NOVUS RESEARCH

Actively Tracking Activists

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Key Findings:

• Assets controlled by activist funds are at record levels. Our aggregate long activist portfolio is tracking $176B in publicly reported assets as of June 2014[1]. That is 9.3% of the total long assets of our HF universe compared to 3.9% in 2004

• A portfolio comprised of publicly disclosed longs by activists outperforms both the broad markets and the aggregate hedge fund universe historically as well as during the current market cycle

• Activists have generally been well rewarded for taking illiquidity risk

[1] Not inclusive of updated 6/30/2014 filings. Filings were not available as of the time of this article's creation.

Introduction

Activist investors have been getting a lot of press lately. Parting from the secretive behavior common to hedge funds, many activists actually rely on media to amplify their claims, help influence public opinion and in turn drive profits on their positions. The attention has been well-deserved as of late as many campaigns have been successful in bringing about change in target companies, not to mention tidy profits for activists and their clients. However, this recent trend has been the benefactor of a persistent bull market, and risks do exist in this strategy, the main one being significant illiquidity. The reason illiquidity can pose a serious risk is that during market corrections managers tied up in their names are subject to violent swings without the ability to quickly exit their positions.

For this study we have identified 60 activist managers and combined their publicly disclosed long portfolios (sourced primarily from 13F, D and G filings) into one comingled market value-weighted portfolio containing both active and passive investments. We call this the Novus Activist Portfolio (NAP). By analyzing this data, we wanted to understand some general attributes of activist managers such as their growth in market presence, their ability to generate outsized returns, and some risks inherent in their portfolios.

Activist AUM in context

Assets managed by activist funds have increased dramatically in size since the 2008 crisis and have greatly surpassed their previous 2007 peak.
It should be noted that this graph (Figure 1) tracks the publicly reported longs of both activist and passive positions for the managers identified. Activists now control record amount of assets equaling over 9% of all HF equity assets. To put this in context, activists now control more capital than the famed Tiger Cubs in aggregate.

FIGURE 1: ACTIVISTS REPORTED ASSETS

Returns

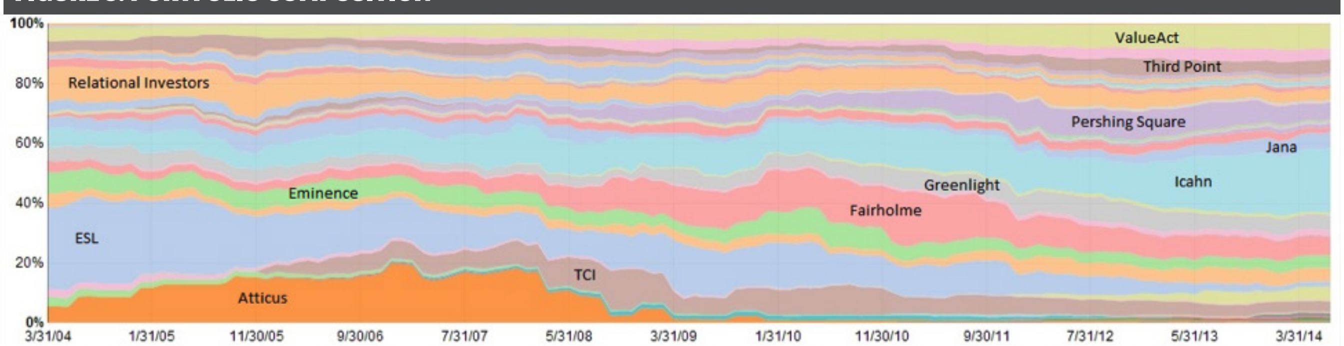
Cumulatively, the activists trounce both the market and the hedge fund universe in terms of simulated absolute return. We should of course keep in mind that this portfolio only tracks the gross performance (before fees) of simulated market-weighted public longs (no shorts, swaps etc.), but clearly their outperformance has persisted in periods of rising markets (Figure 2). Dating back to March 2004, NAP annualized at 13.6% through June 2014, compared to 7.8% for S&P 500 and 5.5% for the HFRI Fund Weighted Composite. They have done so with greater standard deviation (17.24% compared to 14.54% and 6.33%, respectively) and a superior Sortino ratio (1.07 compared to 0.66 and 0.87).

Portfolio composition

The top five managers (by value) in NAP as of June 2014 are Icahn Management, ValueAct Capital, Fairholme Capital, JANA Partners, and Greenlight Capital[2] (Figure 3). Reviewing the portfolio's manager composition historically shows the incredible rise of Carl Icahn's fund that currently stands at 22% of all activist capital. Conversely, we can see the historical fall of managers such as Atticus and ESL.

