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The case *for* and *against* activist hedge funds

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(Opinions expressed herein are strictly those of the authors)

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A subset of so-called hedge funds, henceforth known as "activists", has latched on the idea that many corporations are not managed or governed in a manner likely to maximize value for shareholders. With the capital they have obtained from pension funds and other institutional investors, they take a small position in the equity of publicly traded companies which, in the view of these "activists", have not taken all appropriate measures to raise the price of their shares.

This is a fast growing business. The number of activist attacks, some 27 in 2000, will exceed 320 in 2014. Activist hedge funds, fed by institutional investors, have now amassed an estimated $200 billion in managed assets[1]. To achieve more leverage on companies, smaller hedge funds may band in what has been aptly called «wolf packs».

In a by-now familiar scenario, the activist hedge fund pressures the targeted company to appoint to its board some people of its choosing (threatening a proxy fight if the company is not forthcoming). That is merely a first step, sometimes entirely skipped, in getting the company to adopt a set of measures deemed likely to boost a lagging or stagnating stock price.

Unless the company swiftly gives in to its demands, the hedge fund will produce a paper, or a long letter, critical of the company's management and board and outlining the remedial actions that, in its view, would benefit shareholders. That document will be broadcast widely so as to gather the support of the company's institutional shareholders, even if a tacit one. In due course, if matters come to a proxy fight, the hedge fund will seek to persuade the proxy advisors (ISS and Glass Lewis) to come out in favour of the hedge fund's nominees for the board.

The contents of the attack pieces produced by hedge funds range from broad principles and detailed financial analysis to operating minutiae; for an instance of the latter, the hedge fund Starboard Value criticizes the Darden Corporation, owner of Olive Garden, for the fact that these restaurants no longer salt the water for cooking its pastas! For another instance, hedge fund activist Dan Loeb got the then-CEO of Yahoo, Scott Thompson, to resign in disgrace by publishing an open letter accusing Thompson of "fabricating a computer-science degree"[2].

Activist hedge funds and their academic supporters make several arguments and claims in defense of their actions.

The case *for* activist hedge funds

- *Fostering a more shareholder-oriented and disciplined use of cash and capital*. Activist hedge funds demand that boards and management be much more disciplined in their use of company resources and their allocation of capital, which they believe typical boards of directors rarely do effectively; they urge companies to return any excess cash to shareholders by buying back their shares or paying special dividends; they advocate for effective capital structure, raising leverage where appropriate to reduce the company's cost of capital, using the cash generated thus for additional buy back of shares; they push companies to sell-off or spin-off assets/divisions/subsidiaries with mediocre returns on investment; they urge companies to «simplify» their structure, to shun diversification; they push for the sale of the whole company when they believe a prospective buyer would pay a substantial premium to put its hands on the company; all of these moves, hedge funds claim, make for a more efficient industrial structure, a better allocation of capital overall.

- *Taking a fresh, external look at "strategic" options.* They bring an outsider's perspective on companies, unhindered by the company's tradition, history and values; they may call for a change in the leadership of the company as well as in the level and form of executive compensation; their single-minded objective is to quickly maximize the return for shareholders; typical boards tend to factor in the interests of other stakeholders and to show some deference to the CEO, to the tradition and the values of the company, a complacency in the eyes of activists that only postpones the day of reckoning for the company.

- *Imposing shareholder democracy on imperial boards and management*. The will of the shareholders should be heeded by board of directors. Carl Icahn founded *The Shareholders' Square Table (SST)* as *a platform from which we can unite and fight for our rights as shareholders and steer towards the goal of real corporate democracy*. Activist hedge funds give «voice» to passive, dispersed shareholders, and, in particular, to the holders of shares in indexed funds, of which the targeted company is a component.

- *Arbitraging a governance imperfection*. There is an endemic weakness, or "imperfection", in corporate governance as currently practiced. Board members may be responsible, dedicated people but they operate in a framework of fastidious, punctilious governance; this sort of governance provides board members with a fair degree of legal immunity but maintains the board's vulnerability to, and dependence on, management's vastly superior information, expertise, and experience; activist hedge funds have tapped into this governance "imperfection". They believe that management, unless prodded, will not propose the sort of radical measures hedge funds advocate; boards are generally ill-equipped and unlikely to pressure management to implement these kinds of measures.

