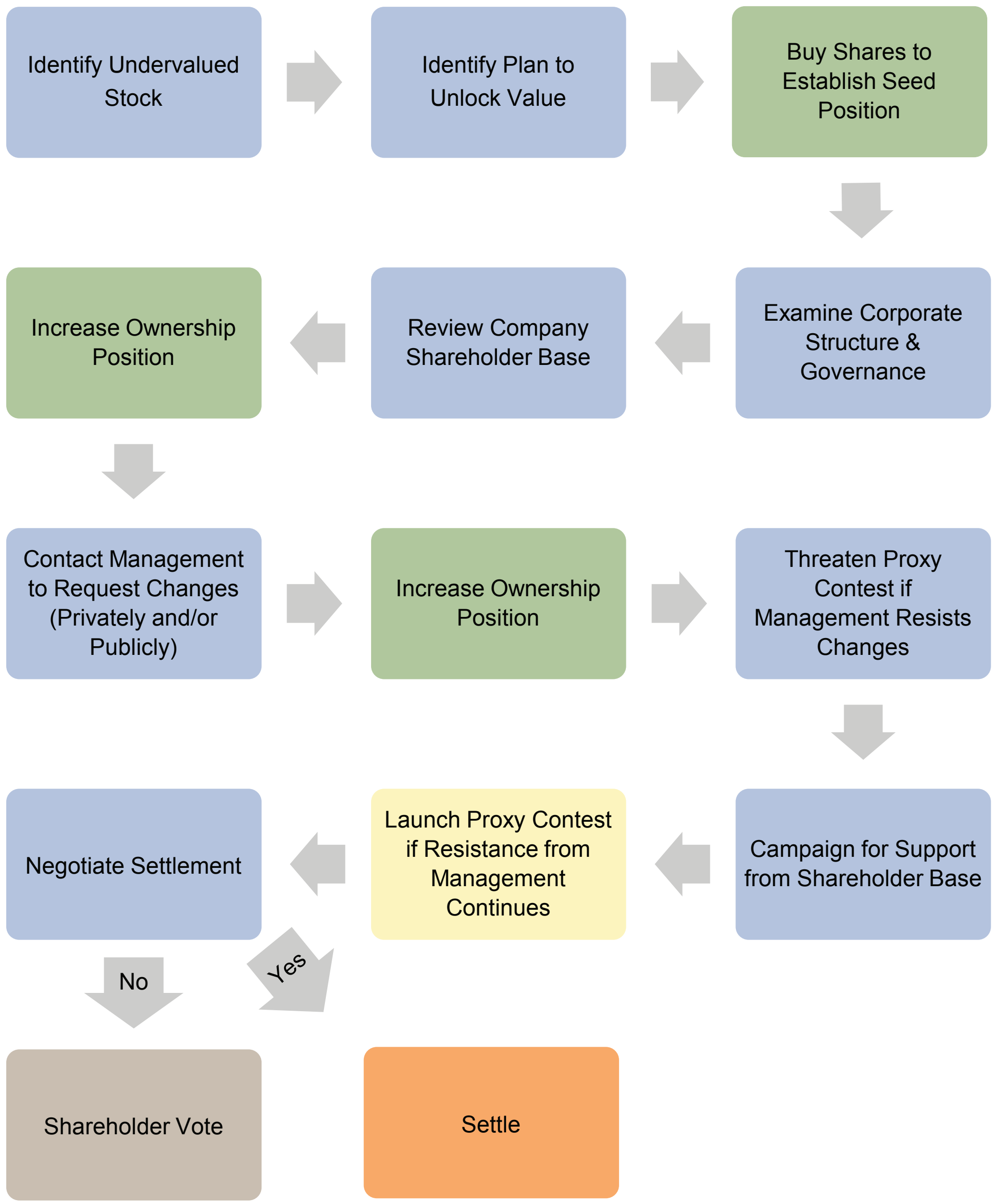
In recent years, the activist investor base has grown and diversified. Support for activist funds by large investors seeking to improve corporate governance, such as the California Public Employees' Retirement System (CalPERS), has attracted other institutional investors to the space. Activist funds have also attracted the interest of a number of hedge funds-of-funds looking for new strategies to diversify their portfolios.

Activist Investment Approach/ Process

The specific approach to activist investing varies across managers. Some asset managers invest exclusively in companies intended from the outset as activist targets, while others may only use activism as an occasional tool or a method of last resort. Once managers decide to become active, they typically begin their involvement by building a relationship with management and other shareholders to convince them to implement their recommendations. Such activists often write a white paper detailing their analysis of the business and recommendations and make presentations to the company to advocate for changes. Some activists start with a friendly approach, and if that is ineffective, will switch to a more aggressive campaign to drive change, such as publishing their white paper or letters to management for other investors to see. As a last resort, activist investors may initiate a proxy contest to replace members of the board of directors, or at least threaten to do so if the company does not agree to a settlement, which may include seats on the board and certain committees as well as changes to the company's operations, bylaws, or financial practices. Some investors start their activism with an outright hardline approach, particularly if they have conviction in their ability to create change quickly and effectively through a process of settlement or winning board seats. Figure 2 outlines a typical path in activist investing.

When investing in a target company, some activist managers will take a smaller-sized "seed" position, which they will only increase in size to a larger "core" position if the valuation becomes more attractive (e.g., the stock falls further in price or the manager becomes

Figure 2. Typical Activist Investment Process



convinced that management and other shareholders would be willing to consider its plan). However, a manager that has made such an investment might also sell the seed position without activist involvement if the stock appreciates substantially. Furthermore, an inventory of seed positions can serve as a source of liquidity in times of stress.

In the United States, investors that take large positions in public company stocks must follow certain procedures. Within ten days of owning 5% or more of a public company's stock, investors are required to file a Schedule 13D when they have plans to influence the strategic direction of the company (or a Schedule 13G otherwise). A 13D filing, which is available to the public, informs other investors of the acquirer's intentions for the company. Such filings are a good opportunity for activist investors to establish credibility and gain the support of other shareholders by publishing their white papers on a company and their letters to management. Similar filing requirements are in place in several other countries.

Activist investors sometimes form alliances with other investors to achieve an objective. While activists occasionally have conflicting plans for a company, they often tend to collaborate. Working together can increase their voting power and expedite implementation of their agendas. The 2006 forced sale of Knight Ridder, the second-largest chain of newspapers in the United States at the time, is one example. Two days after the largest shareholder, Bruce S. Sherman of Private Capital Management, L.P, announced his activist campaign, two other significant investors (Southeastern Asset Management and Harris Associates L.P.) joined with the same agenda; in just weeks, the activist investors pressured Knight Ridder into selling the company to McClatchy (MNI).[1]

Activist managers need to be especially wary about their communication with fellow shareholders when engaging a U.S.-listed company because evidence of group activity not revealed to the U.S. Securities and Exchange Commission through a joint 13D filing can sabotage a venture. The consequences of failing to register as a group can range from securities fraud claims against the activist to a preliminary injunction against a proxy contest.[2] Appendix B of this paper provides an overview of rules and regulations in the United States as they relate to the history of activist investing.

Successful activism requires a pro-shareholder regulatory environment, and some environments are more shareholder friendly than others. Several of the most compelling pro-shareholder regulations can be found in Canada, the Scandinavian countries, and the United Kingdom. For example, candidates for boards of directors at Swedish companies are chosen by a nomination committee made up of the largest shareholders. In addition, there are annual elections for all directors. In such environments, activist investors are finding it easier to win director positions.

Some of the most challenging environments, particularly for foreign activist investors, can be found in Japan and South Korea. In Japan, the country's corporate culture makes it hard for activist investors to influence strategic decisions to unlock shareholder value. The *keiretsu* system of sets of companies with interlocking

[1] Thomas W. Briggs, "Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis," *Journal of Corporation Law*, Vol. 32, No. 4, Summer 2007.
[2] Howard O. Godnick and William H. Gussman, "Beware the Counterattack Against Activist Investors: The Group Trap," Schulte Roth & Zabel, Fall 2006.

business relationships and shareholdings has safeguarded companies from shareholder undertakings (see the case study on The Children's Investment Fund and J-Power in Appendix A). Traditionally, Japanese shareholders have believed in a greater social purpose for corporations, not one limited to profitability. Such differing cultural beliefs and motivations can make it difficult for activists to gain support for their causes.

In South Korea, strong nationalist sentiments have thwarted some Western activist attempts. In particular, the nation's *chaebol* corporate system—characterized by family-controlled conglomerates with strong ties to government agencies—can be daunting for investors looking to become active *vis-à-vis* company managements.

Friendly Versus Hostile Activists

The term "hostile" is often used in the industry to describe activist tactics such as proxy contests and takeout offers that are unwelcome by the target companies. Many activists that engage in such tactics reject the term "hostile" because they believe it evokes an unfortunate association with derogatory public relations campaigns. While some activist investors in the marketplace may resort to such tactics, institutional-quality investment managers employing activist strategies take a professional approach, arguing for change at a company based on data such as operating metrics and stock performance, while clearly explaining disagreements with management's decisions and strategic vision.

Debt-for-Control/ Loan-to-Own Strategies

While this report focuses on equity-oriented activism, it should be noted that activism is common within the distressed debt space. Targets are typically financially troubled companies in need of liquidity to continue operating. Distressed debt players purchase the debt of these corporations and then use the leverage embedded within debt instruments to acquire ownership of companies through a debt-for-equity conversion during a company's reorganization or through credit bids in a company's asset sales. Debt-oriented activism can be attractive for the following reasons:

- There is some downside risk protection for activist investors given asset value support.
- Distressed debt markets lack the transparency of public equity markets and this quality, paired with the distressed financial situation of target companies, often allows investors to gain control of companies at discounts to enterprise value.
- The absence of disclosure requirements on distressed debt purchasers can allow investors to quietly accumulate large positions in a company's debt.
- As large debt positions are accumulated, investors are able to influence the possible economic outcomes.

Investing in Activist Funds

Investors in hedge funds and even some long-only actively managed funds may already have exposure to the activist investing strategy; as previously noted, funds that engage in leveraged buyouts also have some similarities to activist funds. The number of dedicated activist funds (or funds that engage in activism as a core strategy) is small and the institutional-quality universe even smaller. Where investors have a strong desire to gain dedicated exposure and have high conviction in a particular fund, we outline below the role activist funds could play in a portfolio and some of the primary risks associated with investing in such funds.

Role in Portfolio

Activist managers come in many forms. Some managers are hostile; others adopt a friendly approach toward targeted companies. Some managers offer hedge fund vehicles; others offer private equity drawdown types of vehicles. Some managers hedge their portfolios mainly through baskets, indices, and derivatives; others adopt a long-only approach. Finally, a number of managers invest in equity and/or debt instruments. Despite the likelihood of debt instruments, activist strategies, independent of vehicle, should be considered part of a portfolio's growth engine.

Activist funds offer the potential for alpha generation principally through long-only exposures. For the most part, these funds appear to exhibit relatively high correlation to equity markets along with significant volatility. Therefore, investors should generally look elsewhere for diversification benefits such as downside protection and volatility dampening.

In Appendix C, we provide data on and analyze the performance of activist managers in the Cambridge Associates database. These activist investors operate both in the United States and abroad. Some managers, such as Cevian Capital Limited, Starboard Value, and Trian Fund Management, employ activism as part of their core investment strategy. Others, such as Jana Partners, Pershing Square, and Third Point, occasionally engage in activism but have been involved in a number of high-profile cases. Looking at the five-year period ending June 30, 2012, the median manager in our universe of 14 with performance for the full period had an average annual compound return of 2.1%. This compares favorably to the returns of equity and hedge fund indices over the same period: the MSCI World Index returned -3.0%; the S&P 500 Index, 0.2%; and the HFRI Equity Hedge (Total) Index, -0.7%.

