Finding Friends is Hard: Long-Term Investors' Relationship with Proxy Advisors, Activists and Long-Term Private Equity Funds

BY NEIL WHORISKEY ON JULY 31, 2019

Institutional investors are howling for US public companies to focus more on the long-term.[1] This is unsurprising. Long-term focused companies produce significantly better results over time, reporting far greater revenue growth with less volatility, far higher levels of economic profit, and greater total return to shareholders.[2] So if you are holding stock for a long time, a long-term focus for your portfolio companies is critical.

And as every new dollar flows from actively managed funds to passive strategies[3], reducing the ability of funds to trade nimbly in and out of stocks, long-term stewardship naturally emerges as a more important focus for the large fund complexes. Indeed, more institutional investors are recognizing that the scale of their actively-managed funds makes them less able to move fully in and out of their positions, creating funds that are "behaviorally long-term"[4], and, consequently, more profitably focused on the long-term growth of their portfolio companies than on trading strategies.

Adding to the concerns of institutional investors is the fact that, as more funds flow into passive or slightly active funds, the trading prices of their portfolio companies become ever more predominantly driven by the most active, most short term, traders in the market. This, and the decrease in true liquidity resulting from more cash flowing to passive funds, adds not only to volatility, but also to the potentially greater disconnect between the views on portfolio companies as expressed by the market (i.e., the trading price) and the largely unexpressed views of the bulk of the remaining stockholders. In effect, the trading price may mean increasingly less about the long term prospects of a company, and more about the short term prospects for a trading gain or loss,[5] causing further misalignment between long-term holders looking for sustained value growth and managers who are laser focused on trading prices.

And there should be no doubt that managers, after a decade-long campaign by academics and proxy advisors to drive a "shareholder-centric" governance model, have become more focused on the trading market. Managers are often incentivized by their equity-based pay packages to increase trading prices (or, one step removed, to increase earnings per share) in the relatively near term. The

view of a CEO's success in the eyes of his most vocal and active shareholders is tied almost exclusively to the metric of share price.[6] Moreover, as proxy advisors and activists team up to strip away corporate defenses[7], the reactiveness of job-insecure directors and managers to the trading market becomes ever more acute, with activism, *and even the possibility of activism*, leading managers to significantly curtail investment in favor of distributions[8]– a tactic that appears to be contrary to the behavior of companies with a long-term outlook[9]. And, if that is not enough, there is the "just ask them" test: McKinsey's survey of 1000 C-suite level executives and directors showed that 87% of respondents felt pressured to show strong financial performance within 2 years or less, with 51% feeling pressure to show strong financial results in less than a year.[10]

So, given that array of incentives for managers to please the trading market, how can low-cost funds' pleas for a long-term focus be heard over the more persistent, urgent and loudly amplified voices of short term investors who drive trading of the stocks owned by these low-cost funds? And how can these low-cost funds coax performance out of particular poorly performing portfolio companies?

The answer to date has been that (1) at the macro level, the funds can use their bully pulpit and voting power to work on corporate governance issues, in the hope that these efforts will trickle down to improve operating performance, and (2) in the case of specific contested votes, the funds can support activist shareholders. Both of these approaches, as currently implemented, rely on short-sighted friendships with proxy advisors and activists, which have not worked to the benefit of long-term shareholders.

Misaligned Voting on Governance

Proxy advisory firms, to which many long-term investors have outsourced their voting function, are deeply flawed. They rely on dated and discredited studies to promote what is effectively a trader-centric view of governance, which in turn seriously prejudices the ability of management to defend long-term policies. Rather than encourage new and innovative thinking around governance structures or compensation policies, the cookie-cutter approach and rigidity of the proxy advisory firms stifle creative approaches – creating a de facto civil code for corporate governance, designed as much to reduce administrative and monitoring costs for stakeholders as to achieve operating excellence at portfolio companies. Companies must focus on hitting ever more involved, intrusive and rigid governance and compensation "guidelines", or pay the price of a recommendation against their directors.

