INVESTING IN ACTIVIST HEDGE FUND STRATEGIES AN OPPORTUNE TIME

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Executive Summary

The current economic environment presents an attractive opportunity for activist hedge fund investors. With a muted economic growth outlook, high corporate cash balances, a large supply of uninvested private equity capital and an increasingly hospitable climate for shareholder-friendly corporate governance practices, activist investors are finding numerous targets for their value-enhancing investing strategies.

Most commonly considered a component of the broad event driven hedge fund category, activist investors seek to unlock “hidden” value in their target companies. The strategy is primarily equity-focused with a one to three year investment horizon. As a result, activist strategies can play multiple roles in a long-term investment portfolio – as part of an existing hedge fund program, as a complement to a private equity portfolio, or as a substitute for a long-only equity manager allocation. In this paper, we elaborate on various aspects of activism, including its risks and rewards, as well as why we believe the strategy is particularly attractive in the current economic and market environment.

The credit crisis of 2008 and the Lehman bankruptcy created significant changes in the financial structure of corporate America, with companies going into an extreme defensive mode. Their initial reaction was to stop spending, deleverage and accumulate cash. This process continued well into 2009, leading to a significant buildup in corporate cash reserves. In early 2012, JPMorgan estimated that S&P 500 companies, excluding the financial sector, had close to $2 trillion in cash on their balance sheets in aggregate. Alliance Bernstein estimated that as of 2011, the proportion of net debt to equity in the US corporate sector was the lowest in 60 years. Such huge cash balances create a significant drag on earnings, and it is anticipated that many companies will choose to allocate this cash through strategic mergers and acquisitions (M&A) in order to boost growth. However, management teams and boards often lack the skill set required to successfully undertake such strategic maneuvers; this is where we expect activist investors to find opportunities. Activists’ wide network of corporate directors and CEOs may allow them to create the strategic alliances necessary to pursue value-enhancing corporate M&A transactions.

AT NEPC WE BELIEVE THAT ACTIVIST STRATEGIES CAN PLAY AN IMPORTANT ROLE IN ENHANCING THE RETURNS OF LONG-TERM INVESTMENT PROGRAMS.

The build-up of cash is a phenomenon seen not just on corporate balance sheets, but in private equity funds as well. Since 2008, private equity investors have accumulated approximately $425 billion of uninvested capital. As they approach their investment deadlines, these investors will likely look to public markets for opportunities to generate significant “corporate events”. This activity should increase opportunities available to activist investors for participating in buyouts and other strategic acquisition deals.

Lastly, shareholders have learned lessons from the collapse of large companies such as Enron and WorldCom, and from the mismanagement that led to the bailout of large corporations such as AIG. As a result, there is an increased focus on the corporate governance structure of companies, a trend that should translate into better valuations going forward. Some activist investors focus on improving weak governance standards and thereby increasing a company’s valuation. The potential reward for such improvements is considerable, as investors have begun to see the relationship between good governance standards and improved equity valuations.

Briefly: What is Activism?

Activism is a strategy in which an investment manager takes a minority position in a public company with the goal of unlocking value by altering its capital allocation activities. Tactics to accomplish this include financial restructuring, operational turnarounds, and/or strategic initiatives. A key hypothesis underlying this strategy is that the target company is undervalued and is generating earnings below its potential, but is not necessarily distressed.

Activist investing has some key aspects that investors should keep in mind when making an allocation to the space. Activist funds tend to have concentrated portfolios and the underlying positions often have longer investment horizons than many other forms of public market investing. Therefore, funds that utilize an activist strategy tend to have higher volatility and longer lock-ups relative to other public market strategies, including various forms of hedge funds.

Attractive Market Environment

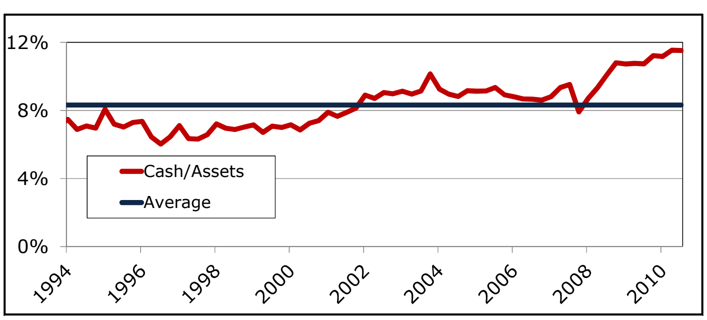
The primary return drivers for the activist strategy are value enhancement tactics undertaken by the fund manager. The recent market environment has provided increased opportunities for hedge fund investors implementing these tactics. There are three primary reasons why we think activist strategies will flourish in the current market environment:

I. Excess cash

There are two key sources of excess cash, one from corporate balance sheets and the other from the uninvested private equity capital.