Risks

Value Added. Whether activists achieve long alpha generation as a group is a question that is difficult to answer. Databases on activist managers are by and large limited and inadequate. Funds that engage in activism are diverse and can range from funds that occasionally engage in activist campaigns in one way or another to funds whose core strategy involves accumulating large blocks of shares and engaging in proxy fights. Another issue with activist fund databases is how funds classify themselves. For example, activists often classify their funds as event-driven funds or long/short value funds. The HFRX Event Driven: Activist Index, which is sometimes used to draw conclusions regarding the strategy's performance, is inadequate given that it consists of only six funds (as of second quarter 2012). As shown in Appendix C, certain activist managers have outperformed market indices over the most recent one-, three-, and five-year periods. However, for all of the aforementioned reasons and because the universe is small with a limited history, it is difficult to draw conclusions on the value added of activism as a strategy. As a result, an investor needs to have a high level of conviction in the ability of an individual manager to add value through an activist approach.

Asset/Liability Mismatches. Activist investing is characterized by position concentration and significant ownership of companies. A manager that does not match assets and liabilities carefully can end up having to satisfy redemptions by selling large blocks of shares in companies at less-than-optimal prices. Such selling activity can disrupt a long-term activist campaign to enhance value, reduce the credibility of the activist *vis-à-vis* companies and other shareholders, as well as put technical pressure on the prices of the shares being sold. In addition, managers that face such pressures might opt to raise gates if fund documents allow them to do so.

Pirate Capital is one example of a hedge fund that confronted an asset/liability mismatch. Founded by activist investor Tom Hudson in 2002, Pirate Capital managed four hedge funds employing activist strategies by the end of 2006, with total assets of close to $1.8 billion. After initially posting strong returns, a combination of key personnel departures and weak returns led to a large wave of investor redemptions. In September 2007, Pirate Capital effectively suspended redemptions on two of its activist funds by designating the stocks held as "special investments."

Headline Risk. Due to both the active and public nature of such strategies, investors should consider (a) whether investing in activist funds can potentially create conflicts with their stated objectives and principles and (b) whether investing in such strategies can have negative effects on their reputation. For example, some activists will incorporate cost-cutting efforts, such as laying off workers or outsourcing, into their approach. Others might publicly and harshly denounce management.

Can You Passively Replicate an Activist Portfolio?

Some in the industry have suggested that investors can passively replicate an activist portfolio by, for example, tracking regulatory filings (such as 13D or 13F* in the United States) and thereby achieve similar returns without incurring the fees. In our view, this argument is weak for the following reasons:

- Investors would need to monitor a specific fund, gather its holdings, and rebalance their portfolio over extended periods of time to replicate the fund's strategy. Such an exercise appears simple on paper, but we question whether a passive investor would have the discipline, patience, and conviction to replicate strategies for an extended period of time.
- In the United States, activists do not disclose a position until a 13D or 13F filing is submitted. Therefore, a passive strategy would not achieve the exact timing of purchases and sales of activist funds' positions. As discussed in Appendix D, evidence suggests that a significant portion of the abnormal returns generated by activism is achieved within a tight time frame surrounding the submission of a 13D filing.
- It would be difficult to impossible to replicate the use of derivatives, hedging, and fixed income instruments that a number of activist funds use as part of their strategy.

* Institutional managers with more than $100 million under advisement are required to file Form 13F quarterly with the U.S. Securities and Exchange Commission. The filing lists specific types of securities held by investors including: exchange-traded or Nasdaq-quoted stocks, equity options and warrants, shares of closed-end investment companies, and certain convertible debt securities.

Commitment/Value Traps. Activist funds can often get deeply involved with companies whose fortunes they cannot change for the better for one reason or another. For example, a manager might spend significant time and money to conduct a proxy fight and win board seats. The manager might fail to win board seats or face a situation in which management is reluctant to implement changes, dragging the activist into a long, arduous, and unfruitful process (see, for example, the Pershing Square and Children's Investment Fund case studies in Appendix A). Other times, an activist might underestimate a company's structural problems and/or the time and effort required to enhance its value.

Due Diligence. Investors should consider the risks associated with activist investing prior to making a commitment to a fund. In addition, an investor's due diligence process should include both quantitative and qualitative analysis. Investors should try to understand:

- Whether the fund has generated alpha over time;
- The asset/liability mix of the fund;
- The quality and concentration of the investor base;
- The level of experience of the fund's principals in activism;
- The fund manager's reputation and credibility within the activist community;
- The fund manager's network and infrastructure (e.g., does the fund have the necessary resources and expertise to conduct a successful proxy contest?); and
- The fund manager's approach (e.g., hostile versus friendly, operations focused versus transactions focused).

Finally, investors would benefit from looking into specific investments during their due diligence process to gain insights about the fund's approach and the team's ability to execute. Given the generally public nature of activism, investors should be able to accumulate significant information on specific cases.

Conclusion

Investors can look to activist funds for alpha generation on the long side of their portfolios over extended periods of time, making activist funds best suited for a portfolio's growth engine. As with any manager, investors should conduct thorough due diligence to ensure an understanding of risks such as the manager's ability to add value, asset/liability mismatches, headline risk, and the manager's ability to avoid value traps. Not all managers are equal and some are better positioned than others to execute activist strategies successfully. The ability of modern-day activists to influence boards, management, and other shareholders through effective communication, the power of their ideas, and a pro-shareholder regulatory environment are all critical for success. ■

Case Studies

This appendix discusses four different attempts by activist investors to influence particular companies. The examples have been selected to illustrate different approaches to activist investing as well as differing levels of success, and their appearance in this appendix is not intended to imply endorsement or criticism of the funds, their targets, or the activist strategies employed.

1. Trian and Heinz

Trian Partners, an activist fund of manager Trian Fund Management, took a position in Heinz in early 2006. In Heinz, Trian believed it had identified an underperforming company that could be significantly improved over the intermediate term. Trian first sought to engage management and later went public in a proxy fight over board representation. The firm eventually won two board seats and maintains a small investment in Heinz today.

Heinz as Potential Activist Target

Four factors in particular put Heinz in the category of stocks activists would have an eye on: stock underperformance, high costs, lack of focus and direction, and an inefficient capital structure.

Underperforming Stock. Heinz's stock had languished since 1998, when a new management team took over. Specifically, the stock returned a cumulative -11% in the eight years from 1998 to 2006, while the S&P 500 returned a cumulative 28%.

Returns also lagged those of comparable companies by substantial margins. Similarly poor performance was evident on a three- and five-year basis.

Trian noted that the company's revenue had declined by $360 million over the period (from $8.74 billion to $8.38 billion), while selling, general, and administrative (SG&A) expenses had increased by $242 million. At the same time, EBITDA had decreased by $275 million while earnings per share remained almost unchanged at $2.14.

Cost Cutting Opportunities. Trian noted that despite exiting several businesses, SG&A expenses at headquarters were not proportionately cut—in fact, they had increased by more than 300 basis points (bps) as a percentage of sales. Trian saw potential for a reduction of 500 bps in SG&A expenses.

Furthermore, Heinz had significantly worse operating efficiency metrics than its peers. Sales per employee for Heinz in 2006 came to $270,000 and sales per plant to $105 million. The median values for peers were $373,000 and $177 million, respectively.

Business Structure Opportunities. Within the core business, Trian believed the company was erroneously trying to compete on price. It was spending more than comparable companies on deals and allowances and less on advertising, marketing, and product innovation. Instead of strengthening and leveraging its huge brand name (e.g., Heinz had a 60% retail share of ketchup in the United States), Heinz was fighting to maintain shelf space. Trian noted that only 40% of French fries, hot dogs, and hamburgers were eaten with ketchup and believed that simple product innovation could increase usage. For example, the company's "tear and squeeze" packets were a likely deterrent to certain potential customers.

According to Trian, Heinz spread itself too thin across many brands, product lines, and geographies, while at the same time performance was deteriorating in key brands and areas such as Europe. In Europe (Heinz's largest segment by sales volume in fiscal year 2005 at 39% of total revenue), sales had declined by 6.9% from 2002 to 2005 in constant currency terms, and EBITDA margins declined by 350 bps.

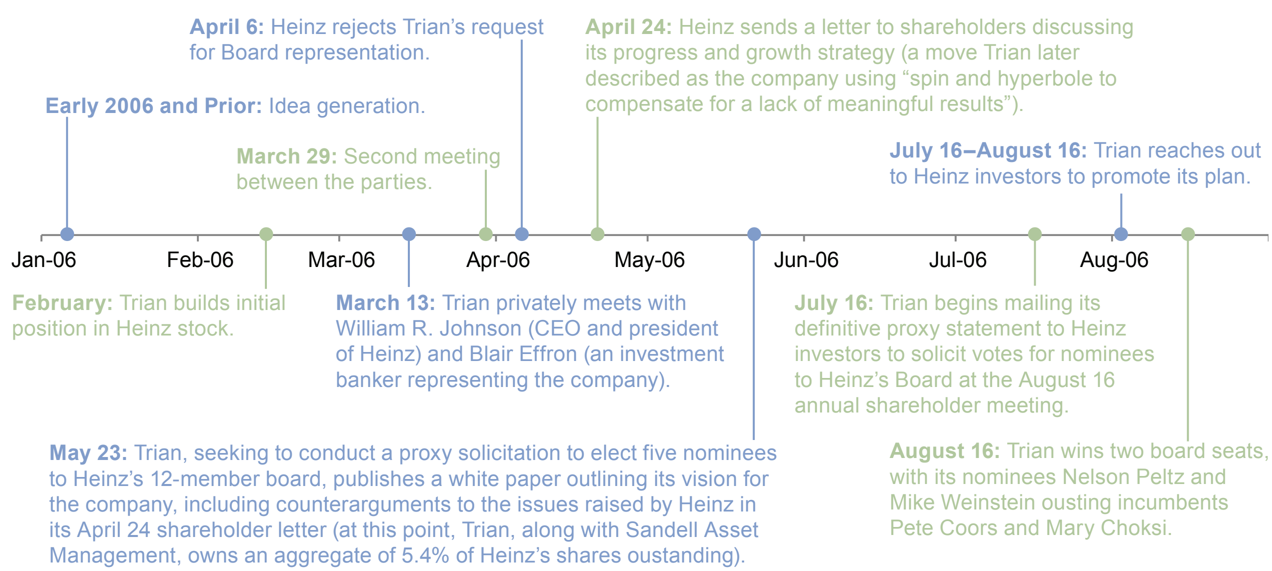
In addition to the aforementioned lack of focus, Trian argued that Heinz had failed in its acquisition and divestiture activity due to the absence of a clear strategic plan. Trian believed that as a result of this flaw, Heinz had let some significant opportunities slip away. Heinz had sold leading businesses in two fast-growing industry sectors, dietary and organic foods, at very low valuations. For example, Weight Watchers was sold in 1999 to a private investment firm for $735 million. Three years later, Weight Watchers went public and, by 2006, had a market capitalization of $4.2 billion.

Capital Structure Opportunities. Given the company's stable and high free cash flow as well as cash balance, Trian believed Heinz's capital structure was inefficient. Trian believed that Heinz could increase its leverage ratio to 3.5, above management's target of 2.4, while maintaining an investment-grade rating. Trian proposed enhancing shareholder returns by increasing share repurchases and the long-term target dividend payout ratio. Furthermore, given the suggested strategic and operational changes, Trian estimated that the leverage ratio could go down to 2.5 on a pro forma basis due to increased cash flow.

Outcome

Trian was successful in executing its plan to gain board representation—see the timeline below for the major events in the Trian-Heinz relationship. Since winning the two board seats, Trian and Heinz management have developed a close relationship and worked together constructively to implement changes.

Timeline of Events in Trian's Attempt to Influence Heinz



Since February 2006, when Trian began building its position in Heinz, the company's financials have improved significantly. In addition, Heinz has been the only company in the packaged food sector with 27 consecutive quarters of organic sales growth.

