Value Creation by Activist Hedge Funds

Jack Gale
Department of Economics
Pomona College
425 N. College Ave
Claremont California 91711
jack.gale@pomona.edu

Introduction

Hedge Funds are investment partnerships that seek above-market returns for their investors or limited partners. The term “hedge fund” developed because managers could “hedge” themselves by going long or short stocks, meaning that they would be able to make money whether the market went up or down. In comparison to other investment companies like mutual funds, hedge funds are only open to accredited investors, have wider investment latitude, and often employ leverage. A public dialogue has surrounded hedge funds since the financial collapse, mostly concerning the often employed “two and twenty” management fee—a 2% asset management fee and then a 20% cut of any excess gains generated—and the exorbitant bonuses that hedge fund managers take home. There have also been studies recently showing that on average hedge funds underperform the market. In 2007 Warren Buffet made a bet that an index fund would outperform a basket of hedge funds over a decade. From the start of the bet through the end of 2016, Mr. Buffet’s S&P index fund returned 7.1% compounded annually, while a competing basket of hedge funds selected by asset manager Protégé Partners returned an average of 2.2%.[1]

Instead of the traditional long/short approach used by many hedge funds, activist hedge funds will purchase a large number of a public company’s shares and then push for major changes in the company. A company can become a target for

[1] Roche, Cullen. “Warren Buffett Made a Bet In 2008 That Has The Potential To Make The Hedge Fund Industry Look Very Bad.” *Business Insider*, 6 Feb. 2014, www.businessinsider.com/warren-buffetts-hedge-fund-bet-2014-2.

activist investors if the company is mismanaged, has excessive costs, could be better run as a private company, or has other problems that activist investors believe could be changed to make the company more valuable. Activists target financial changes like corporate governance, financial restructuring, and cost cutting, and non-financial changes like disinvestment from particular countries or adoption of environmentally friendly policies. Activist funds are in between traditional long/short hedge funds and private equity firms because they do not simply buy and sell mispriced securities, but they also do not buy a majority stake in a company where they can force their changes through. Instead, activists attempt to persuade management by gaining shareholder support.

An activist investor can put pressure on management by gaining support amongst a public company's shareholder base. In addition, gaining seats on a company's board of directors gives activists the ability to question management and more directly impact the company. Activists often lay out their vision for the company when they file a 13D with the SEC, which are required when holding more than 5% of a public company with the intent of publicly advocating for changes within the company. Starboard Value, an activist fund, famously released a 300-page presentation when they filed a 13D for their position in Darden Restaurants that ripped apart management, including an attack on the inadequate salting of Olive Garden's pasta.[2]

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[2] Benoit, David. "Starboard's Olive Garden Slides: Salting the Water, Custom Straws and More." *The Wall Street Journal*, Dow Jones & Company, 12 Sept. 2014, blogs.wsj.com/moneybeat/2014/09/12/starboards-olive-garden-slides-salting-the-water-custom-straws-and-more/?ns=prod%2Faccounts-wsj.

Shareholder activism has gained popularity in recent years as management compensation and cash balances on corporate balance sheets have both increased.[3] Activists, once derided as corporate raiders, are now receiving admiration for causing positive change in public companies. Activists have increasingly transitioned from outside agitators to influential insiders. Still, some believe activist investors will buy large stakes in companies and incentivize short-term profit, for example decreasing R&D costs, to pump up the stock price before they sell their position for a large profit, leaving a gutted company. The goal of this paper will be to determine whether activist intervention adds long-term value to the companies that they target.

In order to ensure that this paper focuses only on activist intervention and not just large holders, it will only include information on the ten largest primary activist funds as determined by their assets under management. These ten funds are:

1. **Icahn Enterprises**. AUM: $34.2 billion. Run by New York City legend Carl Icahn who focused on arbitrage and options trading before he got into activist investing. The fund holds large positions in American Railcar, XO communications, and Tropicana entertainment.

[3] Banks, John M. Mason. "Corporate Cash Balances Continue To Grow: Especially At Major Tech Companies." *Seeking Alpha*, 22 Jan. 2014, seekingalpha.com/article/1960201-corporate-cash-balances-continue-to-grow-especially-at-major-tech-companies.