This is not to say that all of the elements of this new civil code for governance are without merit – some clearly have resulted in the overall improvement of corporate governance. The focus on director qualifications, board refreshment, tenure, diversity and retirement age all come to mind. But these beneficial effects have been severely undercut by other, trading market-friendly, positions,

such as the unyielding opposition to staggered boards (a position that has cost long-term holders literally billions of dollars)[11], opposition to other traditional takeover defenses, frequent support of activist shareholders, and increasingly recondite and inflexible positions on executive compensation. In the end, a qualified, refreshed and diverse board is not much of an improvement from a long-term holder's point of view, if all of the directors on the board align themselves with short-term interests.

That this "macro" approach to stewardship, executed largely through proxy advisors, has not been successful in aligning management with long-term holders, can be seen in the results of the McKinsey survey referred to above: of managers at companies without a self-identified "long-term culture", 55% would delay a new project (even if some value would be sacrificed), and fully 71% would decrease "discretionary" spending such as R&D or advertising, in order to hit a quarterly earnings target. It may be even worse news that, even at companies with a self-identified long-term culture, fully 33% would choose to delay the new project, and 45% would decrease discretionary spending, to hit a quarterly earnings target. In short, the end result may be better qualified boards, but these boards have become obsessively focused on the short-term.

One can also wonder whether this reliance on proxy advisory firms has led to the absence of governance proposals specifically designed to drive long-term value. While these holders have jumped on board with any number of proxy advisor proposals, they have not themselves advanced any proposals to address their particular interests *as long-term shareholders*. To take one example, Professor Coffee in a 2017 article[12], after demonstrating the costs of activist settlements to long-term shareholders, proposed a straightforward bylaw amendment to prevent companies from settling with activists by giving up board seats if long-term shareholders with a greater collective stake objected to such a settlement – if there was an objection, the activist would have to go to a full proxy contest to achieve representation on the target board. That proposal, in spite of clear benefits to long-term shareholders, seems to have gone nowhere. Beyond this particular proposal, it is surprising that long-term shareholders have not leveraged the power of their vote by themselves designing and promoting bylaw amendments that protect long-term value.[13] This could certainly be an area of focus for long-term shareholders as the gap widens between their interests and the interests reflected in the far more influential trading market.

Misalignment with Activists

Long-term shareholders' support of activists, while understandable, is often even more short-sighted. It is natural that long-term shareholders, with their hyper-diversified holdings and low cost approach to investing, would want to rely on activists to discipline underperforming portfolio companies. With concentrated holdings and ample budgets to effect change at portfolio companies, activists are well-positioned to fund and fight with managers and directors to get the results they want. For long-termers, free riding on the efforts of activists to improve portfolio

company performance must at first have seemed like a great way to keep agency costs down. But, as Professor Coffee has pointed out, relying on activists to monitor and discipline portfolio companies has its own set of agency costs, concluding that "After a century of focusing on the perceived domination of shareholders by management, American corporate law needs to focus today, at least, equally on the potential for overreaching by an organized minority of the shareholders."**[14]**

Perhaps the first reason long-term shareholders should be less reliant on activists is that activists and long-term holders differ in their view of what constitutes an "underperforming" company. If long-term investors are concerned with finding companies that are "underperforming" from an *operational* viewpoint, relying on activists will be counterproductive. One foundational study on activism found that firms targeted by activists actually had *greater* pre-intervention profitability than matched firms (measured both by return on assets and cash flow), although they had stock performance that lagged the market.**[15]** It is of course to be expected that activists, as traders, are not going to be buying into companies that are overvalued and undermanaged. And while a poor stock performance can indicate operational or management issues at a company, it could as well indicate that the underlying business is at a cyclical low, that its long-term strategy has been poorly communicated, or that the market, as it does with frightening consistency, has overly-discounted the benefits of a long-term capital investment project**[16]**.

The overall point being the obvious one – that activists, as traders in the market, are going to try to buy on the dips, and will target not necessarily companies with weak franchises or poor operations (which are hard things to fix), but companies that present a near-term opportunity for a significant price bump. Their *goal* is not long-term value enhancement – that is simply not what they are designed or rewarded for. Maybe a short-term price bump will come with a long-term benefit (like an excellent new long-term focused CEO), but, make no mistake – that is simply not the objective. So long- and short-termers' targets may overlap from time to time, but there is no reason to think they will consistently do so.

