REDWOOD
INVESTMENT MANAGEMENT

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The Activist Edge: A Different "Active Factor"

What is Activism?

Markets evolve and change over time leading many investors to search for ways to organize and segment the investable universe in search of an ideal portfolio as well as ways to explain investment returns. A popular initial segmentation strategy was separating investments in a portfolio into asset classes with the classic 60-40 balanced portfolio of 60% stocks and 40% bonds being the poster child. Then, in the early 90's, Morningstar introduced investors to the traditional style box, which separates investment styles, particularly in stocks and stock mutual funds by size, value, and growth. More recently, segmenting with newer "factor" concepts such as momentum and volatility has given rise to "smart beta" investing.

Instead of taking the widely adapted "passive" approach to investing, activists seek to directly influence corporate actions with the goal of increasing shareholder value.

The common denominator across all of these segmentation methods is they are a passive, backwards looking attempt to identify the source(s) of returns. A lesser explored segment of the marketplace takes a very different approach. Rather than being a passive observer of a company's fundamentals and price, an activist investor seeks to pro-actively influence corporate actions with the goal of increasing shareholder value, and ultimately value to themselves and their investors. Typically hedge fund managers, activists often take large positions to gain influence. Their growing involvement and effect on stock prices may be creating a shifting market paradigm as investors seek a differentiated source of returns.

What do activists do?

Substantive Actions	Governance Changes	Tactical Actions
• Increase Dividends • Evaluate Strategic Alternatives (Mergers/Sale) • Buyback Shares	• Align Interest Through Executive Compensation • Initiate Proxy Voting to Refresh Board • Recommend Change/Replace CEO • Increase Size of Board	• Adopt Poison Pill • Recommend Efficient Capital Allocation • Target Value-Adding Business Model • Postpone Meeting Dates or Call Special Meetings • Identify and Evaluate Key Environmental, Social, and Governance Issues

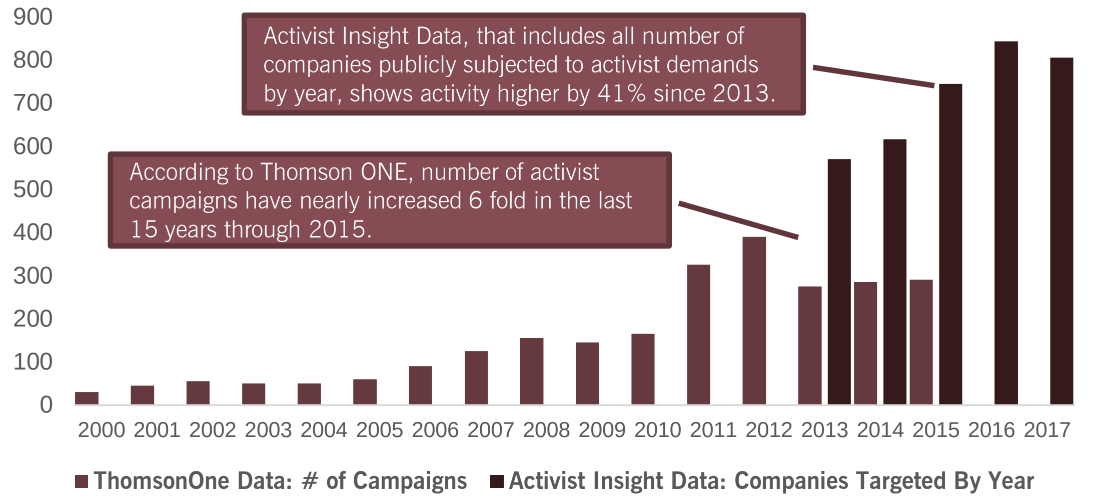
The media typically reports more on substantive actions such as buyouts, but activism can take form whenever an activist identifies an opportunity.

A Growing Relevancy

An increasing number of investors may be looking toward activism as a source of differentiated return in their portfolio. Previously only a small niche strategy, activist campaigns (when an activist pushes for some action) have been becoming a larger segment of the overall marketplace. The number of campaigns launched has increased dramatically over the last 15 years.