Heinz's share price reflected its overall improved financial performance. Since February 2006, when Trian began investing, through the end of 2010 when it sold a majority of its position, the stock returned a cumulative 76%, compared to 49% for the S&P 500 Packaged Food Index and 10% for the S&P 500. As of mid-2012, Trian holds a very small position. Nelson Peltz remains on the board, and has been re-elected on the company's slate for the last five years.

In a September 11, 2006, research note, Institutional Shareholder Services noted that Trian faced a number of hurdles in its attempt at activism, such as:

- the company's large capitalization and Trian's 5% ownership stake;
- the predominance of long-only institutional investors;
- the company's fair performance;
- the absence of obvious governance issues;
- the public support for the incumbents by large activist shareholder groups, the local media, and local politicians; and
- the lack of public support for Trian.

Despite these hurdles, Trian succeeded, and the report declared Trian's victory to be "a milestone victory for dissident shareholders that could potentially spur a significant amount of further activism."

2. Cevian and Panalpina

Traded on the Swiss exchange, Panalpina is one of the world's leading providers of freight forwarding and related logistics services. It specializes in intercontinental air freight, ocean freight shipments, and supply chain management solutions. Panalpina is a global company, with a network of 500 branches in 80 countries. The company was privately owned until 2005, when its owner, the Ernst Göhner Foundation, sold more than 50% of its shares in a public offering. The Foundation remained a 45% shareholder in Panalpina, and this ownership structure was viewed in the market as an impediment to corporate change.

After tracking, analyzing, and interacting with Panalpina since 2008, activist manager Cevian Capital Limited commenced investing in late 2009 and disclosed 5% and 10% ownership stakes in March and June 2010, respectively. Cevian believed Panalpina had two characteristics for a successful investment: the stock was attractive on a standalone basis and had the potential for significant appreciation through multiple types of improvements (operational, governance, corporate strategy, and corporate finance). Cevian met with management and the Foundation over the 12 to 18 months leading up to its investment in the company. Without resorting to a proxy fight, Cevian was eventually able to gain a board seat and begin to advocate for change.

During 2008 and 2009, Cevian undertook extensive fundamental analysis on the industry and Panalpina, conducting over 75 meetings with the company, competitors, customers, and other industry participants. The Cevian team also had prior experience in the freight forwarding industry given a past investment in ASG, a Scandinavian freight forwarder listed on the Stockholm stock exchange. Cevian's co-founder had served as chairman of the board of ASG and had driven an operational restructuring of the company.

Panalpina as Potential Activist Target

Similar to Heinz, Panalpina was an underperforming stock with opportunities to improve operations and corporate strategy. In addition to these factors, Panalpina as a target also presented an opportunity to improve governance, specifically the relationship between management and the board.

Underperforming Stock, Out-of-Favor Industry. At the point of investment, Panalpina was deeply out-of-favor with investors due to company-specific issues as well as overall economic uncertainty. In 2009, revenue had declined by 32% versus the prior year. Additionally, the company had historically consistently underperformed its peers. For example, Panalpina underperformed in operational efficiency, net working capital efficiency, and market volume growth. The company's reputation was tarnished by its poor corporate governance practices, which resulted in an overhaul of the board and management prior to Cevian's investment.

While long-term historical margins at Panalpina had been averaging only 15% compared to 25% for leading peers, Cevian identified that the underperformance was not structural—it could be addressed through the implementation of a comprehensive set of measures. In addition, given cyclically low margins in 2009 (6.9%), Cevian saw significant upside potential in the stock.

Operational Improvements. Cevian believed Panalpina would benefit from a series of operational improvements, such as centralizing procurement of road transport and other goods and services normally managed on a decentralized basis. Cevian also saw opportunities for Panalpina to engage in tighter management of its working capital.

Corporate Strategy. Historically, Panalpina had focused on revenue growth, large customers, and full container loads. Cevian saw an opportunity for the company to use its management information system to focus on individual customer profitability and supported expanding efforts in higher-margin niches such as medium-sized customers and shipment of partial container loads.

Governance. Cevian also sought to improve the functioning of the board and the interaction between the board and management. To help introduce and reinforce a focus on profitability, the manager advocated for restructuring Panalpina's compensation program.

Outcome

Prior to investment, Cevian sought to establish credibility with Panalpina as a value-adding and long-term owner of companies. Eventually, Cevian's co-founder was added to the Panalpina board, with the support of management and the key shareholder.

According to Cevian, good progress has already been achieved at Panalpina. Net working capital, having averaged 5.5% of sales between 2006 and 2009, was brought down to an all-time low of 0.3% at the end of first quarter 2012. In addition, the gap between Panalpina's gross profit levels and those of its peer group fell each quarter in 2010, narrowing it to 1.1% from a high of 3.6%

Since 2009, when Cevian disclosed its investment in the company, through June 30, 2012, the share price return has been 48.9%, compared to 1.7% for the MSCI Europe Transport Index and 14.0% for the MSCI Europe Index over the same period (all in euros). Cevian remains a shareholder in Panalpina.

3. Pershing Square and Target

On March 17, 2009, Pershing Square announced the nomination of five directors to the board of Target Corporation. At the time, Pershing Square owned approximately 7.8% of the company. Pershing Square had begun buying the stock in 2007 after identifying a number of opportunities for improved financial performance. Specifically, Pershing Square determined that Target had a disproportionately (versus other competitors) large investment in retail real estate as well as significant funding and credit risks through its large credit card operation. Pershing Square then reached out to senior management, suggesting that Target transfer the risks of its credit card business by giving up underwriting control to a financial institution with more expertise and scale. In addition, Pershing Square suggested that Target consider the spin-off of a separate publicly traded REIT that would own all of the company's land. Pershing Square believed that such a transaction would increase free cash flow as well as the overall valuation of Target. Over the subsequent months, Pershing Square's proposals were rejected despite a sharp fall in the stock price from a high of $70 in July 2007 to a low of $25 in March 2009. On May 28, 2009, at the company's annual shareholder meeting, none of Pershing Square's director candidates was elected. By March 2011, Pershing Square sold its entire Target position after having suffered sizeable losses.

4. The Children's Investment Fund and J-Power

In a well-publicized case, The Children's Investment Fund (TCI) learned first-hand the difficulties of engaging in activism in Japan. TCI began buying shares in J-Power, a Japanese utility, in 2006. By March 2007, TCI had accumulated a 9.9% stake in the company and demanded that it raise its dividend, buy back shares, and limit cross-shareholdings, among other things. J-Power's board rejected TCI's proposals, and at the June 2007 annual meeting J-Power shareholders rejected TCI's request for a tripling of the company's dividend. Subsequently, TCI sought approval from the Japanese government to raise its stake in J-Power to 20%. Japan's government rejected TCI's application, invoking national security issues. TCI then decided to move on with a proxy battle at the June 2008 annual meeting. All five TCI proposals, including a proposal for a doubling of the dividend, were voted down by shareholders. In October, TCI sold its entire stake back to J-Power for around ¥63.2 billion. TCI suffered a sizeable loss on the position—based on a shareholder filing, TCI had paid ¥75.6 billion for its shares. ■

A Brief History of Activism and Related Rules and Regulations in the United States

Over the past three decades, a number of practices, rules, and regulations have shaped and formed the activist investing landscape. With the collapse of Enron and WorldCom, as well as the enactment of Sarbanes-Oxley in 2002 and Dodd-Frank in 2010, shareholder involvement has increased and there is greater scrutiny of public company boards of directors.

This appendix provides an overview of certain rules and regulations in the United States as they relate to the history of activist investing and particular activist strategies. The decades identified in the sections below represent the period during which the strategy or rule first came into existence or was most popular.

Greenmail (1980s)

Greenmailing was a popular activity during the 1980s, the era of corporate raiders. Targeted corporations would offer insurgents a premium for their shares to drop their campaigns and leave. Such a special payment was known as greenmail and was not made to other shareholders in the company. Well-known examples of greenmailing are Saxon Industries and Carl Icahn in 1979, General Motors and Ross Perot in 1986, Texaco and the Bass Brothers in 1984, and Disney and Saul Steinberg in 1984. In the case of Disney and Steinberg, stockholders sued to recover the amount given to Steinberg for his 11% stake in the company. The case was finally settled out of court in 1989.

Today, greenmailing has become redundant due to changes in corporate governance laws as well as the enactment of Internal Revenue Code Section 5881. Section 5881 imposes an excise tax of 50% on the profits received by the greenmailer. It should be noted that unlike corporate raiders receiving greenmail from a company, modern day activists bear all of the costs of a campaign but share any profits with the other shareholders in the company.

“Corporate Raiding” (1980s)

“Greed, for lack of a better word, is good. Greed is right. Greed works. Greed clarifies, cuts through, and captures the essence of the evolutionary spirit. Greed, in all of its forms; greed for life, for money, for love, knowledge, has marked the upward surge of mankind and greed, you mark my words, will not only save Teldar Paper, but that other malfunctioning corporation called the U.S.A.” —Gordon Gekko

“We’re not about liquidating companies. But if you do that, why is that terrible? We’re not blowing up the factories. The person who buys it should be able to make the asset more productive.” —Carl Icahn

During the 1980s, Michael Milken of Drexel Burnham helped launch the era of corporate raiders by creating the market for junk bond financing of hostile takeovers.

Some of the first activist investors were the corporate raiders of the 1980s. These raiders would often make hostile bids for corporations and then liquidate the business by selling off divisions and assets. The raiders would make their profits through breaking up and selling off company assets or accepting greenmail offers.

While junk bonds helped finance unsolicited tender offers in the 1980s, state anti-takeover legislation and corporate defense mechanisms put an end to coercive tender offers. Today, almost every state has statutes that regulate/impede takeovers, including the following:

- Business combination statutes, such as Delaware Section 203;
- Control share acquisition statutes;
- Expanded constituency statutes;

- Fair price statutes;
- Statutes limiting director liability that give directors broad discretion to reject unsolicited offers; and
- Statutes endorsing the use of poison pills (see below).

Takeover defenses, such as a poison pill combined with a staggered board, have also made unsolicited tender offers more difficult. As Harvard law professor and corporate governance expert Lucian Bebchuk has written, these two defenses, when combined, constitute the most powerful anti-takeover device.

It is difficult today, unlike in the 1970s and 1980s, to find a publicly held company that is not protected by a poison pill, anti-takeover statute, or both. As a result, attempts to take over companies through coercive tender offers are largely a thing of the past.

Poison Pills (1980s)

The poison pill, or shareholder rights plan, was invented by lawyer Martin Lipton of Wachtell, Lipton, Rosen & Katz in 1982 as a response to the hostile takeovers of the corporate raiders and was initially approved by the Delaware court in 1985 under *Moran vs. Household International*. Under a shareholder rights plan, a company can issue rights to existing shareholders that can be converted to shares at a discount to market price if a shareholder buys a certain percentage of the company's shares. If triggered, the poison pill will dilute the share ownership of the buyer of the company's shares.

Managements claim they use poison pills to protect shareholder rights by, for example, pressuring potential acquirers to increase their bids to fair value. Shareholders, on the other hand, often view poison pills as an attempt by management and the board to retain control of a corporation indefinitely irrespective of shareholder interests. Over the past few years, shareholders have increasingly put forth proposals to redeem or require a shareholder vote on poison pills. Beginning with the 2010 proxy season, Institutional Shareholder Services started to recommend voting against or withholding a vote for any director of a corporation up for election who voted to:

- Adopt a poison pill with a term of more than 12 months;
- Renew a poison pill of any duration without shareholder approval; or
- Make a material adverse change to any existing poison pill without shareholder approval.