While it is of course important for any investor, long- or short-term, to have the securities of its portfolio companies consistently and appropriately valued by the market (holders of index funds will need to liquidate their interests from time to time), the fixes activists tend to implement are transactional rather than operational,**[17]** calculated to produce a one-time market swing, not a consistently higher price. When that swing comes at a cost to long-term holders, this is the agency cost described by Professor Coffee.

These agency costs are not insignificant. There is value reaped by activists in interventions, but where does that value come from? After reviewing the academic literature, Professors Coffee and Palia concluded that the preponderance of studies show there is "no improvement"**[18]** in the operating performance of target companies, and no value attributable to changes in governance,

management compensation, capital structure changes, etc. – what they term "managerial agency problems". If this is correct, there is no operational value creation in the interventions and no reduction of managerial agency costs. As a result, the analysis shifts to a zero sum world for stakeholders, where the interventions may produce a *transfer* of value but not its creation.

So who is picking up the tab?

There seem to be a variety of possible answers.

If the bulk of the value transferred comes from the payment of a takeover premium (as Professors Coffee and Palia and Professor Allaire think likely)**[19]**, then the argument could be made that the additional value comes from the third party buyer of the shares – a gift from heaven. However, this may not be something long-term holders should thank activists for. The pie has not actually gotten bigger, and no new value has been created. A sale just represents a cashing in of chips held. For a long-term holder, there is no need to capture the inherent control premium in any particular time period, and there is no reason to think that the time period selected by an activist (with median holding periods of 266 days)**[20]** will be particularly advantageous for long-term holders. In fact, if the activist has bought in while the target stock is at a low, as any good trader will, the premium paid may well be more attractive to the activist than to long-term holders. Here is a situation where agency costs traditionally attributed to management may easily be significantly lower than Coffee's "horizontal" agency cost of allowing traders who likely bought in at a market low to drive the timing of the sale**[21]**. In short, the activist and the long-term holder are far from being fully aligned, even in those interventions most likely to result in a stock price gain.

Another argument that has been advanced is that activists pushing for a large distribution to shareholders, funded by additional debt or by reduced investment, help the target by promoting a more efficient capital allocation. These campaigns have their own name in the academic literature – "investment limiting" campaigns. While these campaigns may please the trading market, which consistently undervalues long-term investments and loves nothing more than a large dividend, there is no reason to believe that cutting R&D and long-term investment will improve the long-term prospects of a target company – quite the contrary. A higher level of R&D and long-term investment seem to be a consistent hallmark of companies that are successful in the long-term. So again, there is no alignment.

Finally, there is the theory that the value reaped by activists comes from a wealth transfer by bondholders to shareholders and/or by employees to shareholders.**[22]** It appears that after an activist intervention, bond returns decline, and this decline "affect[s] long-term bonds the most."**[23]** Coffee and Palia conclude that the academic literature "convincingly shows that there is a wealth transfer from bond holders to shareholders."**[24]** This would seem to be unambiguously good news for long-term shareholders – it is always nice to get free money. However, if the return on long term

bonds declines, as it seems to, then the cost of refinancing those long term bonds will certainly go up. This won't affect short-term holders who have exited, but it does impose a cost – one that will have to be borne by long-term (and future short-term) equity holders.

Similarly, if there is a reduction in employee expenses, the bottom line may look better in the near term, but reducing investment in human capital does not seem any more likely to result in long-term value than any other reduction to long-term investment. So while short-termers may be enjoying a free lunch, the long-term shareholders will pick up the tab somewhere down the line.

In short, there is not much reason to think that activist interventions on the whole create or transfer value to long-term shareholders**[25]**. And some long-term shareholders seem to be figuring this out. Among long-term holders, the gap between the interests of short-term and long-term holders seems to be coming into focus, with Blackstone, for example, voting with dissidents 30% of the time in 2017, but only 7% of the time in 2018.**[26]** Unfortunately, other long-term holders have not recognized their self-interest as clearly, and seem to have continued to vote the dissident card in a far greater percentage of cases.**[27]** One study found that 57% of long-term investors are willing to engage activists who reach out to them in the context of a campaign, and 43% reach out to activists proactively.**[28]**

The question arises as to whether there is anyone else long-term investors could be reaching out to in these situations, and whether there are other actors who could act as focused allies in building long-term value at companies with poor operational performance (as well as poor trading performance). In other words, in those instances where intervention is warranted by poor performance, is there is an actor who will be better aligned with long-term investors than activists, and as effective in pushing for change?