  Typical governance practices draw a strict demarcation between "governance" and "management" and board members are expected to rely on information provided by management and by a limited group of outsiders (auditors, lawyers, compensation consultants). Under such practices, it is rare that the board of directors will come up with, or will be "exposed" to, alternative, shareholder value-creating moves of the sort that hedge funds propose. Yet, strictly from publicly available information (admittedly vastly expanded in this day and age and since the enactment of Reg FD[3] in 2000), hedge funds can purport to show the deficiencies of current strategy and performance and make the case for specific actions.

- *Benefiting all shareholders*. Their interventions, often enough, bring about an increase in share price. That is, to activists, the proof in the pudding, the ultimate justification of their judiciousness and positive role overall. Whether (always questionable[4]) academic studies actually show the long-term positive effects (or the lack of negative effects) of interventions by activist hedge funds[5], is interesting but irrelevant; more often than not, these funds have indeed managed to boost stock prices; what happens after their departure is of no interest to them; they can rightly claim that stock prices depend on so many factors, macro-economic and circumstantial, that it is impossible to trace the influence of actions taken some time ago.

The foregoing outlines, fairly I believe, the rationale of activist hedge funds (and their academic defenders) for their claim that their activism should be welcomed rather than vilified.

What should be taken away from this description of the putative benefits of «activist» hedge funds? One of their key arguments is a valid one; the current board governance practices in *widely held corporations* open the door to the activists. Boards are indeed too often dependent on management, and unable or unwilling to take the vigorous actions needed to create enduring wealth for the company.

That is indeed a problem calling for remedial action but not necessarily of the kind offered by activist hedge funds. We return to this subject in the concluding section of this note.

Let's now examine several of the criticisms aimed at these activists.

The case *against* activist hedge funds

- *To activist hedge funds, business firms are mere "properties".* Activist hedge funds operate in a world without any other stakeholder than shareholders. They have little sympathy or patience for the view that companies should live by values other than stock price, that companies are the *situ* of commitment, passion, and loyalty. All their actions are predicated on business corporations being like "properties" with a single role: enrich shareholders; theirs is a business world without any other constituency or stakeholder or society, with no responsibility but for the bottom line. Were such a myopic concept of the corporation to become the norm for publicly listed companies, it is bound to create social and economic problems, and raise long-term issues of corporate legitimacy. Enlightened CEOs and boards of directors are well aware of this risk. *"[T]he company's success is inextricably linked to society's success. In order to do well by our shareholders, we also have to take into account the needs and concerns of a wide range of stakeholders. If our financial success comes at the expense of the environment, our consumers or our communities, we will not be viable in the long run".* Indra K. Nooyi, Letter to shareholders, **PepsiCo**'s 2013 Annual Report. Ms. Nooyi is right but, for hedge funds, that statement is anathema, even blasphemous.

- *Their game is rigged for short-term pay-offs*. They are in practice ***short-term players***; they, and their academic supporters, argue that their interventions are not strictly-speaking short-term in nature and that they do not cause long-term harm to companies[6]; but their holding period as shareholder is fairly short (see Table 1) and they have no reason to care or worry about what happens to companies once they have exited its stock. For all 1,164 cases included in this study, hedge funds held the shares for less than 15 months on average and for nine months or less in half the cases. Furthermore, the nature of their compensation system, the terms of their funding and their vulnerability to investor withdrawal of funds are likely to induce them to seek a quick pay-back.

TABLE 1

Investment horizon of hedge fund activists (in months)

Percentile	Exit after initial filing	Exit after demand negotiations	Exit after board representation	Exit after proxy contest	Average (per campaign)
25%	0	2	7	10	3
50%	**5**	**6.5**	**15**	**18**	**9**
75%	13	16	27	34	20
90%	25	27	41	64	36
Mean	9.42	10.48	19.43	25.78	**14.66**

Source: Nickolay Gantchev, "The Costs of Shareholder Activism: Evidence from a Sequential Decision Model" *Journal of Financial Economics*, Vol. 107, No. 3, March 2013, pp. 610-631; from a sample of 1,164 distinct campaigns involving 171 hedge funds and 1,023 unique targets, for the period 2000-2007

- *They create value mostly through financial engineering*. Their playbook is essentially made up of a set of financial measures, well-known to boost stock prices for a short while (see Table 2). Even their request for board changes is but a first step to gain the ability to pressure the company to implement one or a combination of the financial engineering moves of Table 2. But these measures are addictive; once the effect wears out, another dose is required to boost the price again. Soon however, that is not possible. There are only so many assets to divest, only so much cash to buy-back shares, only so much leverage to pile on a company. Knowing full well that it is so, hedge funds, if still around by then, will argue for the selling of the company. But that is not a way to run companies for the long term. Nowhere in the public utterances and the investment lexicon of hedge funds will one find references to long-term investments, to increased research expenditures, to concerns for all parties on which the company depends for its long-term success and survival.