Many companies responded to the financial crisis of 2008 by building high cash levels. As reported in the *Financial Times*, a research study by JPMorgan estimated that as of early 2012, S&P 500 companies, excluding the financial sector, had approximately $2 trillion of cash on their balance sheets. Exhibit 1 shows the trend in cash build up in S&P 1500 companies (excluding Financials) since 1994, with levels currently at an all-time high.

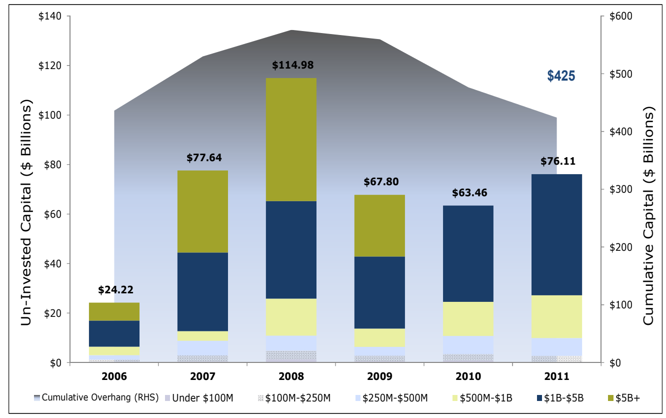
Exhibit 1 : U.S. Corporate Cash – S&P 1500 (Excluding Financials)



Source: Goldman Sachs, Blue Harbour Group

In addition to high corporate cash levels, as of Q1 2012 there was an estimated $425 billion of uninvested private equity capital, much of which is likely to be invested over the next 24-36 months due to expiring investment periods. Exhibit 2 shows this huge overhang of unspent Private Equity capital, much of which will be targeted at public companies due to the sheer volume of assets that need to be deployed.

Exhibit 2: Capital Overhang of U.S. Private Equity Investors by Vintage Year

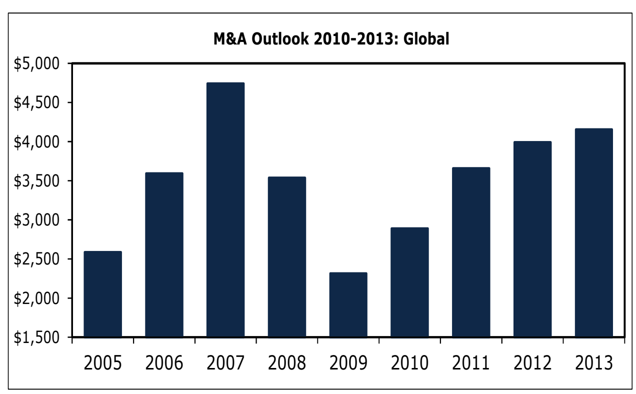


Source: PitchBook: PE Trends 1Q2012

II. Expected increase in M&A activity

As shown in Exhibit 3, after two years of depressed activity, the M&A market experienced a noticeable pickup in activity in 2011. This trend is expected to accelerate in the coming years. With excess corporate cash available and a muted long term GDP growth environment in developed markets, it is expected that more companies will seek strategic M&A transactions to propel both top and bottom lines. Furthermore, company managements and external shareholders appear to be more receptive to strategic as well as operational solutions such as positioning the company as a potential sale target or improving its competitive positioning via strategic acquisitions.

Exhibit 3: Historical and Projected Mergers and Acquisition Activity (in $B)



Source: Sanford C Bernstein & Co.

III. Increasing demand for good corporate governance standards

The third major driver of the activist opportunity set is increased shareholder focus on improving corporate governance standards. Since the collapse of Fortune 500 corporations such as Enron and WorldCom and the 2008 bailout of large financial institutions such as AIG, there has been an increased shareholder focus on the corporate governance structure of companies.

Corporate governance focuses on mitigating potential conflicts of interest between shareholders (who truly own the company) and the managers who operate the company on a day-to-day basis. At times, there can be a misalignment of interest between the two parties, leading to what are referred to as 'agency costs'. Some typical areas of conflict between shareholders and corporate managers include:

- High executive compensation
- Poor capital budgeting/asset allocation decisions
- Lack of transparency and/or inaccurate reporting
- Lack of independent audit committees
- Misuse of non-public information

Over the past decade government has sought to improve corporate governance processes and procedures. Noteworthy initiatives include the passing of the Sarbanes-Oxley Act to monitor corporate management's accountability and responsibility, the creation of special listing requirements targeting corporate governance metrics by the New York Stock Exchange and the initiation of new disclosure requirements by the SEC. Additional details are listed in Appendix 1.

Recent research has pointed to increased valuations being associated with improved corporate governance structures (please refer to Appendix 2). This increased emphasis on better standards has created more opportunities for activist investors that target companies with poor corporate governance structures.

Commonly Deployed Activist Tactics

As explained above, an activist manager attempts to enhance a company's value by restructuring its operations, capital structure, and/or implementing strategic initiatives. Underlying the strategy is a key hypothesis: the target company is undervalued and is generating earnings below its potential, but is not necessarily operating in a distressed state.