2. **Third Point Partners.** AUM: $26.9 billion. Founded by Dan Loeb in 1995, who was previously vice president of high-yield bond sales at Citigroup. Loeb is notable for his sharply worded letters directed at CEOs of his target companies. The fund had big wins in their stakes in Kraft Heinz and eBay.
3. **Cevian Capital**. AUM: $17.2 billion. Cevian was founded by Lars Forberg, an ex-investment banker, and Christer Gardell, a former management consultant who has been dubbed a capitalist "butcher." The firm is backed by Carl Icahn and is the largest activist investor in Europe. It has positions in automaker Volvo, German conglomerate ThyssenKrupp, and British private security firm G4S.
4. **ValueAct Capital Partners**. AUM: $16.5 billion. Started in June 2000 by Jeff Uben in San Francisco. They are known for being more long term than traditional activists and their "strategic partnership" approach. Big successes include their investments in Adobe and Microsoft.
5. **Trian Fund Management**. $12.6 billion. Trian was founded by Wharton dropout and former President and COO of The Wendy's Company, Peter May, and ex-investment banker Ed Garden. The firm bought Snapple from Quaker Oats for $300 million in 1997 and sold it three years later for $1.5 billion.
6. **Pershing Square Capital Management.** AUM: $10.0 billion. Founder Bill Ackman started the fund in 2004 with $54 million in AUM. The fund makes large, concentrated bets, such as the highly publicized crusade

against nutrition giant Herbalife. Pershing Square pocketed about $2.6 billion in profits when the portfolio company Allergen agreed to sell itself to Actavis. Losing bets on Valeant and Herbalife, and three straight years of subpar performance, have caused investors to pull money from the fund at rapid rates.

7. **Starboard Value**. AUM: $5.9 billion. Starboard was launched in 2005 as part of Cowen Group's Ramius until Ramius spun off its hedge fund unit in early 2011. The now independent fund is run by Jeff Smith, Mark Mitchell, and Peter Feld. The activist fund has waged fights with Yahoo, Brink's Home Security, and Macy's.
8. **MHR Fund Management**. AUM: $5.4 billion. MHR is run by Mark Rachesky, who previously worked for Carl Icahn. Rachesky spent six years working for Icahn but left in 1996 and opened his own New York based fund. The fund has invested in Titan International, Lionsgate Entertainment Corp. and various other companies in the energy sector.
9. **Sachem Head Capital Management**. AUM: $4.3 billion. The fund is run by Scott Ferguson, a protégé of Bill Ackman from Pershing Square. Sachem invested in CDK global shortly after its IPO and became its biggest investor. The stock proceeded to jump more than 80% in the following year.
10. **Blue Harbor Group**. AUM: $3.6 billion. Led by Clifton Robinson, Blue Harbor Group calls itself a "friendly activist." They prefer to talk to management to bring about changes, instead of using hostile tactics like

proxy fights. The firm's core investments include semiconductor distributor Avnet, farm equipment maker AGCO, and clinical software developer Allscripts Healthcare Solutions.

Literature Review

Critics of activist intervention claim that the changes sought decrease value in the long-term even when they are profitable in the short-term. These concerns have been echoed by legal academics, economists, business school professors, business leaders, and corporate lawyers. In an August 2013 article in the *New York Times*, Harvard Business School professor William George argued, "While activists often cloak their demands in the language of long-term actions, their real goal is a short-term bump in the stock price. They lobby publicly for significant structural changes, hoping to drive up the share price and book quick profits. Then they bail out, leaving corporate management to clean up the mess."[4] Martin Lipton, one of the nation's top corporate lawyers, was outraged at David Einhorn of Greenlight Capital over his battle with Apple. Einhorn had pressed Apple to distribute some of its $137 cash hoard to shareholders. In a cutting memo to his clients Lipton warned, "The activist-hedge-fund attack on Apple—in which one of the most successful, long-term-visionary companies of all time is being told by a money manager that Apple is doing things all wrong and should focus on short-term return of cash—is a clarion

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[4] George, William. "Activists Seek Short-Term Gain, Not Long-Term Value." *The New York Times*, The New York Times, 26 Aug. 2013, dealbook.nytimes.com/2013/08/26/activists-seek-short-term-gain-not-long-term-value/.

call for effective action to deal with the misuse of shareholder power."[5] He added that long-term shareholders in public companies are being undermined by "a gaggle of activist hedge funds who troll through S.E.C filings looking for opportunities to demand a change in a company's strategy or portfolio that will create a short term profit without regard to the impact on the company's long-term prospects."

