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Wisely Managed Absolute Return Portfolios

CSD: Taking Advantage of Spinoffs' Extraordinary Returns

In a **spinoff,** an existing subsidiary or division of a corporation becomes a separately traded public entity when the parent corporation distributes shares in the newly formed spinoff directly to its existing shareholders.

For more than 30 years, academic research has pointed out that the announcement of a stock **spinoff** quickly translates into a pop in stock price. Research indicates that in the three day period around the announcement date (from one day before to one day after), the stock of the company announcing the spinoff has an abnormal return of around 2%-4%. This applies to U.S. and non-U.S. companies alike.

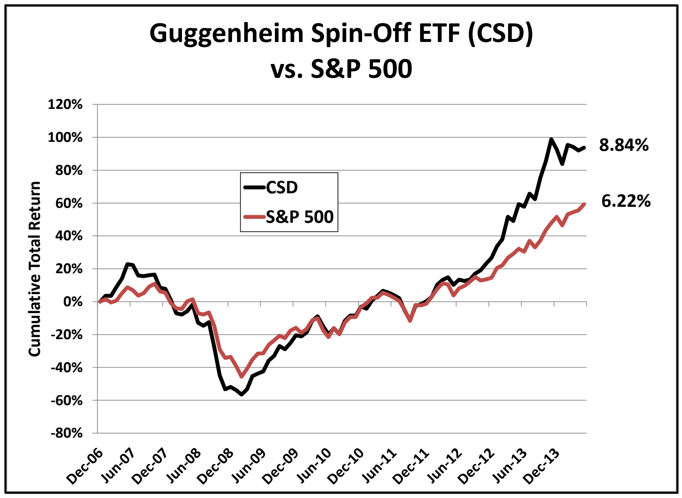
It would be very difficult, if not impossible, for an investor to react quickly enough to the announcement of a spinoff to take advantage of the *announcement's* effect on stock price. However, some studies find that the stock market reacts favorably to a spinoff for a surprisingly long period of time. Cusatis, Miles and Woolridge (1993)[1] studied 146 spinoffs (newly independent subsidiaries) from 1965 to 1988 and found they had an average excess return of **17.4% over 36 months**. Desai and Jain (1999)[2] found a 36-month excess return of **15.2%** based on their investigation of 155 spinoffs from 1975 to 1991. McConnell and Ovtchinnikov (2004)[3] confirm these findings and extend the research from 1965 to 2000, concluding that subsidiaries outperform comparison benchmarks by an average of **20%** in the 36 months following a spinoff.

What might be the cause of this powerful value creation during a spinoff's first three years? Explanations vary:

- **Improved operating efficiency**. Spinning off a subsidiary may reduce coordination inefficiencies, sharpen management focus, and/or allow for a more optimal capital allocation policy.
- **Heightened investor awareness**. The stock market often values the separate pieces more highly than the combined entity. A spinoff may result in more favorable industry valuation comparisons, better alignment with specific investor segments, and/or increased Wall Street analyst coverage.
- **Tax and/or capital structure arbitrage**. Subsidiaries that spinoff with a lot of debt effectively transfer cash flows from the government to the shareholders because of the tax deductibility of interest expense. If existing debt is transferred from the parent to the subsidiary, the debt's credit rating may be downgraded, effectively transferring wealth from bondholders to stockholders.
- **Enhanced management incentives**. The management of the spinoff company is able to tie their incentives specifically to their own operations, and they often negotiate enhanced bonus structures, increased stock options, and other forms of incentive compensation.

Regardless of how one divides up the underlying causes, excess returns of 15%-20% over three years warrant an investor's attention! The difficulty for most investors has been implementation. How do you select the few best spinoffs from among the many that come along?

Fortunately, there is a relatively inexpensive and simple way to invest in a very broad array of spinoffs: **Guggenheim Spin-Off ETF (CSD).** Since its December 15, 2006 launch, the results have been impressive. Through the end of May 2014, CSD has achieved an annualized compound return of 8.84% compared to 6.22% for the S&P 500, **an excess return of 2.62% per year** on average for over seven years.



CSD is based on the **Beacon Spin-Off Index**, which consists of U.S.-traded stocks, ADRs, and MLPs that have been spun-off (in a traditional spin-off or a carve-out) in the 6-30 months preceding its semi-annual reconstitution. The six month lag is probably a reaction to the notion that spinoffs are often indiscriminately dumped by institutional investors within the first six months of their existence, resulting in weak performance during this time period. Index constituent candidates are ranked based on proprietary "growth-oriented, multi-factor filters." No more than 40 securities are included. (There were 34 constituents on March 31, 2014.) The index is "modified capitalization-weighted" with no securities greater than 5%, which results in a small-to-mid cap concentration. (The March 31, 2014 average market capitalization was $2.6 billion, but the more meaningful median was not supplied.)

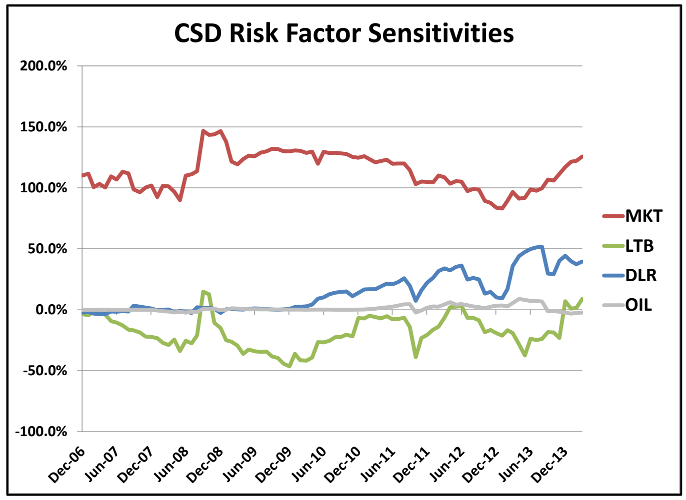
In a **carve-out**, the parent corporation sells an equity stake in a subsidiary to the public for cash, or spins-off only a portion of a subsidiary to existing shareholders (typically much less than the 80% required for the usual type, a "tax-free spin-off").

