Ride the Coattails of Activist Hedge Funds with Form 13D

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Hedge fund performance in aggregate has returned a dismal 3.55% as of the end of June, versus the 13.24% return of the S&P 500 during the same period. As unenviable as these returns are, *activist* hedge funds have attracted a lot of attention this year, and with good reason. Not only are they making headlines for public disputes, but the market environment is back in a position where activists can find alpha-rich trades following the fallow years of the credit crisis.

JP Morgan published a primer on the return of activist hedge funds back in 2010 that outlined how the return of credit to the markets has combined with record levels of corporate cash and a desire for improved corporate governance in the absence of top line growth, providing a fertile environment for hedge fund activists. More recently, law firm Schulte Roth & Zabel's 2012 Shareholder Activism Insight report found that "[using] poor financial performance and the need for management or operational change as motivation" hedge funds and other active investors are expected to add to the growth of shareholder activism, and 84% of the survey's respondents expect a significant rise in shareholder activism in the near future.

The rise of activist hedge fund activity means a steady stream of regulatory filings from these managers, providing an excellent source of alpha-rich trading ideas without the long lockups and heavy fees of investing directly in a hedge fund.

Following Hedge Funds

Hedge funds are by their very nature opaque. However, the various Securities and Exchange Commission (SEC) regulations that apply to hedge funds do compel managers to adhere to various reporting requirements. This includes the quarterly filing of Form 13F, containing the largest long equity holdings of funds over $100M, and Schedule 13D (known as "Form" 13D), which must be filed within 10 days of a manager taking an "active" stake representing more than 5% of outstanding shares in a public company.

Both types of filings have their limitations, and neither presents a perfectly clear picture of what exactly a hedge fund is really doing. For example, Form 13F does not show the "short" side of the manager's book, nor the manager's derivative positions. Similarly, activist managers frequently use tactics to avoid or delay filing Form 13D by establishing large positions in a target using options or derivatives, which skirt the 13D requirements. Despite these limitations, SEC filings can be incredibly useful tools for revealing which companies leading hedge funds are investing in.

The cover page of Form 13D states who is reporting the filing eligible event, what company it relates to, and the number of shares beneficially owned. Within Form 13D, the filer is required to describe seven key Items related to the transaction:

1) Security and Issuer (the target company and the type of shares involved in the transaction)

2) Identity and Background (who is reporting, and if multiple entities, describes the relationship between them)

3) Source and Amount of Funds or Other Consideration (where is the money for the transaction coming from; beware of signs of overleverage where majority of funding comes from debt)

4) Purpose of Transaction (key item; explains why the acquirer is taking a position- i.e. the shares are undervalued.)

5) Interest in Securities of the Issuer (how many shares were purchased in the target by parties listed in Item 2 above)

6) Contracts, Arrangements, Understandings or Relationships With Respect to Securities of the Issuer (Describes any agreements or relationships between parties in Item 2 and the target company)

7) Material to be Filed as Exhibits (may include letters to management)

When identifying filings investors will initially want to focus only on Form 13D filings, which represent new reportable positions in companies, and not the more plentiful Schedule 13D/A filings. Schedule 13D/A contains amendments to previously filed 13Ds, and while interesting (often including letters to management, or a change in the fund's share holdings), they do not disclose new stakes.

Activist Tracking as a Trading Strategy

Hedge fund activist strategies are a particular form of event-driven investment, whereby fund managers invest in underperforming companies and attempt to create a catalyst for the stock price, often through shaking up management, or pressing for a sale. Read more about the activist strategy on the All About Hedge Funds blog.

While many activist hedge fund managers file Form 13F quarterly, it is their Form 13Ds that provide investors with the most valuable insights. Though the practice of tracking 13Fs has become increasingly popular – spawning a few related ETFs (**Global X Top Guru Holdings Index ETF [GURU], AlphaClone Alternative Alpha ETF [ALFA]**), there is currently only one mutual fund employing a 13D strategy, the **13D Activist Fund (DDDAX)**. According to the 13D Activist Fund's Ken Squire, "We invest in those companies that we believe to be the most compelling 13D filings of the most experienced activist investors who publicly take positions that their strategy and ideas are better than managements'."