The three most common tactics (or any combination thereof) used by activist investors are as follows:

I. Financial restructuring

The primary objective of this approach is to create value by restructuring a company's balance sheet, which typically results in altering the leverage structure in an attempt to impact the valuation of the company. Some commonly used tactics for this strategy include reducing excess cash by increasing the dividend payout, initiating share buyback programs, and changing the leverage structure by retiring outstanding debt or restructuring debt.

II. Operational turnaround

The primary objective of this approach is to create value by increasing operating margins. Activist investors have two ways that they can help companies enhance operating margins, either by implementing revenue enhancing techniques or by reducing operating costs. Revenue enhancing techniques include tactics such as modifying product prices, focusing on more prudent target markets and segments, and amending existing product lines for better marketability and cost efficiency. On the cost cutting front, investors might focus on changing the supplier of raw materials (without affecting the output quality), streamlining operational logistics, reducing overhead costs, eliminating loss making franchises and business units, improving marketing, sales, and distribution channels, or restructuring management compensation.

III. Strategic turnaround

While operational turnaround tactics focus on improving operating margins, strategic turnaround tactics are broader in their scope. These typically involve making strategic moves such as M&A transactions, joint ventures, and/or the spin-off of incompatible divisions or product lines. Activist investors use their wide network of corporate relationships in implementing such maneuvers.

Implementing an Activist Strategy

There are many ways that investors implement activism. Generally, the first step is to build up a position in the target company. This can be accomplished via an outright purchase in the stock market or through negotiated transactions with current owners. Some investors have also used options to build up their positions, though the extent of voting power associated with such option positions can be ambiguous. In the U.S., a shareholder who acquires more than a 5% share in a public company is required to file a Schedule 13D with the SEC within 10 days. This form, which is a public document, serves as a resource for both the shareholders as well as to the company's management regarding the intentions of the new equity holder. It also acts as a source of information for those monitoring activist investors in the market. Once a position is established, the investor typically approaches the company's management with a plan to improve the company's valuation using one or a combination of the three tactics described above. Communication can be conducted in either a hostile or a non-hostile manner.

THE PRIMARY RETURN DRIVERS FOR THE STRATEGY ARE VALUE ENHANCEMENT TACTICS UNDERTAKEN BY THE FUND MANAGER.

In a non-hostile situation, company management is open to communication with the investor and reviewing ideas for improving valuation. This type of collaborative approach is often done quietly and without attention from the press. It also tends to be less expensive. Activist investors employing only non-hostile tactics usually tend to avoid ideas that may require them to be outwardly confrontational or launch a public battle with the company.

A hostile situation arises when a target company's management is averse to communicating with the activist investor or accepting the changes recommended by the investor. Such situations usually tend to draw a lot of attention from the press as both parties resort to communicating with each other publicly. These situations tend to be more expensive. The return hurdles for such investments are therefore higher and are perceived as such by the market. The activist manager typically discusses the restructuring plan in public forums and the company's management responds via press releases, analyst calls, and shareholder meetings. Hostile situations usually involve proxy fights, competition for board seats (or nominations), and/or takeover bids.

In a proxy fight the activist investor will try to accumulate as many proxy votes as possible prior to the shareholder or board meetings where a specific item of interest is to be addressed. The idea is to accumulate majority votes so that the activist investor is successful in getting his or her proposed plan approved. There are dedicated proxy advisory firms such RiskMetrics Group and PROXY Governance that provide guidelines to shareholders for voting. Activist investors may also approach such firms with their proposed plans to solicit their views.

In some companies, majority stakeholders or a certain category of investors are entitled to a board nomination. Such elections, however, often require approval from the existing board, which in a hostile situation, may not always work in the activist investor's favor. In such cases the activist manager may resort to communicating publicly with management. Typically, an investment manager will try to nominate either a member of its own team or propose someone from the industry with relevant experience. These nominated board members are expected to drive the plan laid out by the investor. Once nominated to the board, an activist manager is generally able to get better access to information and company management.

In a takeover bid, the activist investor seeks to remove the existing management and install a new management team. The new management then implements changes proposed by the activist investor.

Once the plan recommended by the activist investor is implemented and company valuations begin to improve, the investor begins to plan an exit strategy, typically as desired price targets are achieved with positions sold in the open market.

Implementing Activist Strategies Over a Market Cycle

I. Activism in a recessionary market environment

In a recessionary period, company operations generally come under intense scrutiny. Cost cutting is the general theme as management attempts to maintain margins. Amidst such conditions, operational and financial restructuring tactics are typically more appropriate relative to strategic turnarounds. Activist investors focused on streamlining operations and increasing margin efficiency find target company management to be more receptive during such a period.