FIGURE 2: RELATIVE PERFORMANCE

FIGURE 3: PORTFOLIO COMPOSITION



2 – Not all managers selected are pure activist, passive investments also exist. The selection criteria was based on the number of 13-D filings, size of 13-F filings, news articles about managers and other public information about the managers' activities.

Does illiquidity pay?

Manager returns can be viewed as a function of two concepts – how often they are right vs. wrong (batting average) and how much they make when they are right vs. how much they lose when they are wrong (win/loss ratio). Any investor would expect less liquid names to reward activists for taking on illiquidity risk. While the batting averages for all liquidity buckets of NAP are fairly inline (54 – 59%) the win/loss ratios portray a striking trend (Figure 4).

The largest capital allocation for activists are in the least liquid buckets[3] or by our bucketing, names that would take longer than 120 consecutive trading days to liquidate. This is the very bucket that rewards activists with a disproportionate win/loss ratio – when they are right they make 4.7x the P&L they lose when they are wrong. The least liquid portion of the portfolio unsurprisingly, is the bucket with their highest P&L contribution historically.

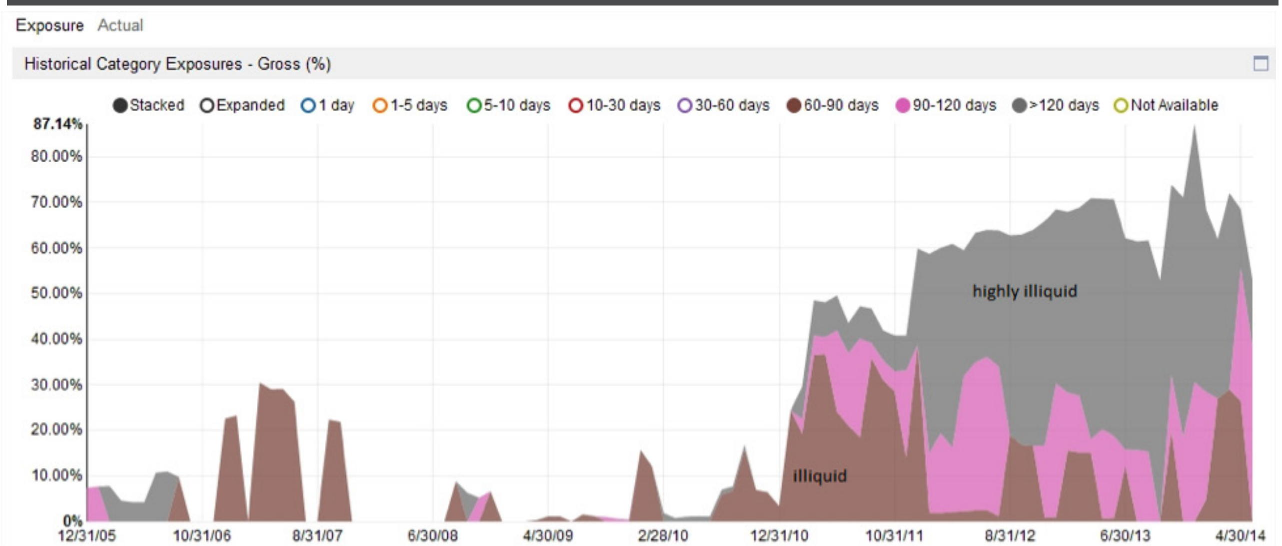
FIGURE 4: WIN/LOSS RATIO BY LIQUIDITY BUCKET

[3] – Novus calculates fund level illiquidity at the position level by computing the 90 day average trading volume and proxying 20% of that average volume as possible to liquidate in one trading day without adversely impacting the price of the stock. The most illiquid buckets are securities which represent outsized percentages of the average daily volume traded.

Risks

Generally high illiquidity is something activists are used to operating with, but an abrupt change in the liquidity profile of a single manager has historically spelled trouble. One of the top ten managers in NAP has experienced a sharp drop-off in liquidity in recent months (Figure 5). A corollary of this is that most of the gains that this particular fund has reported to investors appear to be marked to market, and have not yet been monetized. Since the manager represents large portions of the companies he is invested in, monetizing these gains might be challenging, especially if they experience any withdrawals or a market shock forces a flight to safety. Novus clients have historically received reports alerting to dramatic changes in liquidity profiles.

FIGURE 5: LIQUIDITY PROFILE OF A CERTAIN MANAGER IN NAP



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