It seems that shareholders have managed to influence companies over the past few years. In 2004, there were 266 S&P 500 companies with poison pill provisions; by 2010, the number had fallen to 65. However, a number of recent court decisions have validated the use of poison pills. The most recent example is the *Air Products & Chemicals, Inc. vs. Airgas, Inc.* case, in which Airgas used a poison pill in combination with a staggered board to fend off a hostile takeover from Air Products (see sidebar on the next page).

Staggered Boards (1980s)

"If a company has a staggered board it is nearly impossible to change control of that company in less than two years. But as we all know, two years in the life of a poorly managed company is an eternity."—Carl Icahn, June 15, 2008

With a staggered or classified board, board members are grouped into classes, with typically one-third of the total number of directors in each class. Only one class comes up for election in any given year. For this reason, it would take an activist investor at least two proxy fights to gain the majority of the board.

In recent years, there has been a strong push by shareholders to declassify boards. In 2004, 260 S&P 500 companies had staggered boards; by 2010 the number had fallen to 142.

The Short Slate Rule (1990s)

In 1992, the Securities and Exchange Commission (SEC) adopted what is known as the short slate rule. Prior to the emergence of the rule, shareholders were unable to split their votes between management nominees and dissident nominees. With the emergence of the short slate rule, investors can select candidates on both sides, resulting in proxy contests for minority representation on boards of directors. However, it is still difficult to selectively vote for directors from the management slate and the dissident slate using a proxy card.

Shareholder Communication Regulations (1990s)

In addition to the short slate rule, the SEC adopted a new shareholder communication regulation in 1992. The purpose of the new rules was to free up communication between shareholders by imposing fewer restrictions such as disclosure requirements and/or raising the hurdle for such disclosures to be made. Since 1992, there have been a number of amendments to the communication rules, all in favor of shareholders. Companies today are less able to monitor the activities of dissident shareholders as a result.

Among other things, these rule changes have resulted in the following:

- Activist shareholders can communicate with an unlimited number of other

Air Products vs Airgas

A Recent Court Decision Involving a Staggered Board and Poison Pill

In October 2009, Air Products expressed an interest in acquiring Airgas. Over the next few months, Air Products made three offers and all were rejected. In February 2010, Air Products made yet another attempt at $60 per share. Repeated offers up to $70 per share were made and rejected thereafter. Airgas had adopted its poison pill in May 2007 prior to any approaches by Air Products.

Air Products proceeded to a proxy fight at the annual shareholder meeting in September 2010 and managed to replace the three Airgas directors up for re-election to the company's staggered board. This was a clear signal that shareholders were generally in favor of the offer.

The case went to court, with Air Products seeking to force the Airgas board to redeem the company's poison pill. Air Products argued that the Airgas pill was meant to protect against short-term takeover attempts and that shareholders in this case had had the time to determine the attractiveness of the offer.

In February 2011, Chancellor William B. Chandler III of the Delaware Chancery Court ruled against Air Products, upholding Airgas' poison pill. After the decision, Air Products withdrew its interest in acquiring Airgas. In his decision, Chancellor Chandler commented:

"This case brings to the fore one of the most basic questions animating all of corporate law, which relates to the allocation of power between directors and stockholders. That is, 'when, if ever, will a board's duty to "the corporation and its shareholders" require [the board] to abandon concerns for "long term" values (and other constituencies) and enter a current share value maximizing mode?' More to the point, in the context of a hostile tender offer, who gets to decide when and if the corporation is for sale?

"I conclude that, as Delaware law currently stands, the answer must be that the power to defeat an inadequate hostile tender offer ultimately lies with the board of directors."

shareholders so long as they are not contemplating a proxy fight.

- Activists contemplating a proxy contest have the ability to "test the waters" by soliciting proxies from up to ten other shareholders before becoming subject to SEC rules governing the use of proxy statements.
- Prior to the changes in the rules, investors were required to submit documents to the SEC for pre-approval before talking to the press about issues such as votes on corporate measures. This is no longer the case.

In addition to freeing up communications among shareholders, the SEC has adopted a number of disclosure rules that favor investors by increasing transparency and allowing them to gather valuable information to develop their investment theses and activist strategies:

- In 2003, the SEC under Harvey Pitt approved a regulation requiring registered investment management companies such as mutual funds to disclose their proxy voting records.
- Since 2003, companies need to explain in corporate financial documents how they identify and evaluate board nominees. Further, a company's nomination committee is required to disclose in proxy material whether it approved or rejected a director candidate recommended by an investor group owning more than 5% in a company.
- Since 2006, companies need to disclose and discuss compensation policies in detail in their annual statements.

Broker Non-Votes and the NYSE (2000s)

In October 2006, the New York Stock Exchange (NYSE) moved to eliminate "broker non-votes" by amending Rule 452. Prior to this, brokers holding shares for retail investors had discretion to vote on behalf of these investors in director elections. Brokers would typically vote for the management-backed director slate in uncontested elections. With the amendment of the rule and the subsequent approval by the SEC in 2009, discretionary voting by brokers in all director elections was eliminated. With the advent of "just vote no" campaigns by dissident shareholders and, more recently, majority voting for directors, the elimination of discretionary voting has the ability to impact the outcome of director elections.

Then–NYSE President and Co-COO Catherine Kinney commented:

"The goal of the NYSE has been to not allow the broker to vote on any proposal that substantially affects the rights of shareholders. As mentioned in the report, today the election of directors is simply too important to ever be considered routine, even where the election is uncontested. Shareholder voting on the election of directors is a critical component of good corporate governance."

In January 2012, additional changes were made to Rule 452 that further narrowed the types of routine proposals on which brokers could vote customers' shares in the absence of specific instructions. These changes limited broker voting on corporate governance proposals such as:

- Declassifying a board of directors;
- Majority voting on the election of directors and the elimination of supermajority provisions in charter documents;

- Providing for the use of written consents and the right to call special meetings of shareholders; and
- Certain types of anti-takeover provision overrides.

One implication of these changes is that companies may face increased difficulty in obtaining necessary support for these governance proposals.

Proxy Access (2010s)

In August 2010, the SEC adopted what is known as the proxy access rule to allow shareholders to include their own director candidates in a company's proxy materials. In its press release the SEC commented:

"The new rules require companies to include the nominees of significant, long-term shareholders in their proxy materials, alongside the nominees of management. This 'proxy access' is designed to facilitate the ability of shareholders to exercise their traditional rights under state law to nominate and elect members to company boards of directors.

"Under the rules, shareholders will be eligible to have their nominees included in the proxy materials if they own at least 3 percent of the company's shares continuously for at least the prior three years."

The U.S. Chamber of Commerce and the Business Roundtable sued to overturn the measure, claiming that it would distract management and advance special interest agendas. In October 2010, the SEC stayed the effectiveness of the proxy access rules, pending resolution of the litigation. In July 2011, the D.C. Circuit Court of Appeals struck down the SEC rule, and the SEC decided not to appeal.

In light of the fact that mandatory proxy access was struck down by the D.C. Circuit Court of Appeals in 2011, shareholders have begun to submit "private ordering" proxy access proposals. During the 2012 proxy season, one study noted that more than 20 proxy access proposals were submitted, of which eight came to vote and a majority of shareholders voted in favor of the proposal at two companies. In both cases, the proposal had ownership requirements similar to the 3%/three-year threshold found in the SEC's vacated mandatory proxy access rule.

Changing the Section 13D Reporting Rules: The 2011 Wachtell Lipton Petition

In March 2011, corporate law firm Wachtell, Lipton, Rosen & Katz filed a petition with the SEC to change the rules under Section 13D of the Securities Exchange Act of 1934. Specifically, Wachtell Lipton recommended the following:

- Require 5% beneficial ownership disclosure within one business day;
- Adopt a "cooling-off period" between the acquisition of 5% beneficial ownership until two business days after the initial Schedule 13D filing is made, during which acquirers would be prohibited from acquiring additional beneficial ownership; and
- Adopt a broader definition of beneficial ownership encompassing "ownership of any derivative instrument which includes the opportunity, directly or indirectly, to profit or share in any profit derived from any increase in the value of the subject security."

Some investors and commentators believe that the Wachtell Lipton petition would place significant restrictions on, and reduce the economic incentives for, active shareholder engagement, chilling the market for engaged investing. If the SEC adopted these rules, investors would be constrained in the size of the position they could establish in a company prior to disclosure. For example, under the current 13D filing rule, an investor has the flexibility to continue increasing beneficial ownership above 5% for ten days prior to disclosure. By reducing the filing window to one day from the current ten-day standard, activists would not be able to benefit as much from the documented pop up in the prices of their targets (Appendix D).

Some commentators and members of Congress have called on the SEC to do a cost-benefit analysis of the petition. It remains to be seen how the SEC will react to the Wachtell Lipton petition and what, if any, changes will be made to the Schedule 13D disclosure regime.

Analysis of Activist Manager Performance

This performance analysis includes funds from Cambridge Associates' manager database that employ dedicated activist investment strategies or have been known to exercise activism on a routine basis both in the United States and abroad. The sample contains 15 managers, though not all managers have returns in every period. This analysis does not represent a recommendation to invest with these investment managers and is not representative of the overall activism investment universe. Past performance is not indicative of future results. ■

Activist Managers: Returns

Annual Total Returns (%)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	6 mos 2012
Managers											
Audley European Opportunities	---	---	---	---	44.1	20.3	-61.9	140.6	100.2	-45.6	-20.3
Blue Harbour Strategic Value	---	---	---	8.2	18.4	-10.5	-18.3	14.8	22.4	3.0	6.5
Cevian	---	---	---	---	---	19.3	-32.8	35.6	42.5	-9.8	7.0
Icahn Partners	---	---	---	14.3	32.5	7.8	-37.4	32.0	13.5	---	---
Ichigo Japan	---	---	---	---	---	12.3	-42.9	6.6	19.8	-4.3	10.9
JANA	10.3	45.8	25.9	11.2	16.3	7.5	-23.5	23.9	8.4	-2.2	11.2
P2 Capital	---	---	---	---	---	---	-15.7	19.9	12.3	-3.8	13.1
Pershing Square	---	---	42.6	40.0	22.5	22.0	-13.0	40.6	29.7	-1.1	2.3
Red Mountain	---	---	---	---	---	-18.8	-45.8	75.5	56.9	-12.4	16.1
Starboard Value	---	43.8	15.5	21.3	23.8	6.3	-20.8	16.9	31.7	7.6	9.0
The Children's Investment Master Fund	---	---	41.9	49.7	39.0	37.6	-43.1	10.2	8.7	7.3	16.4
Third Point	-7.0	51.5	30.2	20.0	15.1	16.6	-32.8	38.2	41.8	-0.5	4.5
Trian	---	---	---	---	14.3	5.4	-19.0	16.0	17.9	3.9	0.2
ValueAct	-2.2	19.0	30.5	16.7	18.3	-2.1	-28.7	28.5	42.5	14.4	6.4
Wynnefield Small Cap Value	3.6	34.3	26.1	10.9	13.1	8.6	-35.7	12.2	33.5	-3.3	8.8
Indices											
MSCI World	-19.9	33.1	14.7	9.5	20.1	9.0	-40.7	30.0	11.8	-5.5	5.9
MSCI All Country World	-19.0	34.6	15.8	11.4	21.5	12.2	-41.8	35.4	13.2	-6.9	6.0
S&P 500	-22.1	28.7	10.9	4.9	15.8	5.5	-37.0	26.5	15.1	2.1	9.5
Russell 2000® Value	-11.4	46.0	22.2	4.7	23.5	-9.8	-28.9	20.6	24.5	-5.5	8.2
Russell Midcap®	-16.2	40.1	20.2	12.7	15.3	5.6	-41.5	40.5	25.5	-1.5	8.0
HFRI FOF Diversified	1.1	11.4	7.2	7.5	10.2	9.7	-20.9	11.5	5.5	-5.0	1.1
HFRI Equity Hedge (Total)	-4.7	20.5	7.7	10.6	11.7	10.5	-26.7	24.6	10.5	-8.4	2.1
Barclays Aggregate Bond	10.3	4.1	4.3	2.4	4.3	7.0	5.2	5.9	6.5	7.9	2.4