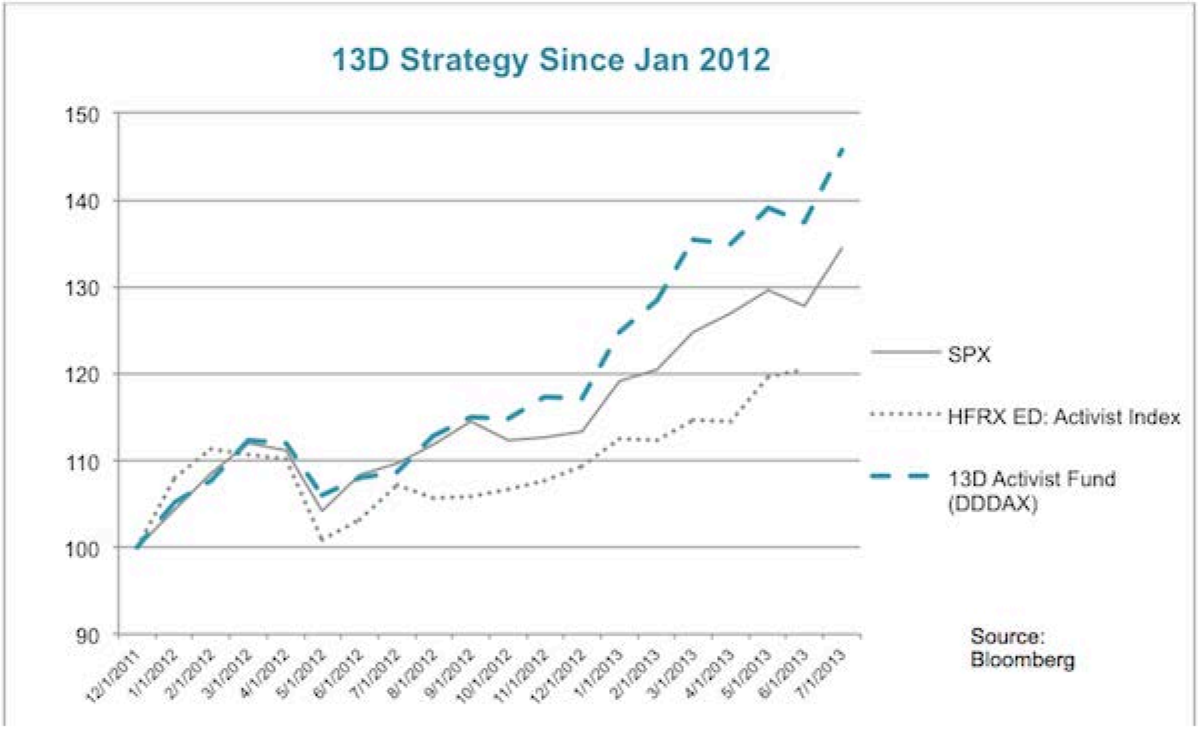
So, if you employ a similar strategy (not a bad idea – DDDAX is up 24.32% YTD according to Bloomberg), you need to be able to "analyze the activist [hedge fund], his track record, the sector, and the activist's track record in that sector…[as well as the] activist strategy that will be employed and the type of returns that strategy typically creates." All of that analysis sounds like a lot of work, but there are alternatives for the non-hedge fund specialist to gleam alpha-rich ideas from 13D filings.

Figure 1: Performance of a 13D tracking mutual fund

	YTD Cumulative Return	Last 12 Months Cumulative Return	YTD Sharpe Ratio	Last 12 Months Sharpe Ratio
S&P 500	12.63%	17.92%	3.13	2.47
HFRX ED- Activist Index	10.19%	16.77%	3.10	2.60
13D ACTIVIST FUND	17.24%	27.22%	3.07	2.93

Notes:
Based on monthly data from Bloomberg and PerTrac as of the end of June 2013
Sharpe Ratio uses ML 3-Month T-Bills as benchmark

Figure 1B: Performance of a 13D tracking mutual fund



Step 1: Finding Good Activists

While the 13D Activist Fund states that it will "take between 20 and 40 positions [in] 10 to 15 activists" at any given time, it's not really necessary to follow that many managers to do a basic 13D strategy. Two things to remember about activist managers: there are not that many activist managers out there, and in general, the top performing hedge funds are the funds to watch. This second point may seem obvious, and plenty of ink has spilt on the topic of whether smaller or larger hedge funds outperform, but the reality is that it is a minority of managers that produce the highest returns. In short, find a few good managers, and stick to them.

