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Can America's Companies Survive America's Most Aggressive Investors?

So-called activist investors are increasingly gaining control of legacy corporations, forcing them to trim payrolls and downsize research operations—and, quite possibly, damaging the entire economy.

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WILMINGTON, Del.—Ron Ozer was thrilled to get a job with DuPont, the two-centuries-old chemical company, when he finished his Ph.D. from Cornell in 1990. It was *the* place to go for young, ambitious chemists; it offered salary and benefits so generous that some people called it "Uncle Dupey." For 26 years, he invented things for DuPont, filing patent after patent, working on renewable plastic bottles and polymers from the company's Experimental Station, a research lab where Kevlar, Neoprene, and nylon were all invented.

Then, in January of this year, he was abruptly fired, along with hundreds of other employees at the Experimental Station, part of a company-wide wave of 1,700 layoffs, one-third of DuPont's Delaware workforce. Globally, DuPont cut 10 percent of its workforce, or 5,000 people in early 2016.

The cuts came as DuPont prepared to merge with another legacy chemical behemoth, Dow Chemical Co., by early 2017. The merger, which is awaiting approval from regulators, was prompted, Wall Street analysts say, by a very public campaign by the hedge-fund investor Nelson Peltz and his company Trian Fund Management. Trian, which was DuPont's fifth-largest shareholder, in early 2015 said it wanted DuPont to double its share price and cut $4 billion from its business, according to filings by Trian. Trian publicly demanded that the company cut costs, and threatened to convince DuPont shareholders to vote out members of the company's board supportive of key executives. Carry out our demands, Trian essentially said, or we will gain control of your company and change it without your input. (Through a spokeswoman, Trian declined to comment for this article.)

DuPont is one of dozens of American companies that have abandoned a long-term approach to doing business after being the target of so-called activist investors. These investors buy up shares of a company and attempt to maximize the returns to their shares, usually by replacing members of the board of directors with hand-picked candidates who will push the company to cut costs. Activity by such investors has skyrocketed of late. In a 20-month stretch in 2005 and 2006, there were only 52 activist campaigns, according to John C. Coffee, a professor at Columbia University Law School. Between 2010 and early 2014, by contrast, there were 1,115 activist campaigns. “Hedge-fund activism has recently spiked, almost hyperbolically,” Coffee writes in a 2016 paper, “The Wolf at The Door: The Impact of Hedge Fund Activism on Corporate Governance.”

These campaigns are damaging to the long-term outlook of individual companies like DuPont and also to America’s economy more generally. They often result in big cuts to research and development, substantial reductions in the workforce, and a focus on outcomes—in particular short-term profit—that hurt a company’s ability to survive in the long-term. The threat of activism affects companies across the economy: Even public companies not targeted by activists often change their behavior and cut costs to avoid becoming a target. This may be one of the reasons why America is slipping in funding research and development projects when compared with other countries.

“You have to look after the goose that lays the golden egg,” Anne Simpson, the senior portfolio manager at California Public Employees’ Retirement System (CalPERS), told me. CalPERS owns shares in DuPont, and opposed the Trian actions. “Cutting R&D can make everything look sparkly and bright for a while, but if you’re like us, and looking decades into the future, you won’t generate new products.”

Though he initially lost a battle to replace four members of DuPont’s board of directors with people of his choosing, Peltz has succeeded in changing the company. Trian seems to have convinced DuPont shareholders and executives that the company needs to focus on making more money. Beginning in late 2015, shortly after Peltz’s campaign to “optimize stockholder value,” DuPont made a number of changes. DuPont’s CEO Ellen Kullman, a company veteran, abruptly resigned. The new CEO, Ed Breen, is a veteran of dismantling large conglomerates, and plans to merge DuPont with Dow and then split the giant company into three different parts, a split Peltz had long wanted. The changes mean cutting back on research-and-development costs (R&D)—most significantly with the closure of the research lab that employed Ron Ozer—and eliminating certain departments, and slashing thousands of jobs. “This company is over 200 years old, and this guy who has nothing to do with the industry has basically got people on the board slashing R&D, just pumping money out of the company," William Lazonick, an economist at the University of Massachusetts-Lowell, told me. "And none of it is illegal."