Average Annual Compound Returns (%) Through June 30, 2012

	10 Yr	9 Yr	8 Yr	7 Yr	6 Yr	5 Yr	4 Yr	3 Yr	2 Yr	1 Yr
Managers										
Audley European Opportunities	---	---	---	---	2.9	-4.6	-12.7	6.6	-5.8	-55.1
Blue Harbour Strategic Value	---	---	---	5.1	4.5	1.5	5.6	13.6	14.3	1.9
Cevian	---	---	---	---	12.0	4.4	10.4	20.7	11.8	-7.2
Ichigo Japan	---	---	---	---	---	-4.5	-1.9	1.8	9.3	9.1
JANA	11.5	9.7	7.4	5.5	4.7	1.1	1.8	10.6	8.5	6.6
P2 Capital	---	---	---	---	---	3.6	5.9	14.7	12.3	3.1
Pershing Square	---	---	19.8	15.3	14.8	12.0	12.2	18.6	12.8	0.4
Red Mountain	---	---	---	---	6.8	2.6	18.3	23.8	13.6	-6.8
Starboard Value	---	13.6	10.8	11.6	8.6	5.5	10.4	19.4	20.1	9.7
The Children's Investment Master Fund	---	---	14.5	10.6	6.1	0.3	-0.8	17.0	22.4	7.3
Third Point	14.2	15.9	12.6	10.6	9.5	6.6	7.2	24.5	14.3	-1.9
Trian	---	---	---	---	4.3	1.5	6.2	14.5	8.9	-2.2
ValueAct	12.8	14.0	12.3	10.8	9.4	6.9	14.1	25.9	24.4	-1.0
Wynnefield Small Cap Value	7.4	8.9	5.7	4.5	2.9	0.5	0.1	17.5	11.1	-8.6
Indices										
MSCI World	5.2	6.1	4.0	3.2	1.0	-3.0	-0.9	11.0	11.4	-5.0
MSCI All Country World	6.3	7.2	5.1	4.2	2.0	-2.2	-0.4	11.4	10.9	-6.0
S&P 500	5.3	5.9	4.4	4.1	3.4	0.2	3.9	16.4	17.4	5.4
Russell 2000® Value	6.5	7.7	4.7	3.4	1.6	-1.0	4.9	17.4	13.8	-1.4
Russell Midcap®	8.5	9.1	6.8	5.4	4.1	1.1	4.4	19.4	16.7	-1.7
HFRI FOF Diversified	3.3	3.1	2.5	2.0	0.7	-1.9	-2.2	2.4	1.1	-3.8
HFRI Equity Hedge (Total)	4.9	5.0	3.9	3.4	1.7	-0.7	-0.5	4.7	2.7	-7.4
Barclays Aggregate Bond	5.6	5.1	5.7	5.6	6.7	6.8	6.7	6.9	5.7	7.5

Sources: Barclays, Cambridge Associates LLC Investment Manager Database, Frank Russell Company, Hedge Fund Research, Inc., MSCI Inc., Standard & Poor's, and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Calculations are based on monthly data, net of fees.

Activist Managers: Maximum Drawdown (Peak to Trough)

As of June 30, 2012

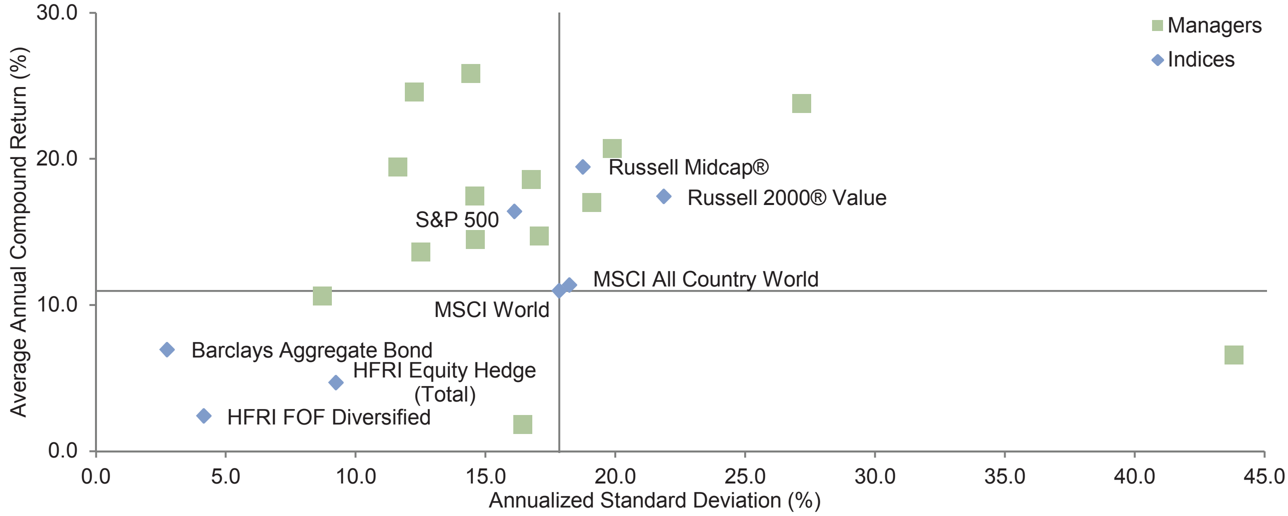
	Returns Inception Date	Manager Specific: Maximum Drawdown (Peak to Trough) From	To	Duration	Return	Recovery By	Time to Recover	Absolute Worst Perf	Month of Absolute Worst Perf
Managers									
Audley European Opportunities	Nov-05	Jul-08	Feb-09	8 mos	-76.1%	Nov-10	21 mos	-34.8%	Oct-08
Blue Harbour Strategic Value	Dec-04	Jun-07	Nov-08	18 mos	-31.8%	Feb-11	27 mos	-10.3%	Oct-08
Cevian	Jul-06	Nov-07	Feb-09	16 mos	-41.5%	Jul-10	17 mos	-14.8%	Aug-11
Ichigo Japan	Nov-06	Jan-08	Feb-09	14 mos	-45.3%	N/A	N/A	-23.4%	Oct-08
JANA	Apr-01	Jun-07	Dec-08	19 mos	-28.7%	Mar-11	27 mos	-9.6%	Jul-08
P2 Capital	Feb-07	Sep-08	Feb-09	6 mos	-27.5%	Mar-10	13 mos	-21.2%	Oct-08
Pershing Square	Jan-04	Feb-08	Feb-09	13 mos	-21.4%	Sep-09	7 mos	-9.4%	Oct-08
Red Mountain	Apr-06	Jul-07	Feb-09	20 mos	-66.7%	Dec-10	22 mos	-20.8%	Dec-08
Starboard Value	Oct-02	Jun-07	Nov-08	18 mos	-30.6%	Oct-10	23 mos	-11.3%	Oct-08
The Children's Investment Master Fund	Jan-04	Jun-08	Apr-09	11 mos	-47.8%	N/A	N/A	-14.9%	Sep-08
Third Point	Jun-95	Jul-08	Mar-09	9 mos	-36.6%	Mar-10	12 mos	-12.2%	Sep-08
Trian	Nov-05	Jun-07	Feb-09	21 mos	-30.5%	Nov-10	21 mos	-9.7%	Jun-08
ValueAct	Jan-01	Jun-07	Feb-09	21 mos	-43.7%	Oct-10	20 mos	-15.5%	Oct-08
Wynnefield Small Cap Value	Jan-93	Nov-07	Feb-09	16 mos	-48.8%	Mar-11	25 mos	-17.5%	Oct-08
Indices (from earliest manager inception)									
MSCI World	Jan-93	Nov-07	Feb-09	16 mos	-54.0%	N/A	N/A	-19.0%	Oct-08
MSCI All Country World	Jan-93	Nov-07	Feb-09	16 mos	-54.6%	N/A	N/A	-19.8%	Oct-08
S&P 500	Jan-93	Nov-07	Feb-09	16 mos	-50.9%	Mar-12	37 mos	-16.8%	Oct-08
Russell 2000® Value	Jan-93	Jun-07	Feb-09	21 mos	-55.5%	N/A	N/A	-20.0%	Oct-08
Russell Midcap®	Jan-93	Jun-07	Feb-09	21 mos	-54.2%	Feb-11	24 mos	-22.4%	Oct-08
HFRI FOF Diversified	Jan-93	Nov-07	Dec-08	14 mos	-21.8%	N/A	N/A	-7.8%	Aug-98
HFRI Equity Hedge (Total)	Jan-93	Nov-07	Feb-09	16 mos	-30.6%	Feb-11	24 mos	-9.5%	Oct-08
Barclays Aggregate Bond	Jan-93	Feb-94	Jun-94	5 mos	-5.1%	Feb-95	8 mos	-3.4%	Jul-03

Sources: Barclays, Cambridge Associates LLC Investment Manager Database, Frank Russell Company, Hedge Fund Research, Inc., MSCI Inc., Standard & Poor's, and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Calculations are based on monthly data, net of fees. Managers with N/A in the recovery by column have yet to recover from their lowest trough.

Activist Managers: Three-Year Risk/Return Analysis

July 1, 2009 – June 30, 2012



	Average Annual Compound Return	Annualized Standard Deviation	Sharpe Ratio*	Beta vs MSCI World
Managers				
Audley European Opportunities	6.6	43.8	0.35	1.77
Blue Harbour Strategic Value	13.6	12.5	1.08	0.60
Cevian	20.7	19.9	1.04	0.93
Ichigo Japan	1.8	16.4	0.18	0.22
JANA	10.6	8.7	1.19	0.39
P2 Capital	14.7	17.1	0.88	0.79
Pershing Square	18.6	16.8	1.10	0.62
Red Mountain	23.8	27.2	0.91	0.83
Starboard Value	19.4	11.6	1.58	0.49
The Children's Investment Master Fund	17.0	19.1	0.92	0.96
Third Point	24.5	12.3	1.86	0.51
Trian	14.5	14.6	0.99	0.54
ValueAct	25.9	14.4	1.67	0.64
Wynnefield Small Cap Value	17.5	14.6	1.17	0.46
Indices				
MSCI World	11.0	17.8	0.67	---
MSCI All Country World	11.4	18.2	0.68	---
S&P 500	16.4	16.1	1.02	---
Russell 2000® Value	17.4	21.9	0.84	---
Russell Midcap®	19.4	18.7	1.04	---
HFRI FOF Diversified	2.4	4.1	0.57	---
HFRI Equity Hedge (Total)	4.7	9.2	0.53	---
Barclays Aggregate Bond	6.9	2.7	2.42	---

Sources: BofA Merrill Lynch, Barclays, Cambridge Associates LLC Investment Manager Database, Frank Russell Company, Hedge Fund Research, Inc., MSCI Inc., Standard & Poor's, and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

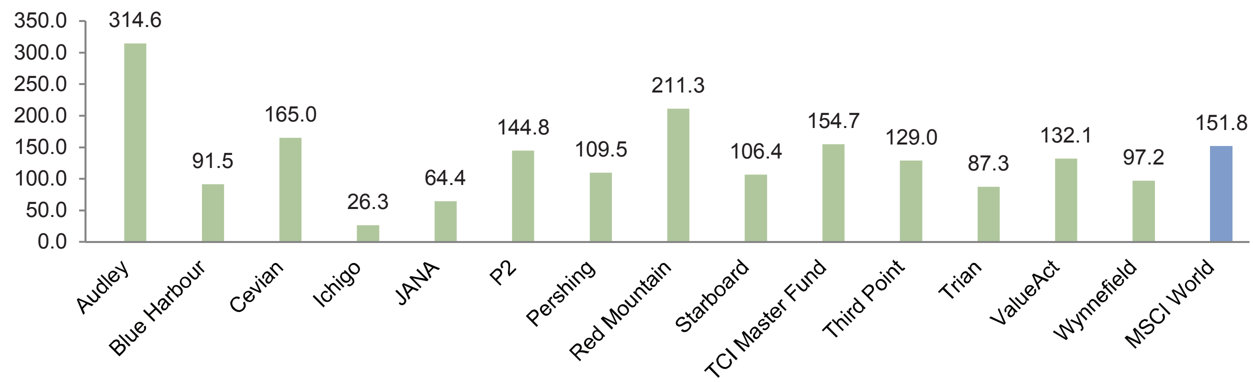
Notes: Calculations are based on monthly data, net of fees.