II. Activism in an upward trending market environment

When an economy is in the process of emerging from a recession many companies remain in a defensive stance. Still reeling from a lack of market liquidity and available credit, companies tend to build up excess cash on their balance sheets. As the economy improves, however, sales typically pick up and unemployment rates decrease.

With improving access to capital, liquidity in the market improves. This encourages management teams to invest in new projects in order to generate organic growth as well as actively seek out corporate transactions to promote growth through acquisitions. Such an environment is usually the best for the strategic turnaround activist approach. With a more willing management and an equally receptive market, activist investors, with their wide network of CEOs and toolkit of operational and financial engineering tactics, can more easily facilitate strategic transactions and restructurings.

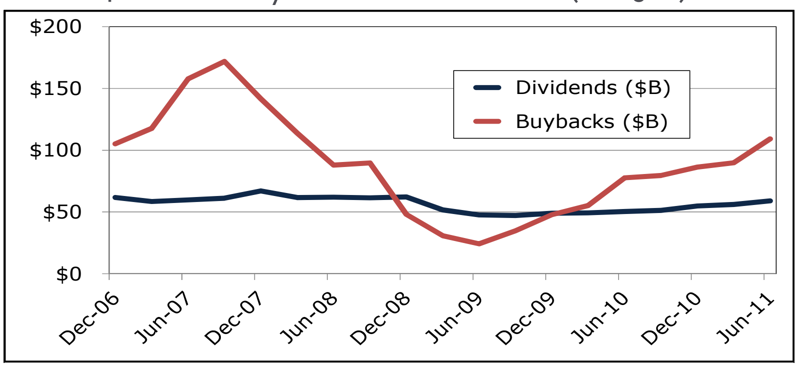
III. Activism in the current market environment

The current high levels of cash on corporate balance sheets should especially benefit activist investors implementing both financial restructuring as well strategic turnaround strategies.

In an environment where organic growth is difficult to achieve, corporate managements have two options for investing their cash: they can either use that cash to restructure their balance sheet by conducting share buybacks or paying out dividends, or they can seek to grow the company strategically by engaging in M&A transactions. However, not all CEOs and managements possess the skill set required to engage in such strategic and financial maneuvers. Both situations provide excellent investment opportunities for activist investors to add value.

Stock buybacks have been on the rise since 2009. Exhibit 4 shows the trend in dividends and buybacks for S&P 500 companies since 2006. If corporate managements are more amenable to such actions, it is easier for activist investors to implement their strategies.

Exhibit 4: Historical Buyback and Dividend Trend (S&P 500)



Source: S&P Research

Other Important Elements of Activist Investing

I. Market capitalization

Activist investing can span the equity market capitalization spectrum. Our research indicates that the activist strategy lends itself more readily to small and mid-cap companies for three primary reasons. First, management teams in small and mid-cap companies are relatively inexperienced compared to large cap companies. They are generally less sophisticated in their capital allocation decisions and therefore tend to be more amenable to changes proposed by an activist investor. Collaborating with such a management team can lead to lower expenses and faster resolutions and an activist campaign can generally be resolved in a less hostile manner. These factors can significantly boost returns. Second, a relatively smaller investment is required in small and mid cap companies to acquire a status of a significant minority shareholder. In other words, it is easier for an activist manager to garner support from other shareholders in small and mid-cap companies with a smaller, more concentrated shareholder base. Lastly, stock valuations can potentially show a significant improvement in small and mid-cap companies, which trade in a relatively inefficient sector of the market; i.e. it is easier to "move the needle" on the price of smaller companies. Large cap companies, in contrast, are generally more efficiently priced and can have limited upside.

II. Geographic location

The corporate culture and shareholder attitude toward activism varies widely across countries. A country's social structure also acts as a strong influencing factor. For example, in some countries (e.g. France) more emphasis is often placed on employment stability than on corporate profitability. Activist investors and their restructuring ideas are not very well received in such geographies. Also, the strategy is more successful in countries with stronger shareholder rights and legal structures.

Activism has been proven to work well in the U.S. and parts of Europe, but less well in Asia. A couple of recent activist campaigns in Japan failed miserably, mostly due to local structural and cultural factors.

III. Board Structure

The structure of the Board of Directors also affects the effectiveness of the strategy. An ideal board structure for this strategy is one in which an activist investor can influence or have control over the key decision makers. Some key factors that can drive that process are:

- Separation of Roles: Separation of the management and board of director including CEO of the company and Chairman of the board, as seen in Europe.
- Seniority and authority of the board over that of the CEO (as seen in Nordic regions like Sweden, Norway, etc.)
- Willingness and ability of the board to influence changes at the company
- Level of shareholder representation in board-nominations

The easier it is for an investment manager to access and influence the board, the more quickly he or she can implement value-enhancing changes.

