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Geopolitics and the Markets

John Micklitsch, CFA, CAIA
Chief Investment Officer

Markets and investor confidence have been rattled recently by geopolitical events. At the moment, three situations are dominating headlines; Russia/Ukraine, Israel/Hamas and instability in Iraq. Each of these issues ignites a variety of emotions for people impacted by the events. For investors however, it is important not to let these events distort your investment thinking or your longer-term investment plan. As depicted in the chart below, history is littered with events that at the time surely felt as though they had the potential to derail markets for an extended period of time.

Source: Fidelity Investments

As you can see, over time, markets have shown resiliency to even some of the most alarming of geopolitical events. That is not to say that this time or next time couldn't be different, but it is our opinion that risk analysis is best handled through a long term asset allocation plan that fits your time horizon, goals, objectives, risk tolerance and unique circumstances as opposed to reacting emotionally to what frequently amount to short-lived geopolitical events.

In the context of this article, however, it is important to understand why geopolitical events can have such a large impact on current stock prices. Generally speaking, it has to do with heightened risk sensitivity on the part of investors and the potential economic impact around the event itself. Higher risk sensitivity leads to a higher margin of safety requirement by investors. This higher margin of safety requirement frequently shows up in higher discount rates associated with financial modeling. Higher discount rates lead to lower present values of future cash flows. In fact, the discount rate is one of the biggest determinants of present value in financial modeling so even the slightest decrease in risk appetite can impact equity prices in a big way. The other lever is the economic impact of the event itself and how that might alter the future cash flows themselves; although in general this does not have the same impact as the discount rate because companies can still grow and innovate even in periods of geopolitical turmoil. As quickly as fear can spike on geopolitical news it can dissipate due to diplomatic solutions or today's shortened news cycle, both of which make investing tactically around global events very difficult especially after factoring in trading costs and potential tax consequences.

In closing, there will always be geopolitical noise in the markets. It is important to know and incorporate the levers (discount rate and actual economic impact on future cash flows) that effect security valuations but to analyze it within the context of your overall asset allocation which should reflect your unique goals, objectives, circumstances, risk tolerance and time horizon. We have quoted Warren Buffett before but it bears repeating that, "In the short run the market is a voting machine. In the long run it is a weighing machine." We believe that you put the odds significantly in your favor focusing on the weighing machine approach to analyzing geopolitical events.

John Micklitsch, CFA, CAIA is the Chief Investment Officer at Ancora Advisors LLC a SEC Registered Investment Advisor.

Inflationary Trends and Outlook

Jim Bernard, CFA
Managing Director, Fixed Income

As the FED has put forth an historically large effort to jump start the U.S. domestic economy through the injection of massive amounts of borrowed funds, many economists and strategists have predicted that this economic cycle will end with extremely high levels of inflation. As we approach the end of "quantitative easing" later this year we have yet to see any significant indication that inflationary rates or trends are increasing. Does this mean that the calls for significant inflation were incorrect, or is it something that will still likely occur at a later date?

Currently, both consumer prices (CPI) and producer prices (PPI) continue their flattish trends with year over year rates of approximately 2%. PPI rates are near the higher end of their two year trend, but it would be a little premature to declare this a sustainable increase. While food and energy continue to remain quite volatile, longer-term trends have done little to influence overall inflationary results. Obviously continued improvements in productivity through technology have accounted for holding price levels in line in recent years. Finally, lack of job growth and a large base of underemployed and displaced workers have helped to hold down labor costs although legislative changes to the minimum wage rate would impact the inflationary picture.

Many economists have argued that there is a strong macroeconomic correlation between the amount of money pumped into an economy and the expected cost of these funds. This is the basis for the argument that massive amounts of borrowed funds will ultimately push up prices once the economy and/or wage pressure begins to rebound. This implies that at some point the economy will return to above average historical growth and job growth trends will lessen the pool of available job seekers and therefore push up labor costs. At this point neither of these events appears likely in the next few years.

If higher inflationary rates do not come from either labor cost push or strong economic growth, where may it come from? The obvious answers are commodity prices and/or real estate prices. On the commodity front, supply/demand imbalances may temporarily push up prices of certain commodities, but we have not observed any sustainable trends of higher prices. Real estate has also recently shown pockets of well above average price increases, primarily on the coasts and other resort type areas, but most other regions have not produced above average price increases and many areas have shown little improvement since the 2007-2009 correction known as the Great Recession.