Despite these fiery claims, much of the recent academic literature on activist intervention has found an overall positive impact. The most influential paper, authored by Bebchuck, Brav, and Jiang (2015), looks at activist intervention from a corporate governance perspective and finds that the initial stock price spikes following intervention and accurately reflects long-term consequences. Similarly, they find there is no evidence for pump-and-dump patterns and that adversarial interventions do not dampen long-term performance. Denes, Karpoff, and McWilliams (2016), summarizes results from 73 studies and finds that activism that can be classified as "corporate takeovers" are more successful than their less active counterparts, and that activism in recent years leads to increases in share value and operating performance that was generally not present in the 1980s and 1990s. Krishnan, Partnoy, and Thomas (2016) found that the most successful activist funds made fewer investments larger companies and success was a result of board representation, improved performance, and monitoring management than from capital structure or dividend policy changes. Zhu (2013) found that an increase in

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[5] Alden, William. "A Warning on Abuses of Shareholder Power." *The New York Times*, The New York Times, 26 Feb. 2013, dealbook.nytimes.com/2013/02/26/a-warning-on-abuses-of-shareholder-power/.

the threat of activist intervention leads to an increase in shareholder distributions as well as decreases in CEO pay, cash, and investments. The reduction in managerial rent seeking and cash hoarding leads to significant increases in performance as measured by ROA. Finally, Gow, Shin, and Srinivasan (2014), found a 2% increase in ROA when activists are able to gain board seats, which is consistent with board representation being an important mechanism for bringing about the kind of changes that activists often seek.

Data and Methods

Monthly stock returns were collected from Wharton Research Data Services using CRSP data. All other data was collected from company profiles from the website Activist Insight. The model for this paper uses the Capital Asset Pricing Model:

$$\text{Expected Return} = \text{Risk Free Rate} + \beta(\text{Market Return} - \text{Risk Free Rate})$$

For the risk free rate, I used the historical returns on CRSP for three month treasury bills and for the market return I used monthly returns on the S&P500, also collected from the CRSP database. Running a regression on X_1, the S&P monthly return above the risk free rate, with y= individual stock's monthly return above the risk free rate produces an equation:

$$Y = \beta\,(x) + \alpha$$

In this equation beta is a measure for how much more volatile a stock is than the S&P and alpha shows the excess returns above the S&P.

I took the date from when each fund filed a 13D with the SEC as a starting date and estimated an alpha from the above equation for each investment for a six-month, three-year, and five-year time period representing the short-run and long-run returns for investments between 2010 and 2017. Next, I went through each investment and used data from Activist Insight to determine whether the fund had gained a seat on the board of directors, and whether the fund's proposed actions were strategic to add long-term value or financial modeling to increase short term returns and pump up the stock price. Demands like business restructuring, increased growth strategies, operational efficiency, and proposed M&A activity were all considered strategic, while demands such as share repurchases and returning cash to shareholders, along with other corporate governance objectives like board and voting restructuring, were not. I created a dummy variable for strategy that was a 1 if strategically or operationally focused, and 0 if they were not. Many activists listed multiple demands, and if even one was strategic they were given a 1 for the dummy variable. It was then possible to run a regression on the six month, three year, and five year alphas separately with the dummy variables for strategy and board of directors used as controls.

Results

It is important to note that these returns are unweighted by size of investment and thus do not represent returns for activist funds and their LPs. For example, if one activist fund invested ten million dollars into a company that returned 10% and another activist invested one million dollars in a company that returned -10% while the market returned 0%, then my model would show that activist funds have returns equal to the market, but an investment of the 11 million dollars into the two companies above would outperform the market by 8.2%. The summary stats for monthly excess returns for six months, three years, and 5 years after filing were:

	6 month alpha	3 year alpha	5 year alpha
Average	1.2%	.25%	.17%
Median	1.0%	.59%	.12%
Standard Deviation	5.9%	2.1%	1.5%

As seen in the above table, on average, the activist investments outperformed the S&P500 in the short-run and less so in the long-run, implying that activist intervention is beneficial for shareholders. It is important to point out the high standard deviations, however, which is consistent with previous findings that funds often have both big winners and big losers. The excess returns in each time period are not statistically significant at the .05 level.