In an email, DuPont told me that its management and board, not Trian, conceived of the merger. A company spokesman contested the idea that the moves had anything to do with Trian. But just about everyone else I talked to said that it was widely accepted on Wall Street that the changes were directly responsive to Peltz's pressure.

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This story has played out at many other companies. Apple, one of America's best-known innovators, recently battled activist investor Carl Icahn, who wanted the company to return more cash to shareholders. Icahn also targeted Xerox Corp, which at his urging split into two companies, cut more than 5,000 jobs over six months, and slashed costs by $700 million. In 2015, the activist investor William Ackman acquired a $5.5 billion stake in Mondelez International, the maker of Oreos and Ritz crackers, and pushed the company to cut costs significantly. Mondelez itself was created when Trian pushed Kraft Foods to spin off its snack-food business from its grocery business. Also, the New York hedge fund Starboard Value targeted Wausau Paper, leading to the closing of a Wisconsin paper mill and the bankrupting of a small town nearby.

Sometimes, activists can improve companies that are floundering. But what's most frustrating to Ozer is that DuPont was performing well before Trian took over. Between the time Ellen Kullman became CEO and the time Trian waged the proxy battle, the company's total shareholder returns had increased 256 percent. The company out-performed the Standard & Poor's 500-stock index, and was already cutting $2 billion in costs. But Trian and, ultimately, the DuPont board, were not content with those numbers. They wanted to see even bigger returns. And that came directly at the expense of people like Ron Ozer and the research he was doing.

"The desire to get a faster return is hurting long-term research," Ozer told me. "Nelson Peltz may be able to buy another Rolls Royce, but that's not going to help the economy."

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Ask business owners of a century ago about activist investors and they'd have had no idea what you were talking about. When public corporations became popular in America in the early 20th century, they issued stock to tens of thousands of investors, who themselves had little interest in weighing in on how to run the company, according to Lynn Stout, a Cornell professor and the author of *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public*. Shareholders also had less of a singular interest in getting big returns. At the time, the thinking was that companies had a purpose beyond making money for shareholders; they existed to provide jobs, serve their customers, and even help society, all the while doing well by their investors. Companies helped society, and that, in part, is what investors were buying a piece of.

But since that time, there's been a change in thinking about the purpose of a company, Stout said. Beginning with a 1970 Milton Friedman essay in *The New York Times Magazine* arguing that a corporation's only responsibility was to increase profits for shareholders, directors abandoned the idea that companies existed for the good of employees, customers, shareholders, and society. A corporation existed, the argument went, to make money for its shareholders. These ideas were further developed by the so-called Chicago School of economics, which believed that principles of economics could be applied to managing corporations. As the Chicago School came to dominate mainstream economic thinking, the idea that corporations should only have economic motives was taught in business schools around the country, creating a generation of CEOs who sought to improve shareholder value above all else, according to Stout. Today, the directors of many companies are pushed to maximize shareholder value, or face lawsuits from investors who say they're not running the company correctly, Lawrence Hamermesh, a professor of corporate and business law at Widener University, told me.

Activist investors believe they know how to unlock shareholder value better than a company's board or directors do. They operate by doing huge amounts of research about a company, and coming up with better ways to increase the company's share price. Sometimes, their plans result in stronger, more transparent companies. Yet, sometimes, these methods include cutting costs so that a company's profits are higher but its long-term viability is at risk, and then selling the stock.

Companies often resist moves by activist investors, but the investors have gotten more powerful in recent years for a variety of reasons. Regulatory changes have made it easier for the investors to communicate with other shareholders and advocate for changes in the company. And activists manage an increasing amount of money, allowing them to threaten bigger in bigger companies.