It is conceivable that CSD's impressive outperformance of the S&P 500 could have been achieved by holding a lot of stocks with very high stock market betas. In order to control for this and other possible risk effects, I statistically measure the sensitivity of CSD's returns to four **risk factors** that capture much of the risk common to most ETFs:

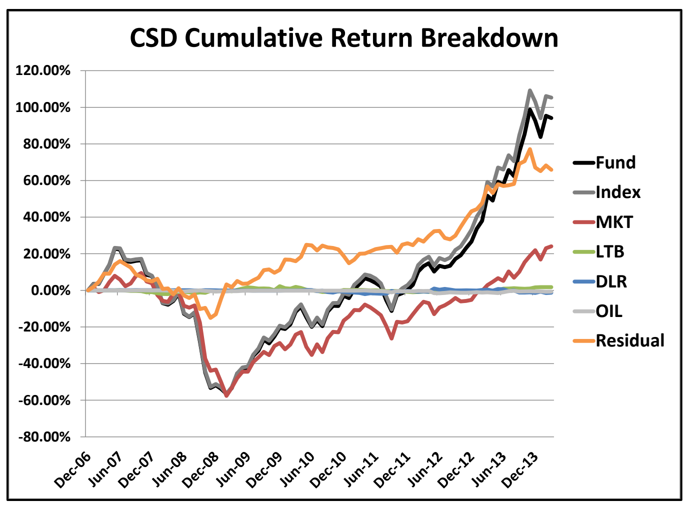
- Stock market risk (MKT), as measured by the S&P 500 Index
- Bond market risk (LTB), as measured by the 10 Year Treasury Benchmark Index
- Currency risk (DLR), as measured by the U.S. Dollar Index
- Commodity risk (OIL), as measured by the West Texas Intermediate Crude Oil Index

I use exponentially-weighted 36-month rolling multiple regressions to measure these risk factor sensitivities (often called *betas*). By using a somewhat short historical time period (*36 months* rather than 60 months) and by *exponentially weighting* rather than equally weighting the regression (half of the weight is on the most recent 12 months), the risk factor sensitivities are more sensitive to changes, and therefore hopefully provide more accurate predictions for the following month. Evaluating all four factors simultaneously in a *multiple* regression accounts for the fact that there may be some statistical overlap among the factors (called "multicollinearity" in statistical terminology). The resulting risk factor sensitivities are depicted in the graph below.

CSD's equity market beta (labeled MKT in red) is its only consistently significant risk factor. Its historical equity market sensitivity has generally been between 80% and 150% (or a beta of .8 to 1.5). Its bond market sensitivity (LTB in green) has been erratic but generally negative, meaning that a falling bond market (rising interest rates) has been generally positive for this ETF. Perhaps this indicates that the spinoff stocks held, which tend to be small to medium in market capitalization size, were more sensitive to economic outlook than to interest rates. Sensitivity to the U.S. dollar (DLR in blue) was neutral to positive, though also unstable. Smaller companies tend to export less and be more focused on the domestic economy, and are therefore not harmed by a rising dollar. Oil prices did not have a meaningful influence at any time.



The next graph tracks the cumulative return of CSD since its December 15, 2006 inception. The fund (black) slightly separates from the index (grey) over time as expected because of the 0.65% expense ratio. Much of the fund's return is explained by its equity market sensitivity (red), as expected for an ETF with an average MKT sensitivity of over 100%. The other three risk factors (LTB, DLR, and OIL) had virtually no impact on CSD's returns. The critical line for my purposes is the *residual return* (orange), defined as the total return minus the return from the four risk factor sensitivities.)



Granted CSD's **residual return (or alpha)** has not been exceedingly smooth, but **since its nadir at the end of 2008, it has averaged 11.7% per year**! That is almost as high as the 15%-20% level of excess return found in the three studies cited above.

Most ETFs (and indeed, most investments) have *no* discernible alpha—their returns are entirely explained by risk factor sensitivities. CSD's risk-adjusted returns are quite impressive, indicating that despite widely published and well-known research on the efficacy of investing in spin-offs, the strategy remains powerful.

I am content to keep CSD as one of my favorite ETF holdings for myself and my clients.

Kevin Means, CFA
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Endnotes

[1] Patrick J. Cusatis, James A. Miles, and J. Randall Woodridge, (1993) "Restructuring through spinoffs: The stock market evidence," *Journal of Financial Economics*, 33(3), June 1993, pages 293-311.
http://www.sciencedirect.com/science/article/pii/0304405X9390009Z

[2]Hemang Desai and Prem C. Jain, (1999), "Firm performance and focus: long-run stock market performance following spinoffs," *Journal of Financial Economics*, 54(1), October 1999, pages 75-101.
http://www.sciencedirect.com/science/article/pii/S0304405X9900032X

[3]YJohn J. McConnell and Alexei V. Ovtchinnikov, (2004), "Predictability of Long-Term 'Spinoff Returns," Journal of Investment Management, 2(3), Third Quarter 2004, pp. 35-44.
http://www.krannert.purdue.edu/faculty/mcconnell/publications/PublicationsPDFS/Predictability...JOIM.pdf

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