The results of the regressions to test for the impact of different strategies and board of director influence were:

	Constant	Board Seat	Strategy
6 Months	1.3% (-.12%, 2.7%)	-1.7% (-3.7%, .29%)	1.7% (-.33%, 3.8%)
3 Years	.55% (-.15%, 1.3%)	-1.2% (-2.2%, -.29%)	1.0% (.05%, 2.0%)
5 Years	.28% (-.31%, .87%)	-.74% (-1.6%, .10%)	.67% (-.20%, 1.5%)

The coefficients for the constant and operational strategy were all positive, while the coefficients for gaining a seat on the board of directors were all negative. Looking at the confidence intervals on each of the variables, however, the coefficients are inconclusive and not statistically significant from 0. It is interesting to note that an operationally focused proposed strategy did have a statistically significant coefficient in the three-year time horizon, which is on average how long activists tend to hold positions.

It is important to note that there could a type of survivor bias at play. The sample size for the six-month period was 143, while the three-year period was 80, and the five-year period was 59. Because I included all investments between 2010 and 2017, obviously a large portion of this is simply because there is not a long enough time period to reach a three or five-year window, but a significant number of the stocks I looked at had returns that stopped before 2017. The majority of these were companies that were acquired. When a company gets acquired by another company it is often at a premium to the target's current share price. If investors know that a common exit for activist intervention is through a sale of the company, then it could increase the company's share price in the short term. For example, if an activist invests in a company and pushes for it to get acquired by a larger company, investors expecting this could expect the sale at a premium and drive the stock price up. Then when the company is sold, the original ticker is no longer listed, meaning the stock experiences a significant increase in my six-month period, but then is not included in my three or five-year period. On paper this would look like activists boost stock prices and then let them collapse when they exit, but in reality the shareholders of the original company would have been well compensated for their outstanding shares. Another difficulty was generating the dummy variable for operational strategy demands. Most investments were accompanied by several demands and for many it was difficult to determine the long-term strategy for the company and which demands were ultimately successful.

Future studies on this topic would benefit from a larger data set. As activism has increased in recent years more private information service companies have entered the market, but the scope of their data is still relatively recent. Along with steep costs, acquiring an adequate amount of data is a difficult task, but could lead to more robust results.

Appendix

Table 1.

Ticker	6mo alpha	36mo alpha	60mo alpha	Board	Strategy
ABB	-0.021	-	-	1	1
ACTI	0.049	-	-	0	0
ACTL	0.044	-	-	1	1
ADBE	0.010	0.005	0.009	1	1
ADP	-0.056	-	-	0	1
ADSK	0.025	-	-	0	0
AFI	-0.005	-	-	1	0
AGCO	0.002	-	-	0	0
AGYS	0.006	-0.004	-0.010	0	0
ALEX	0.053	0.004	-0.001	0	0
ALOG	0.029	0.007	0.005	0	0
ALR	0.031	-0.026	-0.006	0	0
ALSN	0.032	0.002	-	1	0
AOL	0.130	0.032	0.000	0	1
APD	-0.012	0.006	-	0	0
AVID	0.205	-0.009	-0.023	0	0
AVNW	0.014	-0.019	-0.024	1	1
AWI	0.003	-0.006	-	1	0
BAX	0.007	-	-	0	0
BBND	0.007	-	-	1	0
BCO	0.033	-	-	0	1
BCR	0.021	0.007	0.009	1	1
BHI	0.018	-	-	0	1
BID	0.001	-0.016	-	1	0
BIVV	0.010	-	-	0	0
BKR	0.030	-	-	0	0
BKW	0.040	-	-	0	1
BLOX	0.101	-	-	0	0
BZC	0.009	0.014	0.013	0	0
CACI	-0.016	-0.006	-0.004	0	0
CBG	-0.017	0.001	-0.006	1	0
CCC	-0.028	-0.006	0.000	0	1
CDK	0.063	0.015	-	0	0
CHK	-0.016	-0.007	-0.028	1	0
CHS	-0.030	-0.005	-	0	0
CLX	0.025	0.008	0.012	0	1
CMC	0.029	-0.012	-0.005	0	0
CMG	-0.035	-	-	1	0
CNDT	-0.009	-	-	0	0
COL	0.009	0.003	0.004	0	0
CP	-0.002	0.023	0.008	1	1
CPY	0.179	-	-	0	0
CVI	0.035	0.006	0.004	0	1
CVRR	0.001	-0.009	-0.007	1	0
CYPB	0.065	-	-	0	0
DELL	0.022	-	-	0	1
DEPO	0.138	-	-	1	1
DRI	-0.022	0.017	-	1	1
DSPG	-0.042	-0.010	-0.001	1	1
DYN	0.025	-0.034	-0.028	1	1
ELX	-0.043	-	-	0	1