Enter: Long Term PE Funds(?)

Probably no investor is more wary of holding an investment in a public company than private equity funds. Private equity funds will access the public markets to exit an investment or to purchase a public company (often rescuing it from a short term focused shareholder base). But, other than the occasional PIPE (typically in a distress or transactional context), they do not want to be investors in the public markets.

Yet there is a new breed of private equity fund emerging that could not be better suited to serve as an ally to long-term holders of public company equities. They just need to be convinced to participate.

Long-term private equity funds are relatively new to the market, but are offered by industry stalwarts such as Carlyle, Blackstone and KKR. Like activists, they are focused on a limited number of targets, with a large interest in making those few investments work out well. Unlike activist funds, they are

designed to hold investments for up to 15-20 years, so their interest is not only focused, but sustained for the long-term. Their expected returns are reportedly a good bit lower than shorter term PE funds, being in the 12%-15% range, rather than 20%-plus, reducing the need to implement a swing-for-the-fences strategy at any particular company.[29] Critically, these large PE fund complexes have also spent the last decade or more building up very deep benches of personnel with industry and operational expertise, making them ideal stewards.

Unfortunately, the PE funds built up this expertise without any intention of serving as the agent of long-term passive funds, and without the slightest desire to run a company subject to the pressure and scrutiny of the public market. (Many consider the ability to make management and operational changes without public market scrutiny to be one of the distinct advantages of their asset class.) Nonetheless, private equity stepping in as a white squire in an activist situation is not without precedent[30].

From an economic point of view, there would not seem to be any special obstacles to a private equity fund buying into a public company. In a typical PIPE deal, private equity will often protect their downside by investing in a convertible bond or in preferred shares, but the upside of the instrument is generally well-aligned with other shareholders. In any situation, there will be a question as to the buy-in price, but the public market price sets a very useful reference point. In short, figuring out whether there is an acceptable economic deal for the PE fund and the company (and their existing shareholders) should not be hard.

As important, however, is whether the private equity firms will have the consistent and thoughtful support of institutional investors necessary to allow them to take the actions needed to improve the investment. The support of institutional investors would amplify the voices of private equity representatives on the portfolio company board, giving the private equity investor comfort that they would be able to implement the changes required to drive long-term value, regardless of any short-term reaction of the trading market. To give the long-term private equity funds comfort on this critical element, passive and slightly active investors could assist their case by pro-actively building bridges, reaching out to long-term private equity funds to demonstrate that they can be a reliable partner in a long-term investment, rather than simply another investor floating along on the tides of the trading market.

Every agent comes with some cost, but presumably, the greater the alignment the lower the costs. The insulation from market pressures provided by an alliance between long-term private equity and institutional investors would come from the shareholders themselves, allaying academics' concerns about management agency costs that arise in the absence of market discipline. And the close alignment of interests between these two types of long-term investors could presumably lower the "horizontal" agency costs Professor Coffee has identified that arise when institutional investors turn the keys over to activists. It is of course hard to say how the new eco-system will develop and

whether long-term private equity funds will have any interest in investing in public equities, but it would be a salutary development for institutional investors interested in attracting long-term, truly active investors into the public markets. As friends go, institutional investors have done worse.