Our conclusion continues to be that while a modest increase in inflation to the 3%-4% range, may occur, the odds of significantly higher inflation, 6% or higher annual increases, are unlikely. With regard to interest rates, if we were to see inflation blip up towards 3.5% based on a modestly better economy showing 3%+ real GDP and continued job growth, combined with a return to a more average relationship between long term interest rates and inflation, we would not be surprised to see the 10 year treasury note trading in the range of 4%-5% in the next few years vs. its current yield of 2.418%.

Jim Bernard, CFA, is the Managing Director, Fixed Income at Ancora Advisors LLC a SEC Registered Investment Advisor. He is also a Registered Representative and Registered Principal of Safeguard Securities, Inc. (Member, FINRA/SIPC)

Shareholder Activism Defined and Reviewed

James Chadwick
Portfolio Manager

Over the past 20 years shareholder activism has evolved from an obscure, frequently vilified strategy to a mainstream form of investing that is not only increasingly regarded for its high-return potential, but also as a necessary component of our public equity markets.

Definition and origins of shareholder activism

The term shareholder activism has become ubiquitous for what in reality is an extremely wide spectrum of investor activity. The origins of shareholder activism lay in the 1980s during the era of corporate raiders and hostile takeovers. The mass adoption of shareholder rights plans (also known as the "poison pill") brought an end to the hostile takeover era and ushered in the first activist funds during the 1990s. By the mid-2000s, the strategy became even more mainstream. There are investors who label themselves "shareholder activists" that pursue a diverse array of agendas, including:

- Share price underperformance / undervaluation
- Corporate governance – shareholder rights specific
- ESG - environmental, social and corporate governance
- Executive compensation, among other causes

As the financial media typically refers it to, however, shareholder activism is an investment strategy whereby minority shareholders (as opposed to controlling shareholders) exercise their ownership rights with the objective of improving shareholder value. In the process, activist investors proactively identify investment opportunities in which the utilization of activism can unlock value by serving as the catalyst for change. Where other active investors identify value-appreciating catalyst events and then hope for that event to occur, activist investors replace hope with action by exercising their rights as shareholders to effect change.

There are numerous change-creating tools at the activist's disposal, the most extreme being a proxy contest, which is a shareholder vote for board representation/control. In addition, activists often sponsor other shareholder resolutions and/or proposals, and utilize public filings to broadcast communication to other investors (frequently contained within the SEC 13D filing – which is a required filing for active investors that cross over 5% ownership of a public company's shares). Despite the high profile media attention certain activist investors receive, by and large, most shareholder activism occurs behind closed doors and out of the press. In fact, research by McKinsey & Co. indicates the highest return outcomes from activist campaigns come about from collaborative resolutions / settlements[1]. Although 75% of all activist campaigns start off collaboratively, 60% become hostile before they are resolved, of which approximately half end in a public threat of shareholder intervention, with the remainder resulting in either a proxy fight, litigation, or takeover bids[2]. For the most part, it is unusual for activists to attempt to outright acquire a public company.

Shareholder activism also plays a role in well-functioning public markets. For example, while shareholder activists frequently do the heavy lifting, the benefits of activism generally accrue to all shareholders. In addition, the fear of becoming the target of an activist contributes to the overall efficiency of capital markets by holding management teams accountable for the diligent stewardship of corporate assets. Increasingly, activists present well-conceived capital allocation and business plans to management ensuring that a wide variety of value creating strategies are explored. Rarely do the more collaborative activists lead with a demand to sell the company. However if management fails to pursue clear-cut value creating strategies, activists can and will push for a potential sale of the company if they believe it is in the best interest of shareholders. Lastly, shareholder activism gives the value oriented investor additional levers to pull by proactively pursuing identifiable company catalysts. This event driven optionality can be useful to investors across a wide variety of market environments.

In closing, shareholder activism plays a vital role in well-functioning capital markets, in our view, by holding companies more accountable to shareholders. It is the shareholders after all who own the company. Whether you invest directly in a targeted activist strategy, own a mutual fund or own shares of common stock in a publicly traded company, it is becoming increasingly likely that you will be touched by some form of shareholder activism during your investing lifetime. In our opinion, when an activist rings the doorbell, it is generally a good idea to answer it.

[1]McKinsey & Co. research report: "Learning to Deal with Activist Shareholders", April 7, 2014.
[2]McKinsey & Co. research report: "Learning to Deal with Activist Shareholders", April 7, 2014.

James Chadwick, is the Portfolio Manager, at Ancora Advisors LLC a SEC Registered Investment Advisor.

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