Activism may be growing as a driver of returns in the marketplace.

Number of Activist Campaigns Has Been Trending Higher



Sources: Thomson ONE, Activist Insights (2017 Annual Review). Data from Thomson ONE is estimated from 2000-2015; data from Activist Insight is from 2013-2017. Thomson ONE data shows the number of activism campaigns as calculated by Thomson ONE. Activist Insight data shows the number of companies publicly subjected to activist demands by the year. For illustration purposes only.

In addition, the growing success of campaigns may have led activism toward larger capitalization companies. Even in large cap stocks, activism may be an effective strategy over passively waiting on the sidelines after taking a position. The data below suggests that activists are gaining a larger appetite for large cap targets. Evolution of technology may have also played a role as activists use social media and the internet to communicate their ideas to more disparate shareholder bases, improving chances for a successful campaign against larger companies. This means that investors looking to maintain exposure in large-cap can still use activism as a factor.

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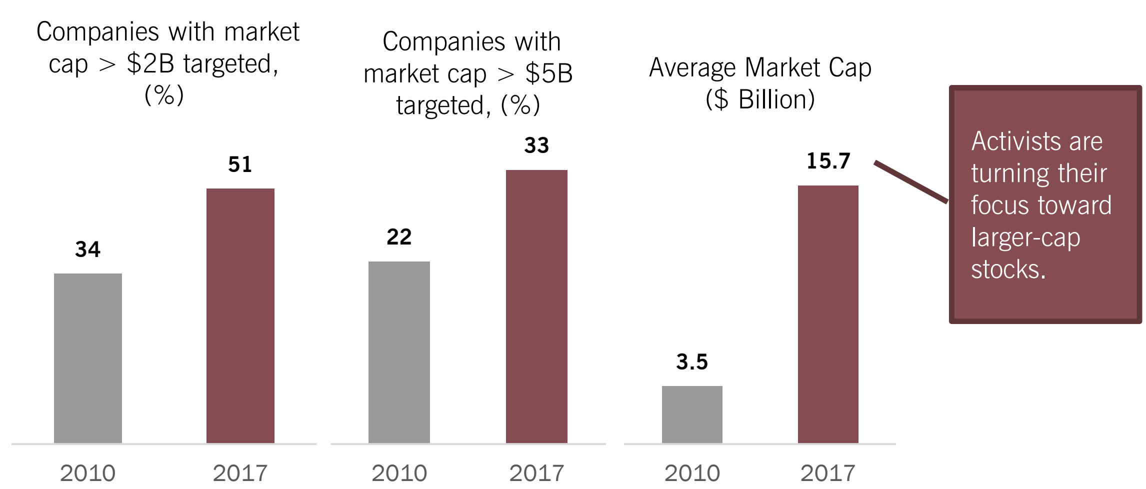
Activist Campaigns Against Large U.S. Companies



Sources: Bloomberg, Redwood. Data is from January 2010 through December 2017 based on Activists positions queried on Bloomberg Intelligence. For illustration purposes only.

Activists – Leading Their Own Success

It is important to note that activism and active management is not the same. While many people have the conversation of passive vs. active management, the strategies that activists deploy are beyond the scope of what has been traditionally called "active management." The traditional version of active management typically refers to managers that buy and sell securities based on their viewpoint of whether a security will appreciate or depreciate in value. Because this style constitutes more active trading, they have been referred to as "active managers".

Activists lead a very different style of investing, where they take large buy and hold positions in stocks to exert some external influence on the fundamental management of the companies in which they invest. This means that an activist investor potentially has more control over the outcome of their investment versus making a timing decision. This may have led to historically high batting ratios, which is the percentage of "winning" trades by profit and loss.