(Lucas Jackson / Reuters)

In 1992, for instance, the Securities and Exchange Commission (SEC) cut back on rules that prohibited shareholders like hedge funds from communicating with others during a proxy contest. Prior to this rule change, hedge funds would have to file any information they wanted to share with other shareholders to the SEC for review. After 1992, they could lobby private investors and embark on public campaigns through advertisements and speeches without SEC oversight, according to a paper by Brian R. Cheffins, a professor at the University of Cambridge and John Armour, a professor at Oxford. Then, in 1996, Congress passed the National Securities Market Improvement Act, which opened the door for institutional investors such as pension funds and university endowments to invest in hedge funds. That dramatically increased investments in hedge funds; in 1993, according to Cheffins and Armour, 5 percent of hedge fund assets were institutional, but by 2001, 25 percent of hedge fund assets were institutional.

In 2003, the SEC made another change, requiring that institutional investors disclose how they voted during company elections about governance, and outlining ways in which the investors had to ensure the vote was in the best interest of clients. Such institutional investors did not have the capacity to do in-depth research on governance matters for every company in which they invested, so they outsourced such decisions to so-called proxy advisory firms such as Glass-Lewis and Institutional Shareholder Services. (Stout calls Institutional Shareholder Services "the most powerful institution no one has ever heard of.") Such proxy advisory firms tend to support shareholder activist campaigns, according to Coffee, and often side with hedge funds, rather than company leadership, in proxy battles.

The biggest reason activist funds have gained so much power in the last decade, though, can be tied to the recessions of the 21st century. After the 2001 dot-com bubble burst and then again after the housing bubble in 2007, investors who lost money during the recession needed to play catch-up and earn back the money they had lost. These mutual fund managers and institutional investors such as pension funds turned to private equity and hedge fund investors, who said they could help.

In 2015, for example, public pension funds put 8.3 percent of their portfolios into hedge funds, according to the 2016 Prequin Global Hedge Fund Report, up from 5.7 percent of their portfolio in 2008. Around 420 public pension funds are actively investing in hedge funds. "Hedge funds promised that they could beat the market, and help these [pension and other large institutional] funds catch up on big liabilities they were sitting on," David Webber, an expert in securities law at Boston University, told me. Many such institutional investors funds, desperate for higher earnings, believed them.

These investments mean that hedge funds have more money to play with, which allows them to buy up more shares and force companies to listen to their demands. With more money to invest, they can also target bigger companies. A decade ago, no one thought hedge funds would be able to influence companies such as General Electric or DuPont, because the companies' market values were too high, and it would be too expensive to buy a controlling interest, according to Douglas Chia, the executive director of the Governance Center at The Conference Board, which recently published a piece, "Is Short-Term Behavior Jeopardizing the Future Prosperity of Business?" Now, he told me, "these funds have grown to the point where they're able to buy up meaningful stake in the company's stock." In 2013, almost one-third of activist campaigns focused on companies with a market capitalization of more than $2 billion, according to Coffee.

Activist investors have some supporters. Lucian Bebchuck, a Harvard professor who is known as one of the most devout defenders of activist shareholder campaigns, says that activist interventions target underperforming companies, and that they improve the company's performance in the long-run. "Policymakers and institutional investors should not accept the validity of the frequent assertions that activist interventions are costly to firms and their shareholders in the long term," he writes, in a 2015 paper, "The Long-Term Effects of Hedge Fund Activism."

Even some CEOs say that activists have a positive side, namely, that they force companies to be more transparent and communicative with their shareholders. The head of insurance giant AIG, for example, said earlier this year that investors such as Carl Icahn have forced the company to change the way they report their financials, resulting in more clarity.

A DuPont facility in Delaware (Tim Shaffer / Reuters)

And it's true that hedge-fund activism isn't the only reason there's a spike in short-term thinking in corporate America. Company executives and mutual fund managers also receive bonuses when a stock performs well, even if that's simply because the company has slashed costs, not actually become a stronger company. This began in 1993, when Congress capped executive salary and companies began to compensate them with stock options. It's not just CEOs who are increasingly focused on short-term profits; even pension-fund managers feel pressured to report higher earnings every quarter, Simpson, of CalPERS, told me. Many shareholders, too, are now looking for a quick return. In the 1960s, the average holding period on the New York Stock Exchange was eight years. It's since dropped to about eight months.