TABLE 2

Outcomes of activist engagements*	
Board changes (replacement of the CEO, Chairman or Non-Executive Directors)	35.8%
Changes to pay-out policy (share buybacks or increased/special dividends)	21.5%
Restructuring (divestitures and spin-offs of non-core assets, and blocking diversifying acquisitions)	20.0%
Takeovers (the target firm is acquired by a strategic buyer or private equity fund)	22.7%

* Outcomes of 1358 engagements occurring between 2000 and 2010 per initial regulatory filing or press disclosure. (Becht, M., J. Franks, J. Grant and H. Wagner, 2014)

- *Their standard prescription often makes for hollowed-out companies with little resiliency*. Their actions, when implemented, leave companies with no slack resources, a curtailed ability to invest for the long-term, no diversification of activities to shield the company from industrial sector variations, no buffer for economic downturns; for hedge funds (and some financial theorists) all companies should be "pure-play", that is, a simple, one-industry operation which grows, matures, then disappears, blown away by the winds of «creative destruction». Here's how recent academic papers by *supporters* of hedge funds describe the results of hedge fund activism:

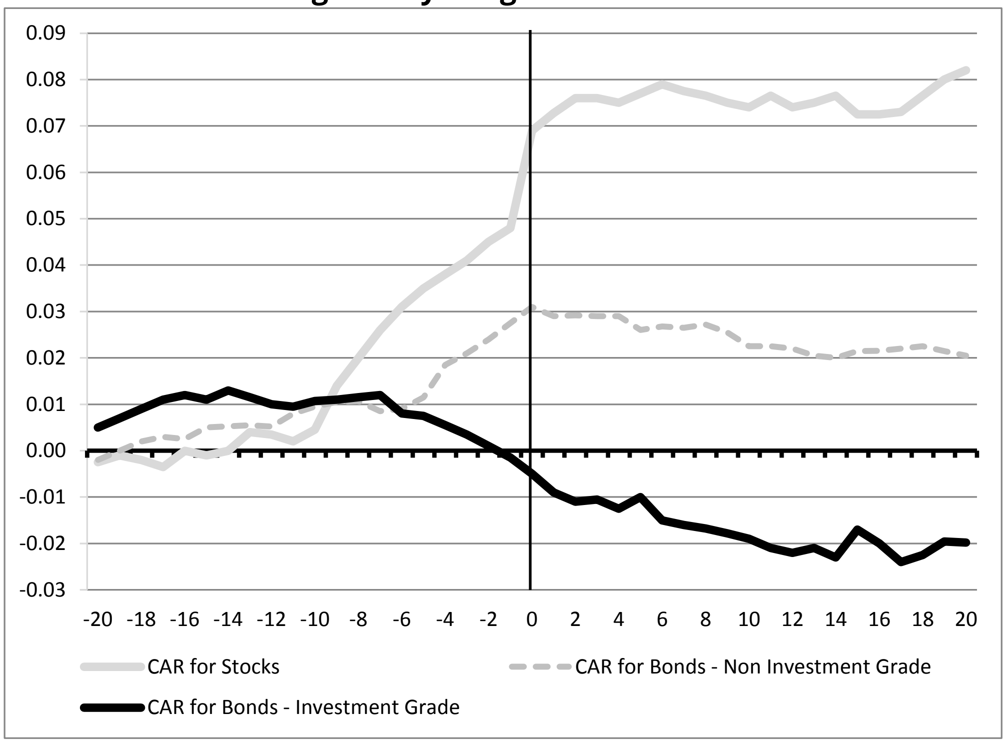
  - *[I]ncreased divestiture, decreased acquisition activity, higher probability of being acquired, lower cash balances, higher payout, greater leverage, higher CEO turnover, lower CEO compensation, and reduced investment*[7] *(Gow, et al., 2014, page 24)*
  - *Firms cut CEO pay, reduce cash holdings and leverage, limit capital investment and R&D expenses, and raise shareholder distributions and CEO turnover*[8] (Zhu, 2013, page 36*)*

- *They are harbingers of dismal collective outcomes*. Given the frequency of their attacks and their success rate lately, activist hedge funds instil fear in the management of many corporations; to forestall an attack, boards and management are counselled to examine their company as seen through the eyes of activist hedge funds and implement measures they would likely urge on the company's management[9]; as the number of activist hedge funds mushrooms, attracted by the immense pay-offs (and manageable risk) of this business, and companies pre-emptively adopt their short-term policies, the net overall effects could be quite toxic for a country's industrial health. It may be that the performance of some companies are improved by the preferred measures of activist hedge funds; however, their standard recipes if applied on a broad scale would result in a weakened, vulnerable, low growth corporate sector and a loss of their social legitimacy.