A few of the more prominent activist hedge funds include:

Figure 2: Leading Activist Hedge Funds

Manager	Primary Sectors	Largest Holdings as of Q1 2013 (via Whalewisdom.com)	Last 3 Schedule 13Ds (new positions)
Carl C Icahn	Healthcare/biotech, technology/media, real estate, natural resources	IEP; CVI; CHK; FRX; NFLX	DELL (5/10/13); HLF (2/14/13); GBX (11/13/12)
Pershing Square Capital Management, L.P.	Retail and consumer, real estate	CP; PG; GGP; BEAM; BKW	CP (10/28/11); ALEX (3/31/11); HHC (11/19/10)
JANA Partners LLC	Not solely an activist; technology; natural resources	AGU; ASH; QEP; VRSN; CPRT	OIS (4/29/13); ASH (4/11/13); AGU (11/19/12)
Relational Investors LLC	Various; telecom, mining, financials, energy, biotech	HP; HES; ITW; IR; TKR	SPW (2/15/13); TKR (11/28/12); FLS (6/25/12)
Trian Fund Management, L.P.	Foodservice, consumer goods	MDLZ; PEP; IR; FDO; WEN	IR (5/9/12); FDO (7/28/10); LM (12/28/09)

Source: AllAboutHedgeFunds.com; JP Morgan

We took a look at the returns from investing in the stock picks from the 13Ds of 3 leading activist hedge funds over the past 24 months: JANA Partners, Carl Icahn, and Relational Investors. Our analysis looked at the returns to investors over the holding period between 1 or 10 business days after the initial 13D, up until present day, or in the case of a closed position, 1 business day after a news release concerning the fund's exit from a company or the large-scale reduction in a position revealed in a quarterly 13F (see Step 4 on exit-timing strategies).

Figure 3: The Holding Period Returns of 13D Picks

JANA Partners, LLC			
Ticker	13D Filing Date	T+1 Period Return	T+10 Period Return
MHFI	8/1/2011	35.96%	55.65%
MPC	1/19/2012	36.43%	15.30%
ASH	4/11/2013	0.33%	1.23%
OIS	4/29/2013	8.75%	-4.45%
AGU	11/19/2012	-9.38%	-8.69%

Carl C Icahn			
Ticker	13D Filing Date	T+1 Period Return	T+10 Period Return
NFLX	10/31/12	244.86%	228.82%
CVI	01/13/12	155.42%	136.92%
NAV	10/09/12	51.98%	75.16%
NAV	09/10/12	35.96%	55.23%
HLF	02/14/13	36.59%	27.92%
CHK	05/25/12	40.72%	26.34%
CMC	07/28/11	-3.31%	23.07%
FRX	06/17/11	9.77%	9.44%
WBMD	10/21/11	-10.22%	4.31%
DELL	05/10/13	-4.16%	-3.01%
OSK	06/30/11	-12.11%	-3.63%
GBX	11/13/12	-9.12%	-14.24%
NAV	10/13/11	-19.49%	-24.18%
VLTC	10/19/12	-24.59%	-36.52%

Relational Investors, LLC			
Ticker	13D Filing Date	T+1 Period Return	T+10 Period Return
PRX	11/25/2011	61.96%	56.38%
FLS	6/25/2012	48.53%	47.46%
TKR	11/28/2012	33.52%	31.18%
ESL	5/24/2012	21.14%	30.31%
HAR	10/13/2011	35.87%	13.50%
PMCS	1/17/2012	4.99%	0.00%
SPW	2/15/2013	-6.33%	-7.93%
LLL	6/22/2011	-17.52%	-17.28%
UNM	7/15/2011	-19.77%	-18.00%

Source: Bloomberg; Data as of 7/17/13

As Figure 3 reveals, tracking the 13D filings of the leading activist managers can either produce eye-popping returns, or lackluster stock picks. While there is no simple trick for separating the wheat from the chaff in terms of stock picks, there are tools to help avoid dangerous mistakes (see Step 3 for a description of pre-investment due diligence). Moreover, our analysis relied on timing exits on when the activist made a public exit, as revealed either in the news or in 13F filings. Many of these picks performed extremely well during periods *within* the analyzed holding periods, and a prudent investor would have taken profits and enhanced their overall return.

Step 2: Follow Your Funds

Both Form 13D and 13F filings are freely available online at the SEC's EDGAR database, which is straightforward and easy to search. However, unless you are checking EDGAR on a daily basis for new filings from your favorite managers, you're not going to know when new filings are submitted in a timely manner.

The easiest solution is to use a 13D tracking tool, commercially available from a number of websites. I prefer WhaleWisdom, which provides its members the ability to setup real-time alerts for new filings for their favorite managers (WhaleWisdom also tweets links to all new filings as they come out @WhaleWisdom).