EMMS	-0.145	0.014	-0.004	0	0
ENPH	-0.086	0.027	-0.010	0	0
ERIC	-0.039	-	-	0	1
EXTR	0.014	-0.001	-0.004	1	0
FCPT	0.071	-	-	0	0
FCX	-0.094	-	-	1	1
FDO	0.052	0.012	0.010	1	1
FEIC	0.048	0.009	0.011	0	0
FNF	0.021	0.015	0.014	0	0
FOXA	-0.012	-	-	1	0
FRX	-0.022	0.021	-	0	0
GCI	0.032	-	-	0	0
GDI	0.064	-	-	0	1
GGP	0.055	0.008	0.007	0	1
HAIN	0.039	0.034	0.028	1	0
HHC	0.100	0.013	0.007	0	0
HLF	0.016	0.007	0.007	1	0
HOLX	-0.020	0.011	-	1	0
HTZ	-0.161	-	-	0	0
IDTI	-0.038	0.007	0.008	1	0
IMMR	0.022	0.016	0.010	0	0
IR	0.018	0.011	0.008	1	1
ISBC	0.006	0.005	-	1	1
ISSI	0.056	-	-	0	0
JACK	-0.020	0.016	0.021	0	0
JCP	0.062	-0.036	-0.018	1	1
KEG	0.031	-0.063	-	1	0
KKR	0.020	-	-	0	0
LEAP	-0.058	-	-	0	0
LM	-0.002	-0.007	-0.003	0	0
LNET	-0.031	-	-	0	0
LNG	-0.107	-	-	1	1
LORL	-0.038	0.008	-0.010	1	0
LVB	0.029	-	-	0	0
LWSN	0.025	-	-	0	1
LXU	0.018	-0.046	-	1	1
MCO	-0.007	0.010	0.008	0	0
MCRL	0.041	-	-	0	0
MCRS	0.010	-	-	0	0
MDAS	0.076	-	-	0	1
MDLZ	0.008	-	-	0	1
MDRX	-0.018	-0.004	-	0	0
MENT	0.032	0.013	0.008	1	1
MIPS	-0.027	-	-	0	0
MRVL	0.015	-	-	0	1
MSCI	0.031	0.019	0.018	1	1
MSI	0.023	0.006	0.011	1	0
MTW	-0.016	0.020	-	1	1
MWV	-0.005	-	-	0	1
NAV	-0.085	-0.042	-0.020	1	1
NFLX	0.208	0.077	0.054	0	1
NSP	0.078	0.033	-	1	1
NUAN	-0.015	-0.003	-	1	0
ODP	0.123	0.034	0.003	1	1
OSK	0.001	0.001	-0.001	0	1
PAH	-0.016	-0.029	-	1	0
PNR	-0.014	-	-	1	1
PRGO	-0.042	-	-	1	1
PRGS	-0.016	-0.014	0.000	0	0