Data suggests that, on the whole, activist investors are not good for employees or for the economy.

As a result, a whole industry has emerged in which Wall Street analysts and everyday investors monitor how a company's stock performs from quarter to quarter. Now, companies set quarterly-earnings forecasts, and are pressured to meet these forecasts or face the wrath of analysts who will advise clients to sell the company's stock—or a campaign from activist investors. This encourages managers to do what they can to increase profits in just one quarter. One survey by McKinsey & Company and Canada Pension Plan Investment Board, found that a majority of executives said they would not be willing to accept "significantly" lower quarterly earnings for an investment that would boost profits by 10 percent over the next three years.

But it's activist investors who have really pushed short-term thinking and figured out how to profit from it, according to Stout. And data suggests that, on the whole, activist investors are not good for employees or for the economy. Companies targeted by activist investors saw employment drop by 4 percent between 2008 and 2013, while all companies on average grew employment nine percent, on average, according to a 2015 study, "Hedge Fund Activism: Preliminary Results and Some New Empirical Evidence," by Yvan Allaire, executive chair of the Institute for Governance of Private and Public Organizations, a Canadian think tank that works on governance issues. Those who had specifically been targeted by activists advocating for cost reduction saw employment shrink 20 percent.

Of course, what this means is that these efforts undermine the livelihoods of thousands who work at these companies. As Allaire puts it, activists' interventions are often merely a "wealth transfer to shareholders from the company's employees." But the problem extends even beyond those directly affected, to the health and ingenuity of the company as a whole.

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America's big companies have fostered innovation for much of the country's history. Products that are now essential parts of modern life—the microwave, the washing machine, the telephone—all were improved upon or invented in labs at companies such as Raytheon, General Electric, and Bell Labs.

One of the companies that added the most to American innovation was DuPont. It developed polymers and compounds including Freon, Neoprene, nylon, Lycra, and Kevlar, to name a few. "DuPont alone has significantly contributed to the way [America works]," Jay Rao, a Babson professor who studies innovation, told me. DuPont was started when Pierre Samuel du Pont de Nemours decided to leave France in 1799 in the aftermath of the French Revolution. Research and development was important to him even then; Du Pont and his sons considered eight different businesses when they arrived in the United States, but only one succeeded: a gunpowder business, according to the Hagley Museum & Library, a Wilmington museum dedicated to the history of the DuPont company. Thanks to spending on research and development, Du Pont and his sons were able to transform that gunpowder business into a more general chemical company. There were few places in the 21st century that spent as much time and money on research as DuPont. "DuPont's success in the 20th century has been made possible by innovative science," the company's 1994 annual report reads. "We are also maintaining our commitment to discovery research, which is essential to our future."

Spools of Kevlar in a DuPont plant in Virginia (Steve Helber / AP)

Yet this changed after the battle with Trian. A decade ago, Dupont's shares were trading at $27 a share. That started to climb up in the aftermath of the recession; between early 2009 and early 2015, the company's share price increased by 210 percent. (For comparison, the S&P 500 increased 140 percent over the same time period.) By 2015, shares were trading at $65. Despite this climb, Trian, in a 2015 presentation to shareholders, said it believed DuPont shareholders could be making more money. This despite the fact that shareholders had made $2.13 per share in 2009, $3.66 per share in 2010, $4.32 per share in 2011, and more than $3.77 per share in every subsequent year. (Trian owned 24.6 million shares of DuPont stock in early 2015, valued at around $1.9 billion.) Investors had seen earnings per share grow around 3 percent a year in 2013, 2014, and 2015. Yet Trian wanted more: It wanted to see earnings per share grow 12 percent a year.