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[1] *See e.g.*, Larry Fink, *Annual Letter to CEOs: Purpose & Profit* (2019), **https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter** ("As we enter 2019, commitment to a long-term approach is more important than ever."); *State Street Global Advisors Letter: Promoting Sustainable Value* (Feb. 1, 2017), **https://www.ssga.com/investment-goals/environmental-social-governance-esg/promoting-sustainable-value.html** ("Our fiduciary responsibility is to ensure we maximize the probability of attractive long term return streams . . ."); *Engaging with Vanguard: A Guide for Company Boards and Management Teams*, Vanguard, **https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/engaging-with-vanguard.pdf** ("As near-permanent owners of the companies in which we invest, we like to focus our discussions on the long term.").
[2] *See* McKinsey Global Institute, *Measuring the Economic Impact of Short-Termism*, McKinsey&Co. (Feb. 2017),
https://www.mckinsey.com/~/media/mckinsey/featured%20insights/Long%20term%20Capitalism/\ Measuring-the-economic-impact-of-short-termism.ashx.

[3] Charles Stein, *Shift from Active to Passive Approaches Tipping Point in 2019*, Bloomberg (Dec. 31, 2018), **https://www.bloomberg.com/news/articles/2018-12-31/shift-from-active-to-passive-approaches-tipping-point-in-2019**.

[4] Glenn Booraem, *Vanguard Investment Stewardship Commentary* 6, Vanguard (Apr. 2019), **https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/what_how_why.pdf**.

[5] Trading value becomes, as Keynes would have it, less a rational evaluation of what the company is worth over the long term, and more a rational evaluation of what someone else will pay for your stock in a fairly short period of time. Herding, rather than the efficient market, becomes a much more powerful explanation of trading prices. See Cremers and Sepe, *The Shareholder Value of Empowered Boards*, 68 Stanford Law Review at 113 ("As explained by Keynes, through his influential metaphor of financial markets as a beauty contest, rational herding behavior may induce investors to react to aggregate market demand rather than to their own information, because 'each competitor has to pick, not those faces which he himself finds prettiest, but those which he thinks most likely to catch the fancy of the other competitors'").

[6] In this regard, one of Blackrock's most useful suggestions for portfolio companies is to clearly and consistently communicate to shareholders the most appropriate milestones or metrics (other than share price) against which to measure the company's progress in their plans for long-term

value creation, giving "better context for certain key business decisions such as capital expenditures, e.g., investments in manufacturing plants, workforce training or research and development, proposed acquisitions or divestments, and plans to return capital to shareholders." *BlackRock Investment Stewardship Commentary* 1, BlackRock (Jan. 2019), **https://www.blackrock.com/corporate/literature/publication/blk-commentary-engaging-on-strategy-purpose-culture.pdf**.

[7] *See* Neil Whoriskey, *Cleary Gottlieb Discusses Long Term Investors' Duty to Revive the Staggered Board*, CLS Blue Sky Blog (June 11, 2018), **http://clsbluesky.law.columbia.edu/2018/06/11/cleary-gottlieb-discusses-long-term-investors-duty-to-revive-the-staggered-board/#_ednref15**.

[8] *See* John C. Coffee, Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance* 10, 53 (Center for Law and Economic Studies at Columbia University School of Law Working Paper No. 521, 2015) (concluding that "research and development expenditures decline significantly in the wake of hedge fund pressure," and that even firms not targeted by activists often "increase leverage and dividends or reduce long-term investments, in fear of the growing risk of such an activist intervention.").

[9] The McKinsey study found that long-term focused companies – the ones with starkly superior earnings and revenue growth – grew their R&D spending by about double compared to other firms in the study. McKinsey Global Institute, *supra* note 2, at 6-7.

[10] Dominic Barton, Jonathan Bailey & Joshua Zoffer, *Rising to the Challenge of Short-Termism* 5, FCLT Global (2016).

[11] *See* K.J. Martijn Cremers and Simone M. Sepe, *Board Declassification Activism: Why Run from the Evidence?* 2 (SSRN, June 26 2017), **https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2991854**.

[12] John C. Coffee Jr., *The Agency Costs of Activism: Information Leakage, Thwarted Majorities, and the Public Morality* (ECGI Law Working Paper No. 373/2017, 2017).

[13] While administrative costs are always an issue for low-cost funds, consider that a pro bono clinic at the Harvard Law School succeeded in stripping away classified boards at over 100 US public companies. Institutional investors should have no problem matching their level of funding.

[14] John C. Coffee Jr., *The Agency Costs of Activism*, *supra* note 12, at 5.