PRXL	0.079	-	-	0	1
QTM	0.050	-0.011	-0.016	1	0
RAX	0.051	-	-	0	0
RDC	-0.053	-0.034	-	1	0
RGS	0.009	-0.014	-0.012	1	1
RIG	-0.065	-0.041	-0.032	1	0
RLD	-0.011	-	-	0	0
RNF	-0.049	-	-	0	0
SEAC	0.011	0.010	-0.002	1	0
SONE	-0.024	-	-	0	0
SPLS	0.036	-	-	0	1
SRDX	-0.101	0.004	0.001	0	0
SSE	-0.227	-	-	0	0
STC	0.006	-	-	0	0
STX	0.008	-	-	1	0
SVVS	0.071	-	-	0	0
SYY	0.020	-	-	1	0
TIF	0.064	0.001	-0.003	0	0
TLM	-0.041	-	-	1	1
TPCG	0.057	-	-	0	0
TQNT	0.052	-	-	0	1
TRN	0.009	-	-	0	0
TUNE	0.007	-	-	1	0
TWI	-0.029	-0.006	-	1	0
VRSN	0.041	0.013	0.010	0	0
VRX	0.139	0.049	0.046	1	1
VVI	0.089	0.015	0.019	0	0
WBMD	-0.066	0.010	0.008	1	1
WCN	0.002	0.009	-	0	0
WLTW	0.027	-	-	0	0
WPP	0.049	0.007	-	1	1
WSH	0.023	0.003	0.001	1	0
XRX	0.013	-	-	1	1

Figure 1.

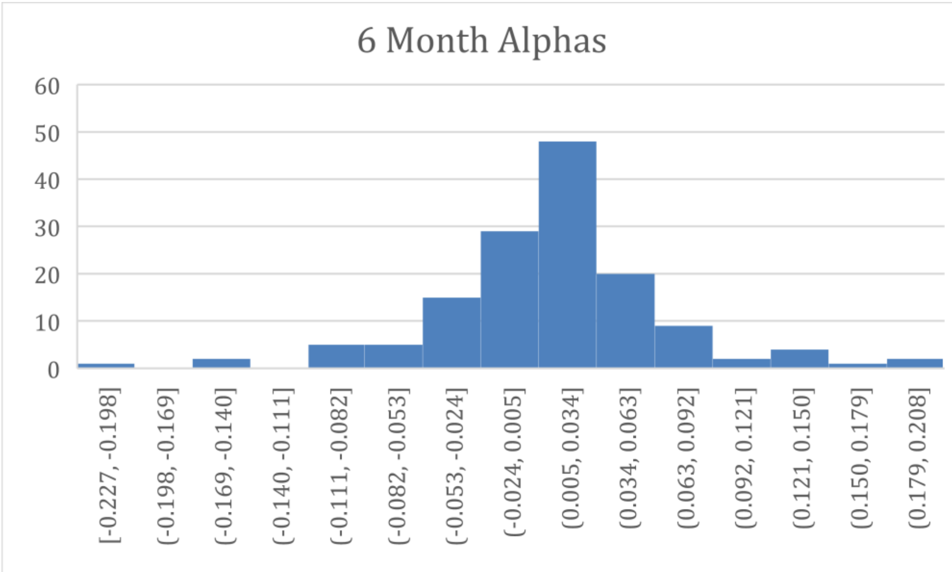


Figure 2.