The Typical Activist Fund Portfolio

A typical portfolio for an activist fund is concentrated, with 8-10 core positions, and long-biased. The average position size can vary from 5-15% of portfolio value based on both the conviction level in the position and the size of the target company. In addition to having core positions, an activist investor typically invests in 10-15 "farm" positions.

These holdings are toe-hold (smaller) positions in companies that the investor is interested in, but may not have enough conviction at that point to establish a full allocation. Creating a toe-hold position typically provides the investor with more access to information from the company and creates a greater incentive for the manager to follow closely any company developments. If the idea gains momentum, it is converted into a full position in the portfolio. Entry into and exits from a position are usually planned such that the fund can meet its liquidity requirements. Each holding often has a specific price target, and, as it is achieved, positions are exited.

Some investors may implement hedges by shorting indices or baskets of stocks. Most of these index hedges are targeted towards reducing systematic market exposure and are not specifically designed to provide protection against individual positions. Basket shorts may reduce exposure to a certain industry or sector, but generally are not intended to be perfect hedges for individual positions.

The average holding period of a position varies but typically ranges from 6 to 36 months. Many activist investors try to match their fund's liquidity terms to this investment horizon. Therefore, even though activist funds are generally invested in liquid positions, they may have longer lock-up periods set to match the investment horizon of the strategy.

Positioning Activist Funds in an Investment Portfolio

To understand how these funds can be positioned in an investment portfolio, we look at some of their basic performance features. In general, due to their high inherent volatility, activist funds should be used to enhance returns but not to reduce total risk. For our analysis below, we use the HFRX Activist Index (please refer to Appendix 3 for details on HFRX Index) to represent the activist hedge fund universe, the S&P 500 representing equity markets and the BarCap Aggregate Index representing the bond market. We acknowledge that there are some limitations (as described in "Risk Factors," below) in using the HFRX index for these analytics; however, it does provide us with the best proxy available of an activist universe for these computations.

I. Diversifying an existing hedge fund allocation

Activist funds are primarily sub-categorized under event driven strategies. They can be used as a part of a long-biased event-driven allocation. Their equity focus will help to diversify an existing credit/distressed-oriented event driven multi-strategy allocation.

Exhibit 5 shows comparative risk-return statistics for different subcategories within the event driven strategy. The HFRX Activist index outperforms all other indices over the seven-year time horizon albeit with greater volatility due to its higher equity bias.

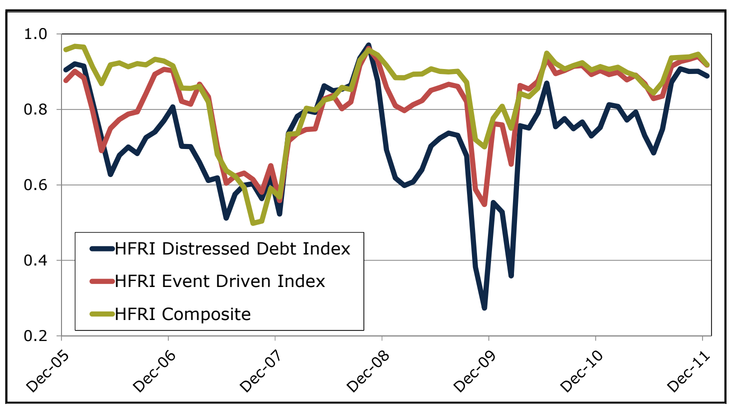
Exhibit 5 : Comparative Returns for Hedge Funds vs. HFRX Activist Index (3/31/2012)

	Return		
Index	**3 Yr**	**5 Yr**	**7 Yr**
HFRX Activist Index	15.6%	1.6%	6.9%
HFRI Event-Driven Index	12.2%	2.5%	5.4%
HFRI ED: Distressed/Restructuring Index	13.9%	2.1%	5.2%
HFRI Fund Weighted Composite Index	9.4%	2.6%	5.3%
	Downside Deviation		
Index	**3 Yr**	**5 Yr**	**7 Yr**
HFRX Activist Index	10.9%	14.3%	12.4%
HFRI Event-Driven Index	4.9%	7.5%	6.5%
HFRI ED: Distressed/Restructuring Index	4.7%	7.7%	6.6%
HFRI Fund Weighted Composite Index	5.0%	7.1%	6.2%
	Maximum Drawdown		
Index	**3 Yr**	**5 Yr**	**7 Yr**
HFRX Activist Index	-21.3%	-37.4%	-37.4%
HFRI Event-Driven Index	-9.1%	-24.8%	-24.8%
HFRI ED: Distressed/Restructuring Index	-8.7%	-27.4%	-27.4%
HFRI Fund Weighted Composite Index	-9.0%	-21.4%	-21.4%

Source: PerTrac

Exhibit 6 shows the rolling correlation of the HFRX Activist Index versus the HFRI Distressed Debt, HFRI Event Driven Index, and the HFRI Composite. The equity focused HFRX Activist Index shows lower correlation to the debt-heavy distressed debt and event driven indices, thereby suggesting good diversification benefits.