[15] Alon Brav, et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance* 20 (FDIC Center for Financial Research Working Paper No. 2008-06, 2008). Even if long-term investors' primary interest was in disciplining firms with relatively poor stock performance, then they should

note that a 2013 SharkRepellent study shows that fully 20% of targeted firms outperformed their indexes by more than 10 percent – so even by that trading price metric, those firms would not necessarily be the picture of a portfolio company in *need* of intervention. Adam Kommel, *Sharkrepellent Study Shows Underperformers Three Times More Likely to be Targeted by Activists than Outperformers*, SharkRepellent (Dec.16, 2013), **https://www.sharkrepellent.net/pub/rs_20131216.html**.

[16] Brian J. Bushee, *Do Institutional Investors Prefer Near-Term Earnings over Long Term Value?*, 18 Contemporary Accounting Research 207, 213 (2001).

[17] In 2018 campaigns, activists sought a review of strategic alternatives 52% of the time; a sale of the company 23% of the time; monetization or separation of assets 27% of the time; and capital return 14% of the time. Operational proposals were advanced in only 11% of the campaigns. On the governance side, activists sought board related changes 47% of the time; governance/compensation changes 31% of the time; management changes 13% of the time; and ESG changes 4% of the time. *FactSet*, SharkRepellent. (Note that percentages do not add up to 100%, as multiple objectives were often stated.)

[18] John C. Coffee, Jr. & Darius Palia, *The Impact of Hedge Fund Activism: Evidence and Implications* 57 (Center for Law and Economic Studies at Columbia University School of Law Working Paper No. 489, 2014).

[19] Id. at 59 ("All told, this evidence suggests that changes in the expected takeover premium, more than operating improvements, account for most of the stock price gain."); Yvan Allaire & Francois Dauphin, *The Game of 'Activist' Hedge Funds: Cui Bono?* 26, International Journal of Disclosure and Governance (Dec. 31, 2015) ("Our study, similar to several others, show that the best way, bar none, for these activists to make money for their funds is to get the company sold off or substantial assets spun off.").

[20] *Supra* note 18, at 66.

[21] Long-term holders, moreover, may own stakes in both the buyer and the target, and so any "over-payment" comes in part out of their own pocket. Even when the stakes are of equivalent size, in this situation, the only way the long term holder wins is if there are genuinely valuable synergies created to offset the greater portfolio concentration.

[22] *Supra* note 18, at 59-60.

[23] Surendranath Jory et al., *The Effect of Shareholder Activism on Bondholders and Stockholders*, 66 Quarterly Review of Econ. and Finance 328 (2017).

[24] *Supra* note 18, at 60.

[25] *See also*, Ed deHaan et al., *Long-Term Economic Consequences of Hedge Fund Activist Interventions* 5 (ECGI Finance Working Paper No. 577/2018, 2018) ("Altogether, we interpret our returns tests as providing minimal support for the hypothesis that activist interventions drive long-term increases in wealth for the typical shareholder."). Those who want statistical evidence of the effects of activism would do well to review the findings of the deHaan study, another study that confirms no long-term benefit (and potentially a long-term negative effect) of activist intervention on mid-size to large companies, in a significantly more statistically sophisticated manner than prior studies attributing long-term benefits to activism.

[26] S*upra* note 17.

[27] S*upra* note 17. Vanguard voted with dissidents 39% of the time in 2017 and 37% of the time in 2018; SSGA voted with dissidents 40% of the time in 2017 and 21% of the time in 2018.

[28] *Long-Term Investors are Reaching out to Activists for Help*, Institutional Investor (Mar. 14, 2017), **https://www.institutionalinvestor.com/article/b1505p4q57k6mz/long-term-investors-are-reaching-out-to-activists-for-help**.

[29] Miriam Gottfried, *Private Equity Firms Create Funds That Are Built to Last*, WSJ (Jan. 2, 2019), **https://www.wsj.com/articles/private-equity-firms-create-funds-that-are-built-to-last-11546362000**

[30] Silver Lake's investment in Motorola Mobility, after the intervention by the activist fund ValueAct, has reportedly been successful both for Silver Lake and for Motorola Mobility's other shareholders.

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