Example of Batting Ratios of Activist Investors

Activist	Batting Ratio	# of Campaigns
Elliott Associates LP	81.63%	49
Starboard Value LP	68.89%	45
Icahn Associates Holding LLC	74.29%	35
ValueAct Capital Partners LP	93.33%	30
JANA Partners LLC	75.00%	28
Clinton Group Inc	46.15%	26
Ancora Advisors LLC	82.61%	23
Raging Capital Management LLC	42.11%	19
Engaged Capital LLC	83.33%	18
Lone Star Value Management LLC	22.22%	18

Some Activists can enjoy over 80% batting ratios, but are often organized as a hedge fund, and typically charge performance fees, making them difficult and expensive to access.

Sources: Bloomberg, Redwood. Data is from January 2010 through December 2017 based on Activists positions queried on Bloomberg Intelligence. Batting ratio is calculated using the top 20 Activists defined by the highest # of campaigns in the period using daily price data For illustration purposes only.

Conclusion

Many investors over the past few decades have taken a passive approach to investing. In an ironic twist, this may contradict the ethos of ''hard work pays off', that may have created an investor's initial investing capital in the first place. Strong, differentiated returns do not come easy however. The intensive capital, talent, experience, and stardom required to be a successful activist investor is a large barrier to entry. Not to mention the amount of due diligence required for each company that activists employ prior to taking a large bet. This is likely why typical activist investing requires both a management fee and performance fee such as the hedge fund standard 2% annualized management fee and 20% of profits. Although the potential alpha generation may be attracting more investors and activity in the space, it still isn't as mainstream as one might expect, potentially because of this difficulty of access. However, there are systematic ways to access activists' ideas and intellectual capital.

While activist managers typically charge the hedge fund standard 2% annualized management fee and 20% performance fee, there are alternative ways to access the intellectual capital tied to activism.

By regulation, a public filing schedule 13D form is required anytime an investor acquires more than 5% of a stock, and subsequently a 13D-A when they drop below 5%. Activists often take large positions, many times in excess of 5% so that they have more influence in company decisions, which allows a systematic approach to participate in activists' ideas. This opens the door to investors searching for meaningful ways to diversify equity returns from a fully passive approach, making activism a leading factor that could be more relevant in today's investment environment.

Definitions & Indices: High Dividend Yielding is defined by Redwood as stocks that have a dividend yield relatively higher than the average dividend yield of the general stock market. **Dividend yield** is a dividend expressed as a percentage of current share price. **Defensive sector** is synonymous to a sector with non-cyclical stocks, or companies whose business performance and sales are not highly correlated with the larger economic cycle. **Interest rate** is in reference to the U.S. 10-Year U.S. Treasury note yield. The interest rate risk is the risk that an investment's value will change due to a change in the absolute level of interest rates, in the spread between two rates, in the shape of the yield curve, or in any other interest rate relationship. Furthermore, Interest rate sensitivity is a measure of how much the price of an investment will fluctuate as a result of changes in the interest rate environment. Securities that are more sensitive have greater price fluctuations than those with less sensitivity. **Annualized return** is the geometric average of returns over one year. The S&P High Yield Dividend Aristocrats Index is designed to measure the performance of companies that have followed a managed-dividends policy of consistently increasing dividends every year for at least 20 years. The **S&P 500 Index** is a stock market index based on the market capitalizations of 500 leading companies publicly traded in the U.S. stock market, as determined by Standard & Poor's. **S&P 500 Sector Returns:** returns within the S&P 500 Index broken down by GICS (Global Industry Classification Standards). Indices used to show performance are the S&P 500 Utilities Sector Index (Utilities), S&P 500 Telecommunications Sector Index (Telecom), S&P Consumer Staples Sector Index (Consumer Staples), S&P 500 Health Care Sector Index (Health Care), S&P 500 Industrial Sector Index (Industrials), S&P 500 Technology Sector Index (Technology), S&P 500 Consumer Discretionary Sector Index (Consumer Disc.), S&P 500 Materials Sector Index (Materials), S&P 500 Energy Sector Index (Energy), S&P 500 Financials Sector Index (Financials). Unless otherwise noted, index returns reflect the reinvestment of income dividends and capital gains, if any, but do not reflect fees, brokerage commissions or other expenses of investing. Investors may not make direct investments in an index.