Exhibit 6: Rolling Correlation – HFRX Activist Index vs. Hedge Fund Indices



Source: PerTrac

II. As a complement to a private equity allocation

As discussed earlier, although the underlying holdings in most activist funds are typically liquid and publicly traded, the average time for a complete investment cycle is longer than most hedge fund strategies. To match this investment horizon, activist funds typically require longer lock-ups and offer more restrictive liquidity terms than most hedge funds. Therefore, an allocation to an activist fund should be considered as a relatively illiquid position in a client's portfolio, akin to a private equity allocation. Thus, while it is not intended to serve as a direct substitute for a private equity allocation, investment in an activist fund may offer some characteristics similar to that of a private equity buyout fund. One major difference, however, between activist funds and buyout funds is the leverage factor. Buyout firms use leverage as an inherent part of their strategy whereas activist firms typically do not use the addition of leverage as a corporate tactic. Also, whereas buyouts generally involve taking public companies private and "fixing" them with the goal of an IPO or sale as the exit, activism is typically focused on companies that will remain public as value-creating tactics are implemented. An allocation to an activist fund offers some advantages to an allocation to a traditional buyout fund:

Liquidity: Higher liquidity compared to a buyout allocation. An activist fund's typical investment horizon is shorter than that of a buyout firm. A buyout firm has a 10-12 year investment structure compared to an activist fund's 2-4 year horizon.

Absence of "J-curve" effect: Like most private equity funds, buyout fund returns are subject to a "J" curve effect. This is absent in an activist fund.

Similarity in structure: Many activist funds are set up to charge incentive fees at the end of the lock up period. Some activist investors also offer funds with capital commitments/drawdown structure similar to a private equity fund. However, most activist hedge funds do not offer hurdle rates.

III. Diversifying a Traditional Long-only Equity Allocation

The HFRX Activist Index shows a high positive correlation to many equity indices, which can be explained by the long-biased equity portfolios of the constituent funds. This suggests that activist hedge funds can be used as an equity substitute or as a complementary exposure for a long equity portfolio. However, the difference in the liquidity profile of a traditional equity allocation and an activist manager should be kept in mind when making such an allocation.

Exhibit 7 shows the value added impact of complementing a traditional long-only equity allocation with an activist fund. The HFRX Activist Index demonstrates a higher return over a 3 and 5 year horizon with lower downside volatility, i.e., enhancing portfolio return with less risk.

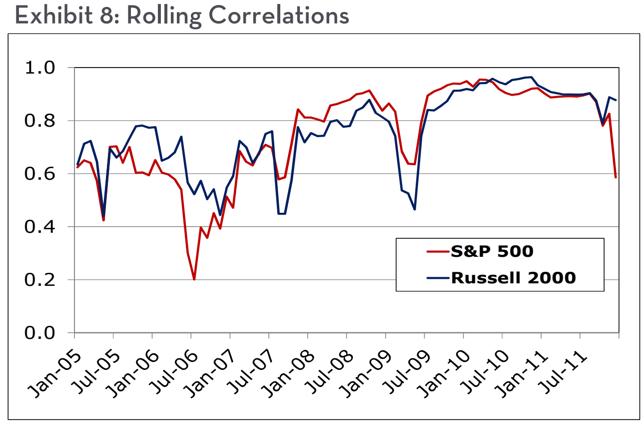
Exhibit 7: Comparative Returns:
HFRX Activist Index vs. Traditional Indices 3/31/2012

	Return		
Index	Ann 3 Year	Ann 5 Year	Ann 7 Year
HFRX Activist Index	15.6%	1.6%	6.9%
S&P 500 TR	23.4%	2.0%	4.7%
Russell 2000 Index	25.2%	0.7%	4.4%
	Downside Risk		
Index	3 Yr Downside Deviation	5 Yr Downside Deviation	7 Yr Downside Deviation
HFRX Activist Index	10.9%	14.3%	12.4%
S&P 500 TR	9.8%	15.3%	13.2%
Russell 2000 Index	13.9%	19.5%	17.0%
	Maximum Drawdown		
Index	3 Yr Max Drawdown	5 Yr Max Drawdown	7 Yr Max Drawdown
HFRX Activist Index	-21.3%	-37.4%	-37.4%
S&P 500 TR	-16.3%	-50.9%	-50.9%
Russell 2000 Index	-25.6%	-54.1%	-54.1%

Source: PerTrac

Exhibit 8 shows the rolling correlation between the HFRX Activist Index and the most commonly referenced equity indices—the S&P 500 and Russell 2000. The hedge fund index generally shows high correlation to both the equity indices, which supports the use of activist investors as an equity substitute.