* The Sharpe ratio represents the amount of return over the risk-free rate that can be expected for each unit of risk accepted. To calculate this number, subtract the average T-bill return (risk-free return) from the manager's average return, then divide by the manager's standard deviation.

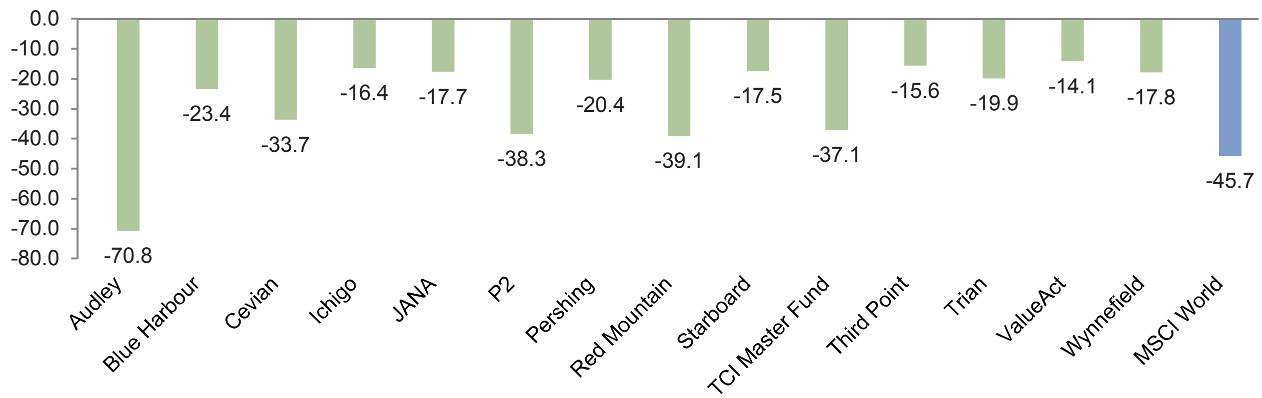
Activist Managers: Three-Year Cumulative Performance in Up/Down Markets

July 1, 2009 – June 30, 2012

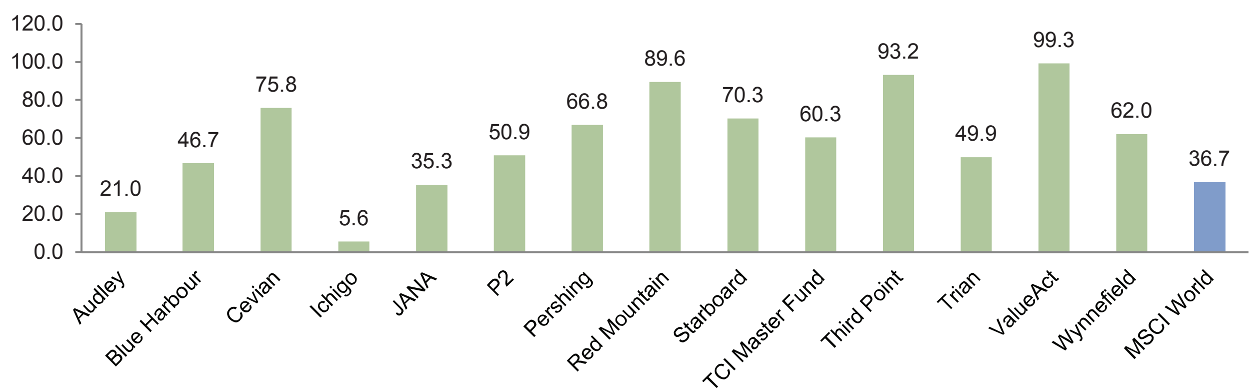
Cumulative Performance During Up Months of the MSCI World Index



Cumulative Performance During Down Months of the MSCI World Index



Cumulative Performance During All Months



Sources: Cambridge Associates LLC Investment Manager Database, MSCI Inc., and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties

Notes: Calculations are based on monthly data, net of fees.

Activist Managers: Three-Year Correlations Among Managers and with Indices

July 1, 2009 – June 30, 2012

	Audley European Opportunities	Blue Harbour Strategic Value	Cevian	Ichigo Japan	JANA	P2 Capital	Pershing Square	Red Mountain	Starboard Value	The Children's Investment Master Fund	Third Point	Trian	ValueAct	Wynnefield Small Cap Value
Managers														
Audley European Opportunities		0.73	0.77	0.36	0.66	0.69	0.65	0.46	0.49	0.60	0.76	0.62	0.61	0.56
Blue Harbour Strategic Value	0.73		0.82	0.29	0.75	0.83	0.70	0.55	0.71	0.79	0.68	0.72	0.77	0.54
Cevian	0.77	0.82		0.26	0.74	0.76	0.68	0.55	0.56	0.73	0.64	0.59	0.72	0.54
Ichigo Japan	0.36	0.29	0.26		0.28	0.18	0.13	0.42	0.30	0.21	0.34	0.17	0.09	0.40
JANA	0.66	0.75	0.74	0.28		0.80	0.65	0.45	0.65	0.74	0.78	0.50	0.64	0.45
P2 Capital	0.69	0.83	0.76	0.18	0.80		0.72	0.56	0.67	0.73	0.68	0.65	0.66	0.50
Pershing Square	0.65	0.70	0.68	0.13	0.65	0.72		0.50	0.39	0.63	0.50	0.69	0.62	0.42
Red Mountain	0.46	0.55	0.55	0.42	0.45	0.56	0.50		0.55	0.45	0.55	0.42	0.53	0.75
Starboard Value	0.49	0.71	0.56	0.30	0.65	0.67	0.39	0.55		0.60	0.70	0.47	0.57	0.37
The Children's Investment Master Fund	0.60	0.79	0.73	0.21	0.74	0.73	0.63	0.45	0.60		0.57	0.56	0.70	0.54
Third Point	0.76	0.68	0.64	0.34	0.78	0.68	0.50	0.55	0.70	0.57		0.51	0.65	0.60
Trian	0.62	0.72	0.59	0.17	0.50	0.65	0.69	0.42	0.47	0.56	0.51		0.51	0.45
ValueAct	0.61	0.77	0.72	0.09	0.64	0.66	0.62	0.53	0.57	0.70	0.65	0.51		0.54
Wynnefield Small Cap Value	0.56	0.54	0.54	0.40	0.45	0.50	0.42	0.75	0.37	0.54	0.60	0.45	0.54	
Indices														
MSCI World	0.72	0.85	0.84	0.24	0.80	0.83	0.66	0.55	0.75	0.90	0.75	0.65	0.79	0.56
MSCI All Country World	0.73	0.85	0.85	0.22	0.80	0.83	0.67	0.56	0.74	0.91	0.74	0.65	0.80	0.58
S&P 500	0.71	0.88	0.82	0.25	0.81	0.88	0.71	0.59	0.76	0.86	0.75	0.71	0.79	0.53
Russell 2000® Value	0.75	0.91	0.81	0.35	0.79	0.88	0.76	0.70	0.74	0.79	0.77	0.77	0.74	0.63
Russell Midcap®	0.76	0.91	0.84	0.27	0.83	0.91	0.78	0.64	0.75	0.83	0.78	0.76	0.80	0.62
HFRI FOF Diversified	0.79	0.74	0.80	0.27	0.81	0.74	0.60	0.56	0.68	0.75	0.89	0.54	0.74	0.65
HFRI Equity Hedge (Total)	0.80	0.87	0.86	0.26	0.84	0.84	0.75	0.61	0.69	0.88	0.80	0.65	0.82	0.69
Barclays Aggregate Bond	-0.30	-0.40	-0.23	-0.41	-0.30	-0.36	-0.40	-0.15	-0.28	-0.27	-0.22	-0.21	-0.16	-0.20

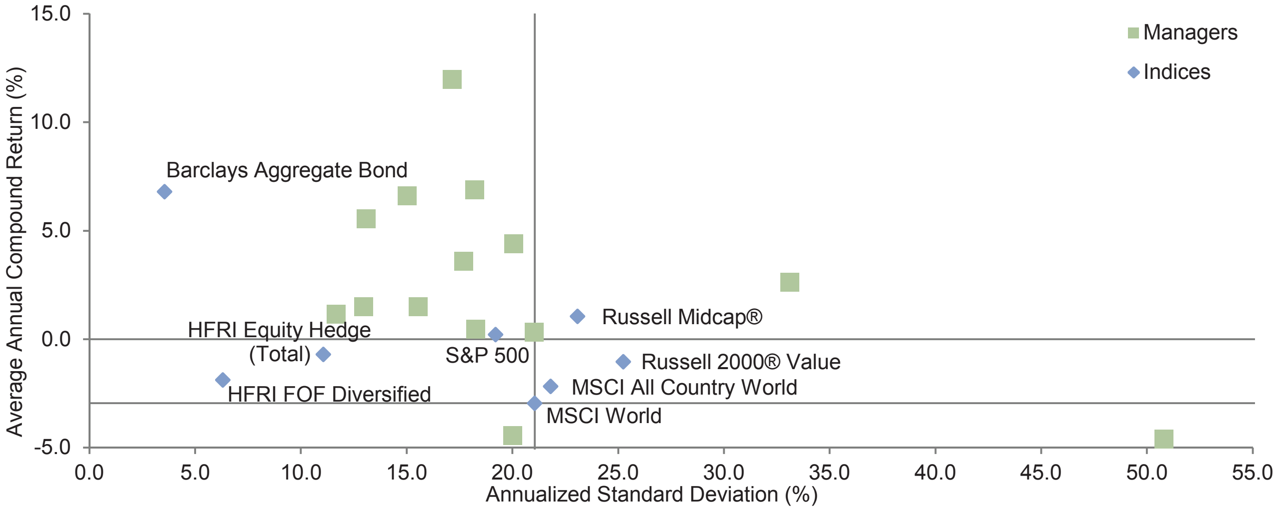
Correlation > 0.66
0.66 >= Correlation > 0.33
0.33 >= Correlation > 0.00
0.00 >= Correlation

Sources: Barclays, Cambridge Associates LLC Investment Manager Database, Frank Russell Company, Hedge Fund Research, Inc., MSCI Inc., Standard & Poor's, and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Calculations are based on monthly data, net of fees.