Step 3: Analyzing Your Alpha-Rich Ideas

When a top hedge fund you are tracking files a new Form 13D, you might be tempted to immediately take a new position in the stock – especially if the stock is starting to "pop" as other digest the new filing. Be forewarned- unless you are deeply familiar with the stock found in the new 13D, and the details of the potential strategy the activist intends to employ, you need to do your basic due diligence before jumping on board. If possible, you may want to do that thorough analysis quickly – our review of three top activist managers – JANA Partners, LLC, Carl Icahn, and Relational Investors, LLC – found that investors who bought those managers' 13D stocks at 1 full business day after a filing was released frequently outperformed those that bought 10 business days after the 13D filing.

As Figure 3 shows, not *all* stock picks from famous managers are successful – and not all activist campaigns go smoothly. For example, Carl Icahn dumped GBX only a month after the 13D filing when his effort to merge it with his American Railcar failed. Investors following that filing could have lost 9-14% on the trade (see Figure 3). Therefore, it is important to understand the fundamentals of a company before making the decision to buy. For example, let's look at the last three new positions from Carl Icahn's 13Ds: **Greenbriar Companies, Inc. (GBX)**, **Herbalife (HLF),** and **Dell (DELL):**

1. Greenbrier Companies (GBX, Earnings, Analysts, Financials): Engages in the design, manufacture, and marketing of railroad freight car equipment in North America and Europe.

Market cap at $584.29M, most recent closing price at $21.95.
- P/E Ratio: N/A
- EPS: -$0.93
- Debt/Equity: 1.15

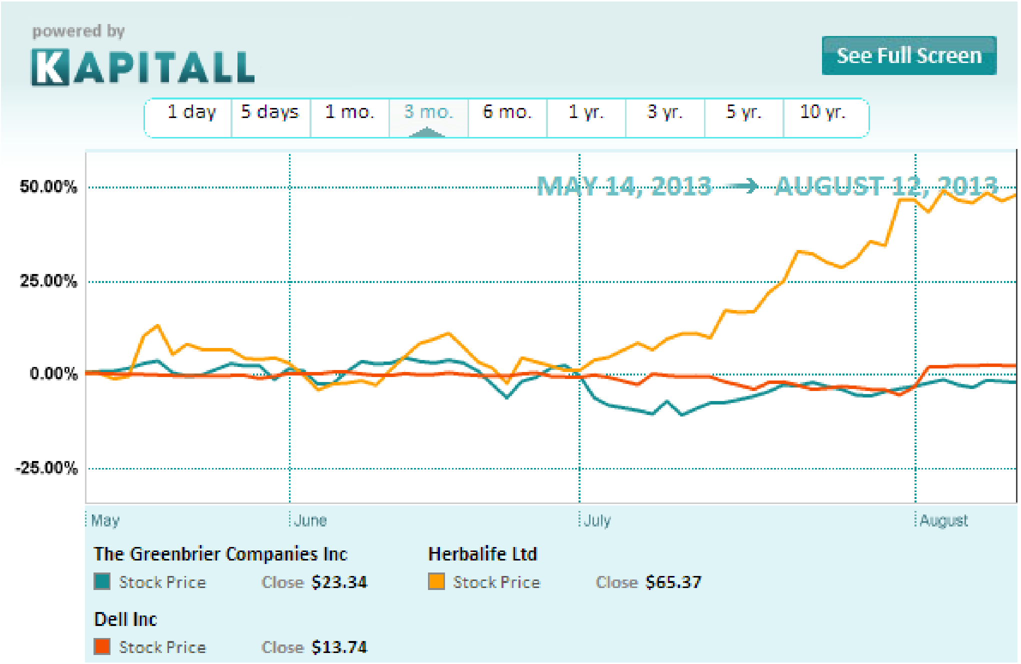
2. Herbalife Ltd. (HLF, Earnings, Analysts, Financials): Sells weight management, nutritional supplement, energy, sports and fitness, and personal care products worldwide.