- *Stealing from John to give to Paul*. When activist hedge funds bring some lasting value for shareholders, it often takes the form of wealth transfer to shareholders from the company's employees and debt holders rather than wealth creation; here is the conclusion of two researchers who are supporters of hedge funds: *hedge fund activism facilitates a transfer of "labor rents" to shareholders which may account for part of the positive abnormal return at the announcement of hedge fund interventions.*"[10]. Several authors have documented the transfer of value from debt holders to shareholders as a result of hedge fund activism[11]. Table 3 vividly describes the phenomenon.

  Both Moody's and Standard and Poor's have warned about the debt downgrades likely to result from the sort of initiatives pushed unto companies by hedge funds[12].

TABLE 3
Cumulative abnormal returns of stocks and bonds of companies targeted by hedge fund activism



Source: adapted from Hadiye Aslan and Hilda Maraachlian, "Wealth effects of hedge fund activism," *Paper submitted to the European Finance Association*, 36th annual conference, February 2009, Figure 2,3 and 4; from a sample of 1,332 target firms, for the period 1996-2008.

- *They are "fair weather" activists*. In good economic times, their stratagems are well received by investors and stock markets. When the bad times come around, companies, having depleted their financial buffers, will struggle to cope with difficult economic circumstances. They, the activist hedge funds, will then change their game and become massive short-sellers, as they did in 2007-2008.

- *Their misguided actions and mistakes inflict collateral damages*. The assumption that their medicine is an appropriate cure for all targeted companies has inflicted costly set-backs on these funds. But those mistakes also damage companies which had to allocate cash and plenty of executive time to fend off the misguided attacks of some hedge fund. For instance, the errant hedge fund campaigns at Target Stores and J.C. Penney inflicted harm on these companies. Yet apart from losing some of its investors' money, the hedge

> fund manager was not held accountable for these damages. As hedge funds multiply, it is likely that misguided activism will go rampant in the corporate world, inflicting great costs on the economy.

What should be taken away from this description of arguments against «activist» hedge funds? First of all, the hedge funds' "remedial actions" are well known and could be applied willingly and easily by any company; actually, many do as the massive amount of share buy-backs by corporations bear witness. But the fact that many companies refuse to carry out these financial manoeuvres may be an indication that their management and boards believe that these would be improper and detrimental to the company's long-term interest. Who is right? Why should it be assumed that boards are motivated by crass self-interest or afflicted with chronic incompetence but hedge funds are bearers of wisdom acting in the superior interest of the company and its shareholders[13]?

Then, in the world according to activist hedge funds, companies should pay out to shareholders all potential cash, and operate as resource-poor, cash starved, pure plays. Should they disappear, either bought or bankrupt, that is but the iron law of economics. But is this how the formidable American corporations, the economic engines of the US, were built? The GE, IBM, Johnson and Johnson, Apple, Google, Facebook, Amazon, to name a few, would find these prescriptions of hedge funds suicidal. Yet, even they are not beyond reach of these hedge funds as institutional investors keep pouring money into their coffers, unless, as some have done, they adopted a capital structure that keeps the control of the company in the hands of the founding entrepreneurs.

Taking in all aspects of hedge fund activism, it appears that whatever benefits it may bring are vastly outweighed by its negative impact on companies, and by the narrow, soulless concept of the corporation that it embodies.

What is to be done?

To the extent that hedge fund activism is deemed unhealthy for the long-term well-being of shareholders, stakeholders and society at large, the question of how to limit their ability to do harm begs for an answer. There are several measures which would inhibit the spreading of this activism. Some have low plausibility in the context of American financial markets, although they are quite feasible in other jurisdictions.

1. Institutional investors bear heavy responsibility for the emergence and mushrooming of activist hedge funds.

A) Their "soft" activism, aided and abetted by proxy advisors and programs like Professor Lucian Bebchuk's *Harvard Shareholder Rights Project*, has taken the form of campaigns to remove all impediments to direct shareholder involvement in decisions that used to be the preserve of boards (staggered boards, poison pills, say-on-pay, majority voting, board nominees, hostile takeovers, etc.)[14]; in doing so, and irrespective of the merits of these proposals, institutional investors unwittingly facilitated the emergence and success of activist hedge funds.