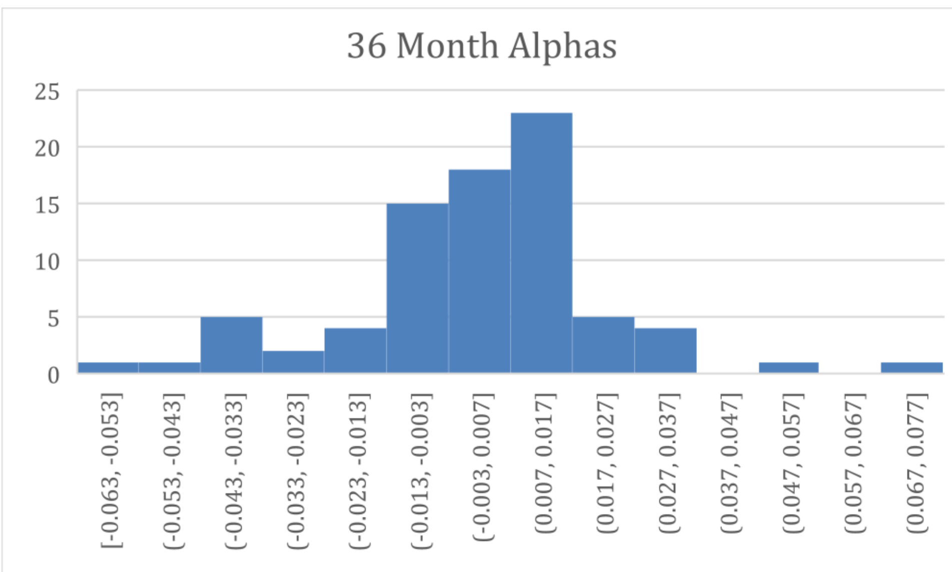
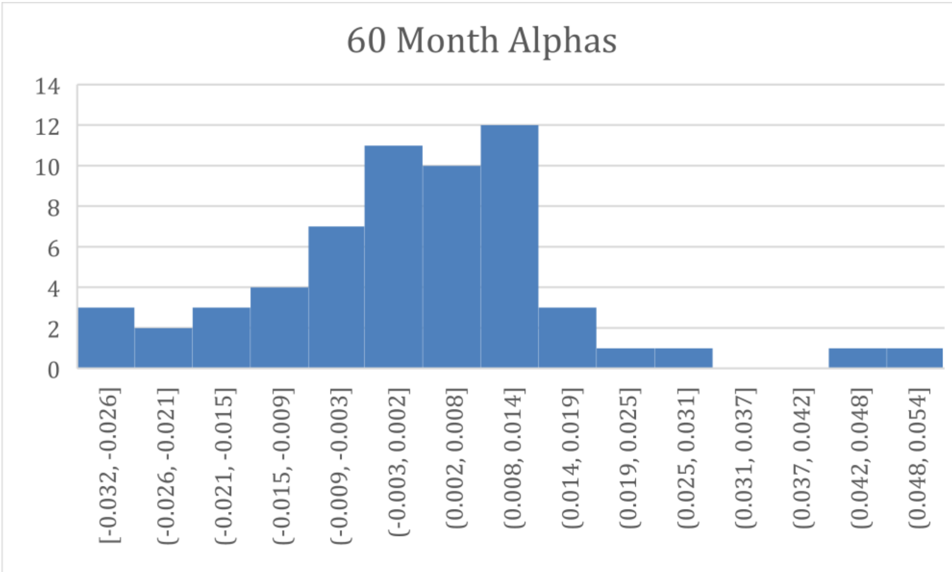


Figure 3.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Additional Fund Information

Blue Harbor Group

	All Investments	Current	Exited
No. Outperforming S&P:	40	4	36
No. Underperforming S&P	43	12	31
Average Annualized Total Return	21.75%	-6.05%	28.02%

Icahn Enterprises

	All Investments	Current	Exited
No. Outperforming S&P:	22	6	16
No. Underperforming S&P	28	10	18
Average Annualized Total Return	9.79%	-1.57%	14.38%

Cevian Capital

	All Investments	Current	Exited
No. Outperforming S&P:	4	3	1
No. Underperforming S&P	10	10	0
Average Annualized Total Return	7.82%	4.79%	47.27%

MHR Fund Management

	All Investments	Current	Exited
No. Outperforming S&P:	5	4	1
No. Underperforming S&P	5	5	0
Average Annualized Total Return	10.94%	7.07%	30.30%

Pershing Square Capital Management

	All Investments	Current	Exited
No. Outperforming S&P:	13	3	10
No. Underperforming S&P	14	5	9
Average Annualized Total Return	6.81%	0.89%	9.18%

Sachem Head Capital Management

	All Investments	Current	Exited
No. Outperforming S&P:	21	6	15
No. Underperforming S&P	23	5	18
Average Annualized Total Return	19.62%	21.28%	19.04%

Starboard Value

	All Investments	Current	Exited
No. Outperforming S&P:	78	9	69
No. Underperforming S&P	51	7	44
Average Annualized Total Return	59.19%	21.90%	64.42%

Third Point Partners

	All Investments	Current	Exited
No. Outperforming S&P:	85	20	65
No. Underperforming S&P	82	21	61
Average Annualized Total Return	40.73%	11.30%	49.05%

Trian Fund Management

	All Investments	Current	Exited
No. Outperforming S&P:	13	2	11
No. Underperforming S&P	8	4	4
Average Annualized Total Return	16.07%	3.53%	21.24%

ValueAct Capital Partners

	All Investments	Current	Exited
No. Outperforming S&P:	39	8	31
No. Underperforming S&P	23	4	18
Average Annualized Total Return	19.45%	21.46%	19.09%