Activist Managers: Five-Year Risk/Return Analysis

July 1, 2007 – June 30, 2012



	Average Annual Compound Return	Annualized Standard Deviation	Sharpe Ratio*	Beta vs MSCI World
Managers				
Audley European Opportunities	-4.6	50.8	0.14	1.82
Blue Harbour Strategic Value	1.5	13.0	0.10	0.47
Cevian	4.4	20.1	0.27	0.81
Ichigo Japan	-4.5	20.0	NM	0.51
JANA	1.1	11.7	0.07	0.35
P2 Capital	3.6	17.7	0.23	0.66
Pershing Square	12.0	17.2	0.69	0.48
Red Mountain	2.6	33.1	0.21	0.96
Starboard Value	5.5	13.1	0.40	0.44
The Children's Investment Master Fund	0.3	21.0	0.07	0.77
Third Point	6.6	15.0	0.44	0.45
Trian	1.5	15.5	0.11	0.52
ValueAct	6.9	18.2	0.40	0.72
Wynnefield Small Cap Value	0.5	18.3	0.06	0.63
Indices				
MSCI World	-3.0	21.1	NM	---
MSCI All Country World	-2.2	21.8	NM	---
S&P 500	0.2	19.2	0.06	---
Russell 2000® Value	-1.0	25.2	0.05	---
Russell Midcap®	1.1	23.1	0.12	---
HFRI FOF Diversified	-1.9	6.3	NM	---
HFRI Equity Hedge (Total)	-0.7	11.1	NM	---
Barclays Aggregate Bond	6.8	3.6	1.60	---

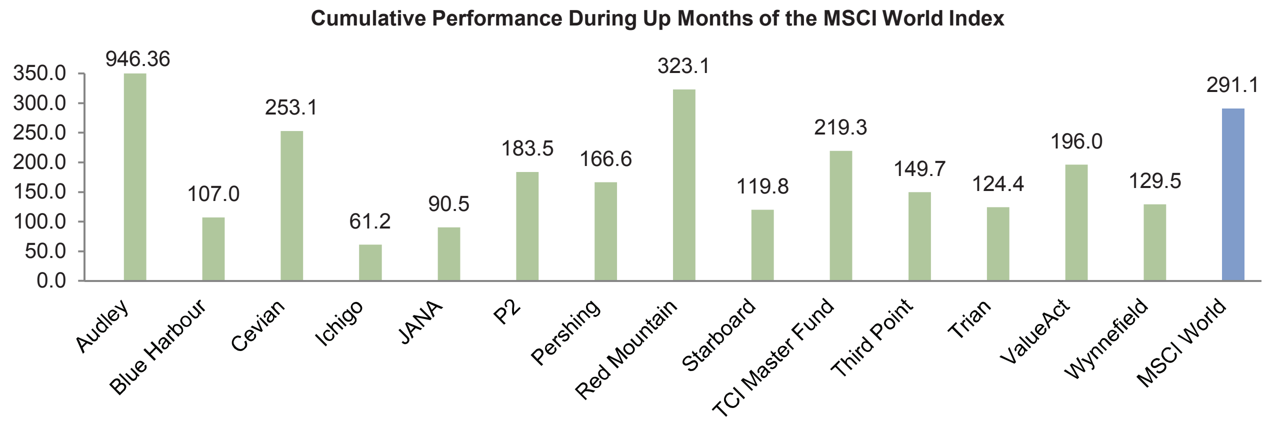
Sources: BofA Merrill Lynch, Barclays, Cambridge Associates LLC Investment Manager Database, Frank Russell Company, Hedge Fund Research, Inc., MSCI Inc., Standard & Poor's, and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

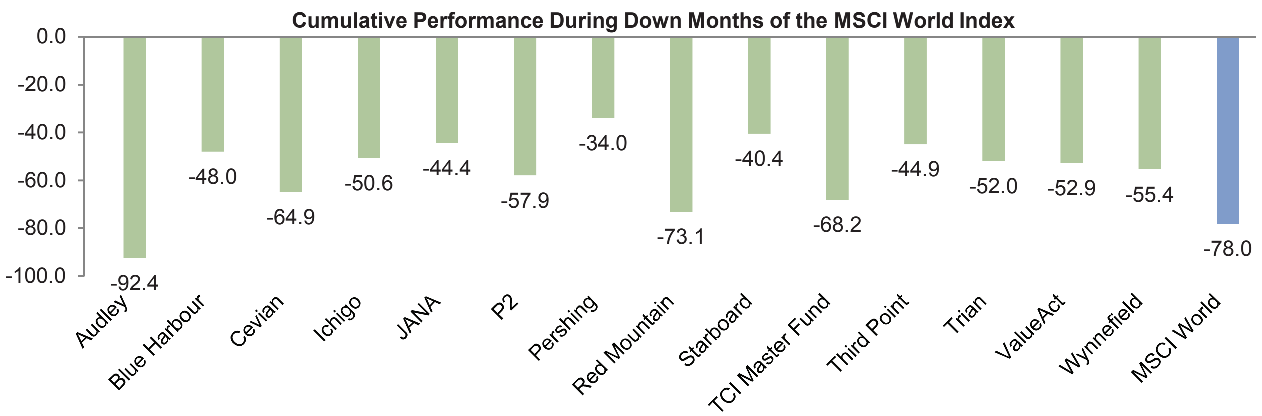
Notes: Calculations are based on monthly data, net of fees. NM indicates not meaningful.

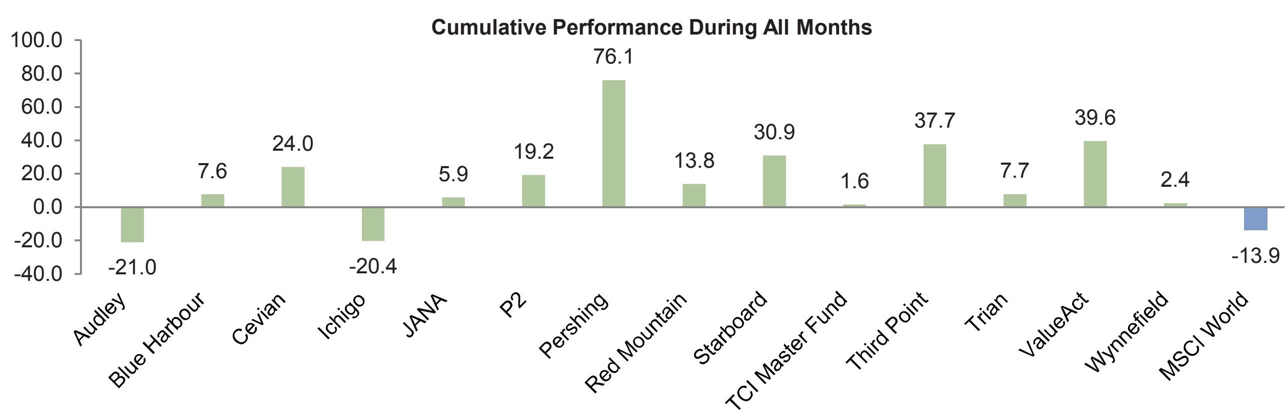
* The Sharpe ratio represents the amount of return over the risk-free rate that can be expected for each unit of risk accepted. To calculate this number, subtract the average T-bill return (risk-free return) from the manager's average return, then divide by the manager's standard deviation.

Activist Managers: Five-Year Cumulative Performance in Up/Down Markets

July 1, 2007 – June 30, 2012







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Notes: Calculations are based on monthly data, net of fees. Scale of up month performance is capped.

Activist Managers: Five-Year Correlations Among Managers and with Indices

July 1, 2007 – June 30, 2012

	Audley European Opportunities	Blue Harbour Strategic Value	Cevian	Ichigo Japan	JANA	P2 Capital	Pershing Square	Red Mountain	Starboard Value	The Children's Investment Master Fund	Third Point	Trian	ValueAct	Wynnefield Small Cap Value
Managers														
Audley European Opportunities		0.65	0.73	0.50	0.64	0.56	0.51	0.53	0.57	0.52	0.68	0.54	0.62	0.68
Blue Harbour Strategic Value	0.65		0.75	0.46	0.68	0.74	0.57	0.47	0.71	0.73	0.65	0.72	0.77	0.58
Cevian	0.73	0.75		0.43	0.61	0.71	0.60	0.55	0.58	0.70	0.56	0.67	0.72	0.61
Ichigo Japan	0.50	0.46	0.43		0.43	0.44	0.24	0.46	0.39	0.41	0.45	0.32	0.42	0.49
JANA	0.64	0.68	0.61	0.43		0.48	0.43	0.28	0.53	0.61	0.77	0.48	0.55	0.44
P2 Capital	0.56	0.74	0.71	0.44	0.48		0.64	0.51	0.64	0.64	0.46	0.64	0.66	0.57
Pershing Square	0.51	0.57	0.60	0.24	0.43	0.64		0.39	0.39	0.50	0.39	0.61	0.52	0.45
Red Mountain	0.53	0.47	0.55	0.46	0.28	0.51	0.39		0.50	0.36	0.41	0.41	0.62	0.72
Starboard Value	0.57	0.71	0.58	0.39	0.53	0.64	0.39	0.50		0.51	0.59	0.57	0.66	0.57
The Children's Investment Master Fund	0.52	0.73	0.70	0.41	0.61	0.64	0.50	0.36	0.51		0.62	0.57	0.63	0.52
Third Point	0.68	0.65	0.56	0.45	0.77	0.46	0.39	0.41	0.59	0.62		0.42	0.55	0.55
Trian	0.54	0.72	0.67	0.32	0.48	0.64	0.61	0.41	0.57	0.57	0.42		0.63	0.54
ValueAct	0.62	0.77	0.72	0.42	0.55	0.66	0.52	0.62	0.66	0.63	0.55	0.63		0.70
Wynnefield Small Cap Value	0.68	0.58	0.61	0.49	0.44	0.57	0.45	0.72	0.57	0.52	0.55	0.54	0.70	
Indices														
MSCI World	0.76	0.75	0.85	0.53	0.62	0.78	0.59	0.61	0.71	0.77	0.62	0.69	0.82	0.73
MSCI All Country World	0.77	0.75	0.85	0.53	0.62	0.77	0.59	0.61	0.69	0.78	0.62	0.68	0.82	0.73
S&P 500	0.71	0.76	0.84	0.51	0.60	0.82	0.65	0.64	0.71	0.75	0.57	0.74	0.84	0.72
Russell 2000® Value	0.67	0.75	0.80	0.45	0.47	0.84	0.67	0.68	0.71	0.63	0.45	0.78	0.77	0.73
Russell Midcap®	0.78	0.79	0.85	0.52	0.65	0.83	0.67	0.64	0.74	0.73	0.61	0.76	0.84	0.76
HFRI FOF Diversified	0.75	0.70	0.66	0.55	0.82	0.50	0.43	0.44	0.60	0.72	0.87	0.48	0.66	0.62
HFRI Equity Hedge (Total)	0.84	0.78	0.82	0.56	0.75	0.69	0.58	0.60	0.66	0.78	0.75	0.62	0.79	0.73
Barclays Aggregate Bond	-0.03	-0.12	0.06	0.17	-0.09	0.13	-0.05	-0.11	0.03	-0.02	-0.05	0.02	0.03	0.00

Correlation > 0.66
0.66 >= Correlation > 0.33
0.33 >= Correlation > 0.00
0.00 >= Correlation

Sources: Barclays, Cambridge Associates LLC Investment Manager Database, Frank Russell Company, Hedge Fund Research, Inc., MSCI Inc., Standard & Poor's, and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

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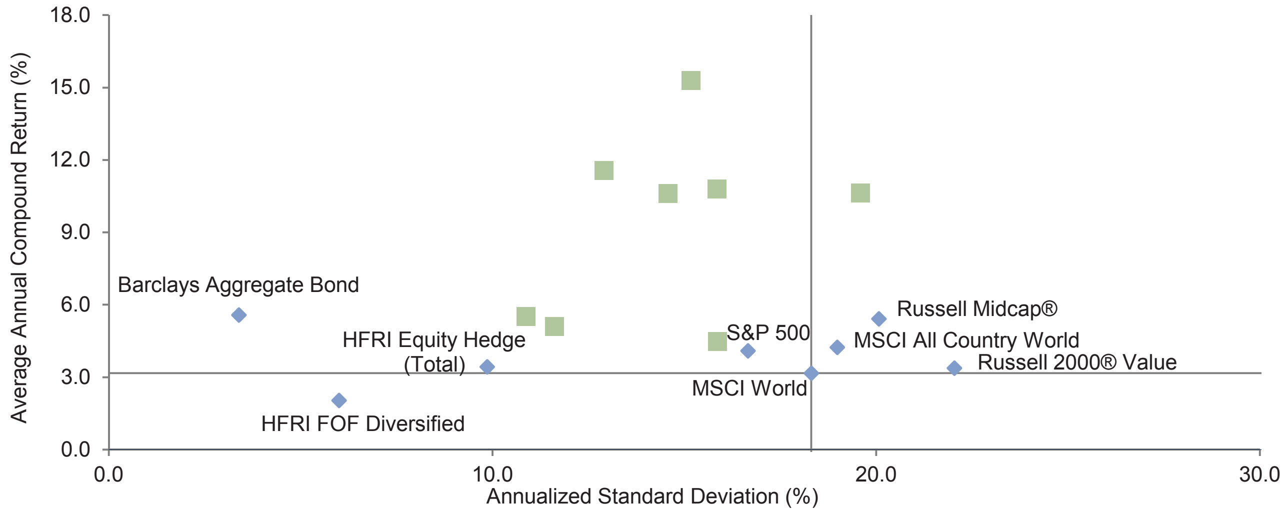
Activist Managers: Seven-Year Risk/Return Analysis