B) As matters now stand, institutional investors, public pension funds in particular, are the prime source of funds for these "activist" hedge funds.

C) Increasingly, pension funds and other institutional investors support the campaigns of activist hedge funds against the management of companies in which institutional investors hold a substantial stake.

We all understand the motivation of institutional investors and their need to generate yields on managed assets that match expectations, beat indexes and/or the performance of comparable funds. In that context, the pitch of activist hedge funds may be hard to resist, but resist they should if they come to the conclusion that, too often, their actions bring only short-term benefits and that the "wealth creation" of these activists consists in fact of "wealth transfer" from employees and debt holders.

Some institutional investors, including BlackRock's Larry Fink, Vanguard's Bill McNabb, and in Canada, Mark Wiseman, CEO of Canada Pension Plan Investment Board and Michael Sabia, CEO of the Caisse de depôt et placement are taking steps to empower companies to focus on long-term, sustainable value and to resist short-term pressures. More funds should follow their lead.

2. Perhaps, corporate debt underwriters should include a covenant clause allowing debt holders to put the debt up for repayment (with suitable make-whole penalty), should an activist hedge fund gain board seats. Given the demonstrated effect of their actions on the value of a company's corporate debt and the spreading popularity of such "activism", that would seem a prudent move.

3. The sacrosanct practice of one-share-one-vote needs to be examined in the context of the contemporary functioning of financial markets. Financial markets are now rife with empty voting, total return swaps, huge quantity of stock derivatives and so on; there is no easy way to establish the equivalence between economic interest and voting power. Dual class of shares, the bogeyman of financial purists and unsophisticated investors, make that relationship very clear and transparent. That capital structure, when structured with safeguards for minority shareholders, has the very significant advantage in this age of unfettered activism to place a company out of reach of hedge funds. Several American companies of note have adopted this form of capital structure: Berkshire Hathaway; Google; Facebook; Groupon; Expedia, UPS; Tyson; Ford, Nike, The NY Times; News Corp; CBS, Comcast, etc. It also includes some entities one would not expect, given their devotion (for others) to unfettered capitalism and shareholder sovereignty: Blackstone; KKR; Apollo; Pershing Square Holdings, Third Point, etc. Of course, for the large number of widely-held, one-share-one-vote companies already in operation, there is no way back. Entrepreneurs should consider this form of capital structure at IPO time.

4. Another dogma of financial markets, the acquisition of voting rights at the time of share purchase, deserves a close examination. It should be pointed out to those, like Mr. Icahn, who advocate for enhanced democratic rights for shareholders, that in all democracies the right to vote is linked to citizenship and, for people not born in a country, that right to vote in that country is acquired after some period of residence. Although paying all pertinent taxes from arrival, immigrants do not get the citizenship and right to vote for a variable period of time. Also, of course, *tourists do not have the right to vote* if they happen to be in the country for a short visit on Election Day. Yet, when it comes to shareholding, new "immigrants" and "tourists" get to vote. It would be a drastic change, but one for the better, if the right to vote shares would be acquired only after a one-year holding period. That suggestion was made by several observers[15],[16],[17]. The adoption of this measure would greatly curtail the ability of activist hedge funds to bully companies.

5. No doubt that much improved fiduciary governance was put in place in listed corporations at the express demand of institutional investors. However, this form of governance, with increasingly detailed and fastidious governance practices is quickly reaching a point of diminishing returns. Furthermore, it never addresses the fundamental problem of governance: the asymmetry in information, knowledge, and experience between management and board members. (For an excellent review of these issues, see the Conference Board Governance Center White Paper[18])

Corporate governance of the widely held corporation often becomes a fiduciary façade for shareholders, a simulacrum of decision-making authority over management. Board members, through no fault on their part, remain surprise-prone, dimly aware of various goings-on in the company, poorly informed, dependent on a management that they are ill-equipped to challenge.

Is that the best we can do? That is the fundamental dilemma of corporate governance. That is also the wedge with which activist hedge funds find their leverage.

Resolution of this dilemma will not come from a further tightening and refining of fiduciary governance. We must develop a new way of governing, a new definition of the role of the board of directors in the widely-held, publicly listed corporation. *Boards must take on a more "activist" role geared towards building long-term sustainable value for the company*; but that is a formidable challenge.