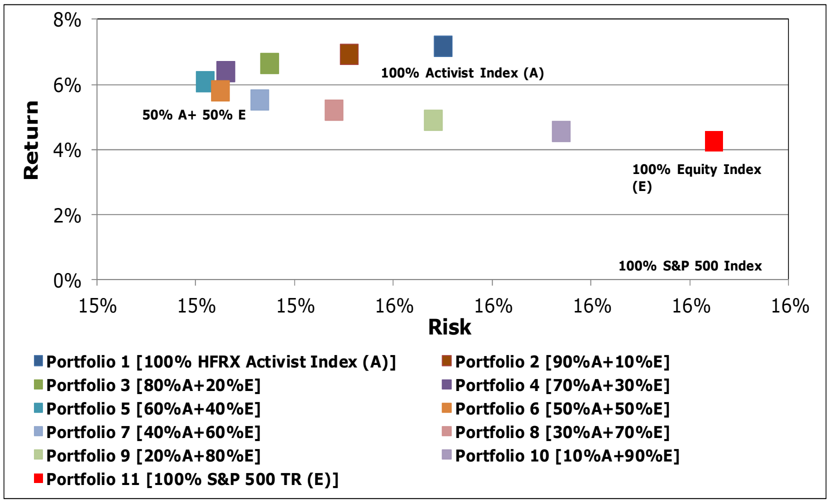
Exhibit 8: Rolling Correlations



Source: PerTrac

For Exhibit 9 we created 11 portfolios with varying weights given to the activist and equity indices (details of the analysis are in Appendix). The portfolio that is comprised 100% of the activist index demonstrated a higher return for lower risk relative to a 100% S&P 500 (equity) portfolio. This indicates that activist hedge funds may also be used to diversify a large cap equity portfolio and enhance its risk-return profile. Of course, this analysis is highly dependent on the particular his-

Exhibit 9: Efficient Frontier (January 2005 to March 2012)



Source: PerTrac

torical period modeled and therefore the results are merely illustrative of these relationships.

Risk Factors and Other Considerations

As with any strategy, activism has its own set of unique risk factors that investors should be aware of when considering an investment in the space.

First, funds are typically concentrated and aggressive with about 8-15 core positions and 10-15 farm positions. They generally have a long bias, although some funds may hedge the overall market or a particular industry or sector using either index or basket shorts. Managers typically do not use position-level hedges. Nevertheless, activist funds can experience equity-like levels of volatility including significant drawdowns.

Second, the strategy invests with a longer investment horizon. Thus, even though these funds invest in publicly traded stocks, they tend to have longer lock ups, often in the one to three year range. Such longer locks are required to provide the activist manager with stable capital for making concentrated, longer-term investments.

Third, activist investors participating in hostile situations tend to frequent the news headlines. This may be a concern for certain types of investors.

Lastly, there is a lack of suitable benchmark for the strategy. HFRX (Hedge Fund Research's investible index series) has an Activist Index available but it does not represent an exhaustive list of managers. Since activist investors use a private equity approach, comparing such funds to an evergreen investible HFRX index is not ideal. Investors can overcome this shortcoming to a certain extent either by using a long-only equity index or assigning it a relevant asset class index, for example using a broad hedge fund index if the allocation is in the hedge fund category.

Conclusion

We believe that the current economic and corporate environment provides an attractive investment opportunity for activist investors. High corporate cash balances, a large overhang of private equity capital, increasing mergers and acquisition activity, and a growing focus on corporate governance can all contribute to successful implementations of this strategy. Activist investors pursuing small and mid-sized companies may have an advantage over those investing in the large cap space due to the relative inexperience of management in small and mid capitalization companies, market inefficiency in these segments, and relatively smaller amount of capital required to gain significant position size.

Investors can implement this strategy in multiple ways; either as a part of their hedge fund or private equity portfolio or as a substitute for their long-only equity allocation. However, given that activist funds typically have a concentrated equity portfolio and a longer investment horizon, volatility and liquidity are key considerations for investors allocating capital to this strategy. Although the terms offered by activist investors are generally comparable across funds, the lack of a hurdle rate may be something that can be improved upon. Implementing a hurdle rate would bring these funds up to par with other offerings in the market that require a longer term capital lockup.

In conclusion, at NEPC we believe that activist strategies can play an important role in enhancing the returns of long-term investment programs, although with an eye to managing the associated risks.