July 1, 2005 – June 30, 2012



	Average Annual Compound Return	Annualized Standard Deviation	Sharpe Ratio*	Beta vs MSCI World
Managers				
Blue Harbour Strategic Value	5.1	11.6	0.31	0.47
JANA	5.5	10.9	0.37	0.37
Pershing Square	15.3	15.2	0.89	0.49
Starboard Value	11.6	12.9	0.76	0.46
The Children's Investment Master Fund	10.6	19.6	0.51	0.82
Third Point	10.6	14.6	0.63	0.49
ValueAct	10.8	15.8	0.60	0.72
Wynnefield Small Cap Value	4.5	15.9	0.23	0.63
Indices				
MSCI World	3.2	18.3	0.16	---
MSCI All Country World	4.2	19.0	0.21	---
S&P 500	4.1	16.7	0.21	---
Russell 2000® Value	3.4	22.0	0.17	---
Russell Midcap®	5.4	20.1	0.27	---
HFRI FOF Diversified	2.0	6.0	0.03	---
HFRI Equity Hedge (Total)	3.4	9.9	0.19	---
Barclays Aggregate Bond	5.6	3.4	1.04	---

Sources: BofA Merrill Lynch, Barclays, Cambridge Associates LLC Investment Manager Database, Frank Russell Company, Hedge Fund Research, Inc., MSCI Inc., Standard & Poor's, and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

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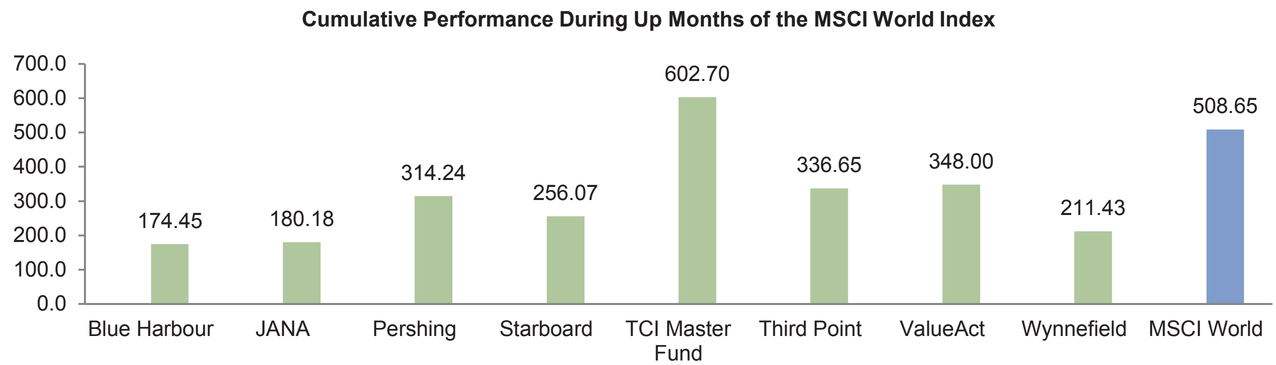
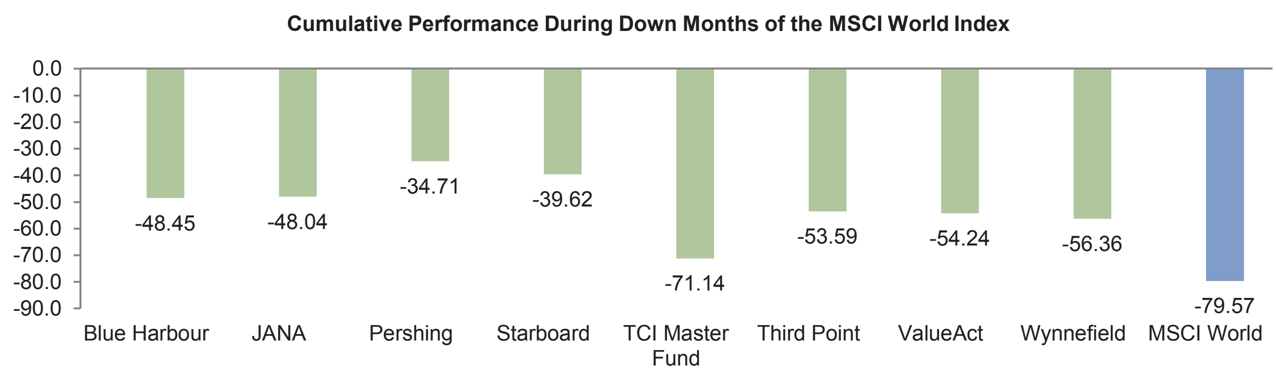
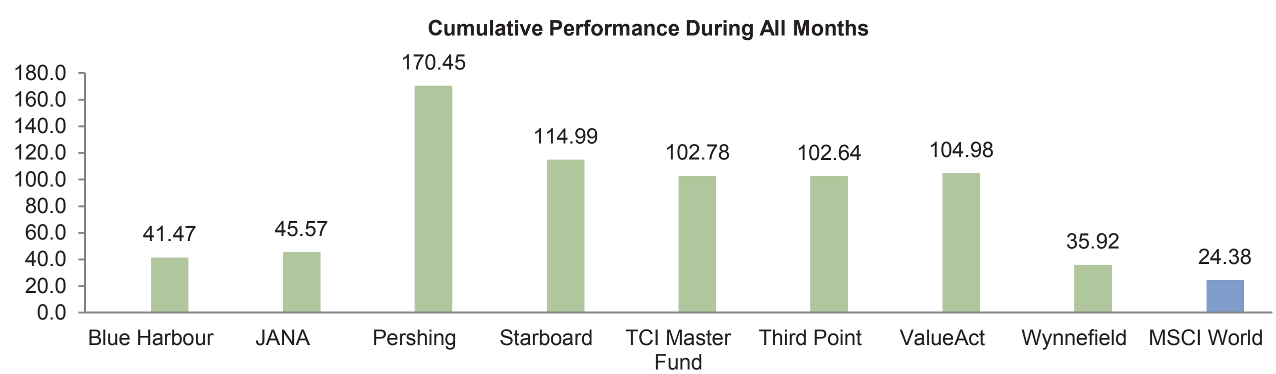
* The Sharpe ratio represents the amount of return over the risk-free rate that can be expected for each unit of risk accepted. To calculate this number, subtract the average T-bill return (risk-free return) from the manager's average return, then divide by the manager's standard deviation.

Activist Managers: Seven-Year Cumulative Performance in Up/Down Markets

July 1, 2005 – June 30, 2012







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Activist Managers: Seven-Year Correlations Among Managers and with Indices

July 1, 2005 – June 30, 2012

	Blue Harbour Strategic Value	JANA	Pershing Square	Starboard Value	The Children's Investment Master Fund	Third Point	ValueAct	Wynnefield Small Cap Value
Managers								
Blue Harbour Strategic Value		0.67	0.59	0.64	0.69	0.62	0.75	0.55
JANA	0.67		0.45	0.51	0.61	0.78	0.55	0.45
Pershing Square	0.59	0.45		0.40	0.49	0.42	0.52	0.44
Starboard Value	0.64	0.51	0.40		0.46	0.54	0.64	0.52
The Children's Investment Master Fund	0.69	0.61	0.49	0.46		0.64	0.62	0.52
Third Point	0.62	0.78	0.42	0.54	0.64		0.54	0.54
ValueAct	0.75	0.55	0.52	0.64	0.62	0.54		0.68
Wynnefield Small Cap Value	0.55	0.45	0.44	0.52	0.52	0.54	0.68	
Indices								
MSCI World	0.74	0.62	0.59	0.65	0.77	0.62	0.82	0.72
MSCI All Country World	0.73	0.63	0.59	0.64	0.77	0.62	0.82	0.72
S&P 500	0.74	0.59	0.65	0.65	0.73	0.56	0.84	0.70
Russell 2000® Value	0.73	0.49	0.67	0.68	0.62	0.47	0.77	0.71
Russell Midcap®	0.77	0.65	0.68	0.69	0.71	0.61	0.83	0.74
HFRI FOF Diversified	0.68	0.81	0.44	0.59	0.75	0.86	0.65	0.62
HFRI Equity Hedge (Total)	0.75	0.75	0.59	0.63	0.78	0.75	0.78	0.73
Barclays Aggregate Bond	-0.06	-0.10	-0.03	-0.07	-0.05	-0.07	0.00	-0.02

Correlation > 0.66
0.66 >= Correlation > 0.33
0.33 >= Correlation > 0.00
0.00 >= Correlation

Sources: Barclays, Cambridge Associates LLC Investment Manager Database, Frank Russell Company, Hedge Fund Research, Inc., MSCI Inc., Standard & Poor's, and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

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Data on Activism

Over the past few years, there have been a number of studies related to activist investing. Arguably the most widely quoted work is that of Professor Alon Brav of the Fuqua School of Business along with Wei Jiang, Frank Partnoy, and Randall Thomas. The team published a series of empirical studies based on 13D filings. In their paper "Hedge Fund Activism, Corporate Governance, and Firm Performance" (*The Journal of Finance*, August 2008) the team presented the results of a comprehensive study of 1,059 events involving 882 targeted companies and 236 hedge funds during the 2001–06 period. In addition to gathering information from the 13D filings regarding these events, the team examined news articles and other public records to determine issues such as the hedge fund's motive, the target's response, and the development and resolution of events. The paper came to some of the following observations and conclusions:

- Undervaluation, capital structure, business strategy, asset/company sales, and governance considerations were the managers' stated objectives for active engagement.
- The targets of activism were generally firms with low market value relative to book value, high return on assets, low payouts to shareholders, and sound operating cash flows.
- The median hedge fund activist holding period was around 20 months.
- The average abnormal buy-and-hold return (defined as the return in excess of the buy-and-hold return on the value-weighted NYSE/Amex/Nasdaq index from the Center for Research in Security Prices) during the 20-day window (20 days prior and 20 days after the 13D filing) surrounding the activist hedge funds' Schedule 13D filings was 7.2%. Over 60% of the events had a positive abnormal return in the 20-day window. Furthermore, the abnormal return persisted with no reversal during the subsequent year.
- Profitability of targeted companies as measured by return on assets generally improved in the second year post-activist involvement.

The researchers involved in this analysis continue to update their findings as they increase their sample size.[1]

Why Do Activists Stick Around for the Long Term?

Based on these findings, it appears that activists tend to be paid to a large extent on expectations that they will execute a value-enhancing plan. However, they often remain invested for the medium to long term. The argument could be made that if an activist started selling after the spike in price of the target company, the market would stop pricing in the expected effects of the activists' work. In other words, this pricing in is subject to the constraint that the activist needs to remain invested for a significant period of time and implement the plan. ■

[1] As of September 2012, updates to this study can be found on the website of Professor Alon Brav, web.duke.edu/~brav.