"There is more value to be unlocked," Trian wrote, in the presentation, adding that, in its view, DuPont had $2 billion of excessive corporate costs a year. Trian took particular offense at the $5 billion DuPont had spent over in agriculture research and development over the last five years with "no new biotech traits, of significance, discovered."

DuPont's 2016 annual report indicates the company's changing attitude towards research and development, a change spurred by Trian. In the report, the company says its R&D objectives were not solely focused on research, but also to "drive revenue and profit growth for the company, thereby delivering sustainable returns to our shareholders." This focus on shareholder returns have since showed up in the company's priorities. In recent years, cuts to research and development have been significant. The company announced in February that it would spend about $1.7 billion on R&D in 2016. In 2014, it had spent $2.1 billion, or 20 percent more.

Ron Ozer says he noticed interest in research and innovation decline over his time at DuPont. At DuPont and many other American research companies, scientists used to be able to embark on projects because they were scientifically important or interesting, even if they weren't obviously profitable. This led to discoveries that helped advance science, and in many cases also proved quite lucrative. "At one time, the research was more academic, with people doing things that might not have an obvious application," he said. "As time went on there was more expectation that the research have a good profit objective."

DuPont isn't the only business that has rolled back R&D spending after being the target of an activist investor. According to the Allaire study, research-and-development expenditures plummet among companies targeted by activists. On average, companies increased research and development as a percentage of sales to 7.65 percent in 2013, from 6.54 percent in 2009, according to the study. Those that had been targeted by activists decreased that spending to 8 percent from 17.34 percent. That data could illustrate that some companies had invested too extensively in R&D, and that the activists were right to adjust that. But such drastic cuts to R&D spending have a big impact.

"It's a game. These activist investors decide to step in and create a short-term action that will cause the stock to go up," Bill George, a Harvard fellow and the former CEO of Medtronic, told me. "But there's a real problem when companies are pressured not to put money into research, because America's competitive strength is based on research."

Companies may be making cuts beyond R&D spending as a reaction to activist investors. According to a *Wall Street Journal* analysis, companies in the S&P 500 targeted by activists increased spending on dividends and buybacks between 2003 and 2013, while cutting spending on plants and equipment over the same time period. Spending on buybacks increases a company's share price, but is essentially sleight-of-hand, leading to no new tangible equipment or research at a company.

Indeed, some in the corporate world fear that this focus on the short-term will have ripple effects on the U.S. economy. Lawrence Fink, the chief executive of

BlackRock, which is the world's biggest investor, with $4.6 trillion under management, expressed concerns about this in November 2015 in an interview with the *Harvard Business Review*. "A company can stop R&D and show fabulous short-term results," he said. "But over the long cycle, that's devastating for the company and, if it's American, probably for the United States as well."

Already, there are signs that America is losing its research & development edge. A study of more than 1,000 U.S. firms with at least one patent found that big firms have significantly reduced their investment in research since 1980, and that they are more focused on developing existing patents (the D of R&D) than on inventing new products. The U.S. ranks 10th globally in another key metric: R&D spending as a percentage of the gross domestic product, according to the National Science Foundation. It has been slipping in this ranking in recent years, the NSF says. While U.S. companies cut investments in science, those in other countries continue to invest in research and development. Chinese businesses spent 79 percent more on research and development in 2013 than they had in 2009, and Korean firms spent 55 percent more. Yet U.S. firms increased their R&D funding by only 7 percent over the same time period.

"There are fewer and fewer executives who are willing to spend more on R&D and long-term returns," Rao said.

Cutting back on research and development might be profitable for a company, but it has a social cost, according to Coffee, the Columbia professor. When products are invented, sometimes new companies are spun off to market and develop those products. A company's competitors often learn from new inventions, a process known as R&D spillover; an agricultural company that sees its competitor begin selling a new type of seed will scurry to figure out how to produce a similar seed, for instance. "The big picture here is that this is a big threat to America's pre-eminence," George told me.