Appendix

1. Some of the key initiatives by government agencies to improve corporate governance practices (Source: 2004 CPA Journal, SEC) include:

2002: The Sarbanes-Oxley Act was passed to focus on the following key aspects:

- Management dealing in an environment full of pervasive conflicts of interest
- Lack of strict transparency, reliability, and accuracy standards in financial reporting
- Lack of independence between the key players in corporate governance (the board of directors, management, and auditors)
- Lack of adequate enforcement tools at the disposal of regulators, and
- Influencing securities market transactions for example colluding to drive stock prices

2003: NYSE & NASDAQ created special corporate governance listing requirements which primarily addressed issues such as:

- •Independence of Board of DirectorsMandatory meeting requirements for non-management directors
- •Guidelines for both internal and external audit committees
- •Independent compensation committees
- •Disclosure of any non-compliance with corporate governance guidelines

2009: The NYSE amended the corporate governance guidelines and the amendments were approved by the SEC

2009: The SEC proposed rules for public companies receiving money from the Troubled Asset Relief Program (TARP) to provide executive compensation on proxy solicitation

2009: The SEC proposed new disclosure requirements for companies addressing:

- •The relationship of a company's overall compensation policies to risk
- •The qualifications of directors, executive officers and nominees
- •Company leadership structure
- •Potential conflicts of interests of compensation consultants

2. Sample Corporate Governance studies include:

McCahery, Joseph A., Starks, Laura T. and Sautner, Zacharias, Behind the Scenes: The Corporate Governance Preferences of Institutional Investors (March 15, 2010). Available at SSRN: abstract=1571046.

"Strong corporate governance feeds through to a company's stock market performance - often resulting in a higher market valuation and improved dividend distribution" – Standard and Poor's. Published by LexisNexis, October 2009.

Allayannis, George S., Lel, Ugur and Miller, Darius P., Corporate Governance and the Hedging Premium Around the World (August 20, 2009). Darden Business School Working Paper No. 03-10. Available at SSRN: http://ssrn.com/abstract=460987 or doi:10.2139/ssrn.460987

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3. HFRX Index Details:

Category	HFRI Monthly Indices	HFRX Indices
Inception	Varies by index (Earliest 1990)	Varies by index (Earliest 1998)
Weighting	Equal-weighted	Varies by index
Reporting Style	Net of all fees	Net of all fees
Performance Time Series Available	Monthly	Daily or Monthly
Index calculated	Three times per month	Daily and Monthly
Index performance finalized	Trailing four months of performance are subject to revision	Performance finalized at month-end
Index rebalanced	Monthly	Quarterly
Criteria for fund inclusion	Reports monthly net of all fees monthly performance and assets in USD	In addition to meeting HFRI criteria, fund must be open to new transparent investment and meet track record and minimum asset size requirements
Minimum Asset Size and/or Track Record for fund inclusion	$50 Million minimum or > 12-Month Track Record	$50 Million and 24-Month Track Record (typical)
Index Denomination	USD; some hedged to GBP, JPY, CHF & EUR	USD; some hedged to GBP, JPY, CHF & EUR
Investable Index	No	HFR Asset Management, LLC constructs investable products that track HFRX Indices
Number of Constituent Funds	Over 2000 in HFRI Fund Weighted Composite; over 650 in HFRI Fund of Funds Composite	Over 250 in total constituent universe, with over 40 of these in the HFRX Global Hedge Fund Index

Source: Hedgefundresearch.com

4. For our efficient frontiers we created 11 portfolios with varying index weights as detailed below:

Portfolio 1: 100% Activist index + 0 % S&P 500 TR index

Portfolio 2: 90% Activist index + 10 % S&P 500 TR index

Portfolio 3: 80% Activist index + 20 % S&P 500 TR index

Portfolio 4: 70% Activist index + 30 % S&P 500 TR index

Portfolio 5: 60% Activist index + 40 % S&P 500 TR index

Portfolio 6: 50% Activist index + 50 % S&P 500 TR index

Portfolio 7: 40% Activist index + 60 % S&P 500 TR index

Portfolio 8: 30% Activist index + 70 % S&P 500 TR index

Portfolio 9: 20% Activist index + 80 % S&P 500 TR index

Portfolio 10: 10% Activist index + 90 % S&P 500 TR index

Portfolio 11: 0% Activist index + 100 % S&P 500 TR index

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Disclaimers and Disclosures

- Past performance is no guarantee of future results.
- Information on market indices was provided by sources external to NEPC, and other data used to prepare this report was obtained directly from the investment manager(s). While NEPC has exercised reasonable professional care in preparing this report, we cannot guarantee the accuracy of all source information contained within.
- This report may contain confidential or proprietary information and may not be copied or redistributed.

In addition, it is important that investors understand the following characteristics of non-traditional investment strategies including hedge funds, real estate and private equity:

1. Performance can be volatile and investors could lose all or a substantial portion of their investment
2. Leverage and other speculative practices may increase the risk of loss
3. Past performance may be revised due to the revaluation of investments
4. These investments can be illiquid, and investors may be subject to lock-ups or lengthy redemption terms
5. A secondary market may not be available for all funds, and any sales that occur may take place at a discount to value
6. These funds are not subject to the same regulatory requirements as registered investment vehicles
7. Managers may not be required to provide periodic pricing or valuation information to investors
8. These funds may have complex tax structures and delays in distributing important tax information
9. These funds often charge high fees
10. Investment agreements often give the manager authority to trade in securities, markets or currencies that are not within the manager's realm of expertise or contemplated investment strategy