Yet, the boards of widely-held firms must cope with this challenge, lest corporations get shoved around by emboldened, mushrooming, cash-rich activists.

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[1] Martin Lipton, Steven A. Rosenblum and Karessa L. Cain, "Some Thoughts for Boards of Directors in 2015," *Memorandum by Wachtell, Lipton, Rosen & Katz*, December 1, 2014.
[2] Carlson, Nicholas "What Happened When Marissa Meyer Tried to Be Steve Jobs", *New York Times Magazine,* December 21st 2014
[3] "Regulation FD provides that when an issuer discloses material nonpublic information to certain individuals or entities—generally, securities market professionals, such as stock analysts, or holders of the issuer's securities who may well trade on the basis of the information—the issuer must make public disclosure of that information. In this way, Regulation FD aims to promote the full and fair disclosure". Source: SEC.
[4] Yvan Allaire and Francois Dauphin, "Activist hedge funds: creators of lasting wealth? What do the empirical studies really say?," *Institute for Governance of Private and Public*

Organizations, July 2014; and, from the same authors, "Hedge fund activism and their long-term consequences: Unanswered questions to Bebchuk, Brav and Jiang," *Institute for Governance of Private and Public Organizations*, August 2014.

[5] See, for instance, Lucian A. Bebchuk, Alon Brav and Wei Jiang, "The long-term effects of hedge fund activism," *Working paper available on SSRN*, July 2013.

[6] See Lucian A. Bebchuk, Alon Brav and Wei Jiang, "The long-term effects of hedge fund activism," Working paper available on SSRN, July 2013.

[7] Ian D. Gow, Sa-Pyung Sean Shin and Suraj Srinivasan, "Activist directors: determinants and consequences, " *Harvard Business School Working Paper*, No. 14-120, June 26, 2014, p.24.

[8] Heqing Zhu, "The preventive effect of hedge fund activism," *Working Paper available on SSRN*, November 2013, p.36.

[9] Nickolay Gantchev, Oleg Gredil and Chotibhak Jotikasthira, "Governance under the gun: spillover effects of hedge fund activism," *Working Paper available on SSRN*, March 2014.

[10] Alon Brav, Wei Jiang and Hyunseob Kim, "The real effects of hedge fund activism: productivity, asset allocation, and industry concentration," *Working Paper available on SSRN*, May 2013, p.22.

[11] See, for instance, April Klein and Emanuel Zur, "The impact of hedge fund activism on the target firm's existing bondholders," *The Review of Financial Studies*, Vol. 24, No. 4, 2011, pp.1735-1771, and Hadiye Aslan and Hilda Maraachlian, "Wealth effects of hedge fund activism," *Paper submitted to the European Finance Association*, 36th annual conference, February 2009, 59p.

[12] See, for instance, Francis Byrd, Drew Hambly and Mark Watson, "Short-Term Shareholder Activists Degrade Creditworthiness of Rated Companies," *Moody's Investors Services Special Comment*, June 2007, and Standard & Poor's press release of the report titled "Spin-Offs, On The Rise Again In The U.S., Can Signal Weaker Credit Quality For Parent Companies", October 10, 2014.

[13] Leo E. Strine, Jr. "Can we do better by ordinary investors?", *Columbia Law Review*, Vol.114:449, 2014

[14] For a discussion of this trend, see Andrew L. Bab and Sean P. Neenan, "Poison Pills in 2011," *The Conference Board Director Notes*, Vol 3, No. 5, March 2011.

[15] Yvan Allaire, "Corporate citizenship and the right to vote: A proposal," Institute for Governance of Private and Public Organizations, Policy Paper #2, November 2006.

[16] A task force set up by the Aspen Institute to address market short-termism proposed among its recommendations time-phased voting. The signatories of the paper issued on September 9, 2009 and titled *Overcoming Short-termism: A Call for a More Responsible Approach to Investment and Business Management,* include, among others, John C. Bogle, Warren E. Buffet, Louis V. Gerstner Jr., Martin Lipton, Jay, W. Lorsch, Ira Millstein and Lynn A. Stout.

[17] Various panels at the World Economic Forum discussed this issue.

[18] S. Jain, B. Blackford. D. Dabney, and J.D. Small III « What is the Optimal Balance in the Relative Roles of Management, Directors, and Investors in the Governance of Public Corporations", *The Conference Board Governance Center White Paper,* 2014.

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