Market cap at $5.11B, most recent closing price at $49.03.
- P/E Ratio: 12.19
- EPS: $1.06
- Debt/Equity: 2.84

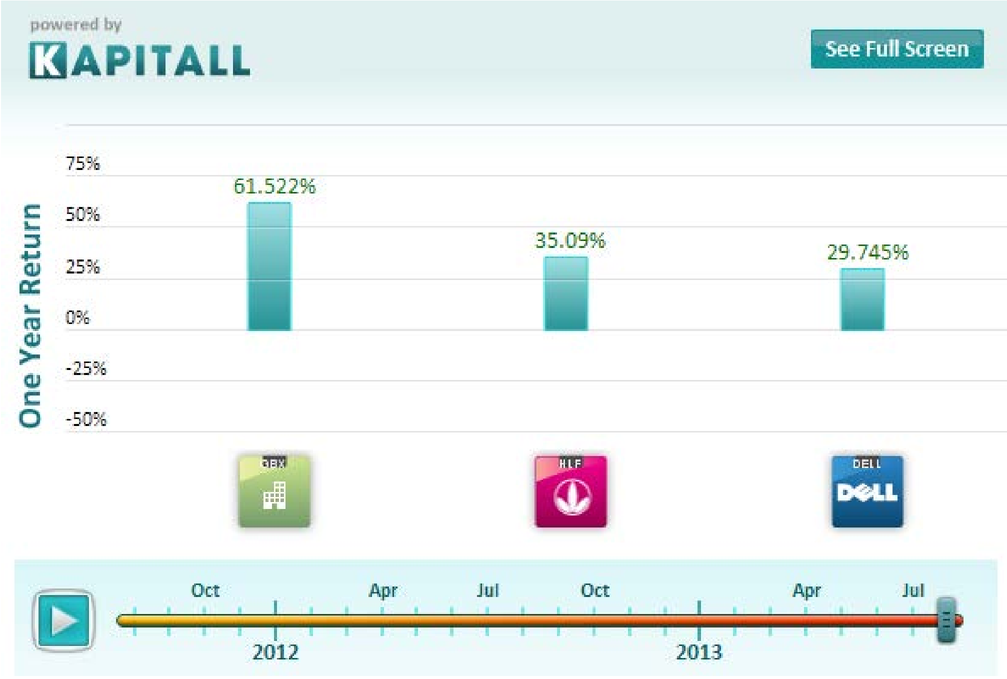
3. Dell Inc. (DELL, Earnings, Analysts, Financials): Provides integrated technology solutions in the information technology (IT) industry worldwide.

Market cap at $23.28B, most recent closing price at $13.32.
- P/E Ratio: 12.15
- EPS: $1.06
- Debt/Equity: 0.67

(Data sourced from FinViz; As of 7/18/13)
Click on the images to see prices and returns over time. Data sourced from Zacks Investment Research.



Looking beyond the last six months, the chart below shows the returns over the last year for all three companies.



Step 4: After The Trade is Made: Risk Management and Exit-Timing

While a 13D tracking strategy allows you to follow the investing patterns of leading activist managers, you do not have access to the risk-management capabilities of the fund manager – a big reason why fund investors are willing to stomach hedge fund fees. The result is that risk-management and position exiting decisions are left to you, the investor.

These issues are particularly important for the activist-tracker, as activist target companies are frequently underperforming and troubled, and the activist hedge fund's strategies may not work, causing the stock to fall. Moreover, while hedge fund managers have strict reporting requirements for acquiring new stakes, they do not have the same requirements for reporting sales, so a fund may dump the stock before the rest of us know what is going on. That said, the typical activist position is held by hedge fund managers for 16-24 months, and as managers center their portfolio on a few high-conviction bets, there is relatively low portfolio turnover.

The bottom line is that activist-trackers need to employ a high level of diligence, both in selecting trading ideas from 13Ds, and in monitoring their positions, their portfolio companies, and their selected activist managers. Google Alerts is a free system that is very useful for real-time monitoring of market-moving news about your portfolio companies and your targeted activist managers. You should also follow you activist manager's amendments (Schedule 13D/A), as well as quarterly Form 13F filings, as the stock holdings listed can tell you if the manager has dumped a stock, assuming that the sale hasn't made the news already.

Conclusion

Hedge funds as an asset class have underwhelmed since the credit crisis, and managers continue to face challenges both retaining assets and delivering "alpha". Nonetheless, bold moves by activist managers in the first two quarters of 2013 and the strong performance of this strategy relative to other hedge fund strategies have turned a spotlight on activist hedge fund managers. While there remains room for discussion whether hedge fund investors do particularly well investing directly with hedge fund managers, there is evidence, both in the performance of the 13D Activist Fund, and in our analysis, that Form 13D can be used to effectively generate "alpha-rich" trading ideas. By combining the tracking of activist managers with due diligence and risk management, average investors can employ an effective 13D strategy.

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