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A focus on shareholder value in the short-term is forcing many public companies to change their behavior, and at the same time hamstringing the American economy. But it doesn't have to be that way.

The first and most obvious solution is for companies to avoid becoming public, or to go private in order to avoid the pressure from shareholders. Michael Dell did this with his company in 2013. A year after the deal, he said, in the Wall Street Journal, that it was a good move. Privatization allowed his employees "the freedom to focus first on innovating for customers in a way that was not always possible when striving to meet the quarterly demands of Wall Street," he wrote. Public markets had been helpful when Dell was growing, he said, but as the company matured, investors were less interested in innovation. As Dell matured there was, he wrote, "an affliction of short-term thinking that drove a wedge between our customer and investor priorities." Dell avoided that by removing his company from the intense gaze of the public markets.

Another solution could be to encourage institutional investors and those who hold big shares in companies to take a stand against short-term thinking. Many such funds don't even decide how to vote in wars over control of a company; they turn proxy advisory services instead. In the DuPont-Trian battle, for instance, both ISS and Glass Lewis advised clients to vote for Peltz and Trian, and the California State Teachers Retirement System (CalSTRS) voted with Trian. Yet the California Public Employees Retirement System (CalPERS), the country's largest pension-fund investor, voted against the changes that Trian wanted. Simpson, the CalPERS director, told me that Trian's plan threatened research and development and that the firm had a "relatively short term" focus. "You have to be very tough to stand your ground over periods of short-term thinking," she told me.

If other pension funds and big holders of stock similarly speak up, there could be enough of a backlash against short-term thinking that activist investors would have to rethink their strategy, Webber told me. After all, pension funds are investing for the long-term; they need a company to still be doing well in 30 years, when they have to make payouts on their investments. "One would like to think long-term institutional investors would start to push back against R&D cuts," he said. "There's a glimmer of hope there."

There are some changes in the tax code that could discourage short-term investment, as well. The Aspen Institute suggests setting capital-gains taxes at a descending rate; the longer an investor holds onto a stock, the lower a capital-gains tax he could pay. Currently, capital-gains tax treatment kicks in after one year, but the government could extend that period so that gains are taxed more if they are from short-term investments. The government could also impose what's called a "financial transaction tax," that would make it costlier to do short-term trades and would encourage longer-term investment, according to the Center for Economic and Policy Research. The U.S. levied a similar tax on stock issuances between 1914 and 1966.

Another tack would be for the SEC to change voting rules for investors so that shareholders with longer-term holdings have more votes; France, for instance, mandates that investors who have held shares for two years or more get double voting rights, unless two-thirds of shareholders have voted against this rule. Earlier this year, two Democratic senators (Tammy Baldwin of Wisconsin and Jeff Merkley of Oregon) also introduced a bill in Congress that would change regulations governing activist investors. The Brokaw Act would shorter the period investors have to disclose that they have bought a large stake in a company. Usually, investors have 10 days to disclose that they've acquired a 5 percent share in the company; the Brokaw Act would reduce that time period to two days. This would make it more difficult for groups of activists to secretly work together to gain a large stake in a company and then force changes.

There's also an option for individual investors who want to make sure the companies they invest in aren't hijacked by hedge funds looking for short-term value. They can invest in public benefit corporations, which are created for purposes other than maximizing shareholder value. Such corporations, which are relatively new entities, are required to consider the needs of stakeholders such as employees and customers, alongside the needs of investors, when they make decisions. Activist investors are unlikely to bother with such companies, since they can't argue that managers aren't focused enough on shareholder value; a company is allowed to think of other things.

Ron Ozer has come up with his own solution. After getting laid off, he joined with dozens of other former DuPont scientists to create a nonprofit called the Science, Technology and Research Institute of Delaware. They want to consult with public and private companies and use their expertise in chemistry and science to keep performing research and development. So far, Ozer says, they're still getting the organization off the ground. They've agreed to keep the business a non-profit. When a company becomes public, after all, anybody could come in and, with enough of a focus on the short-term, take away the part of their work that they love most.

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