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The Myth of Hedge Funds as 'Myopic Activists'

A new study of 2,000 interventions finds they create long-term value.

By Lucian Bebchuk

The recent increase in hedge-fund activism aimed at producing changes in business strategy or leadership—including at large companies such as Apple, Hess, Procter & Gamble and, as announced last week, Air Products—has met intense opposition from public companies and their advisers. Opponents, such as prominent corporate adviser Martin Lipton, argue that such activism is detrimental to the long-term interests of companies and their shareholders: It may pump up short-term stock prices and benefit the activists—who don't stick around to eat their own cooking—but it harms shareholders in the long term.

This "myopic activism" claim has become the key argument for limiting the rights and involvement of public company shareholders. Furthermore, this claim has been successful in influencing the views of Securities and Exchange Commission officials, Delaware judges, and even institutional investors.

But is the claim true? In a comprehensive empirical study, "The Long-Term Effects of Hedge Fund Activism," completed last month and available on the Social Science Research Network, Duke University's Alon Brav, Columbia University's Wei Jiang and I found that it is not.

The claim that activist interventions by hedge funds are followed in the long term by declines in operating performance and shareholder wealth is, fundamentally, an empirical proposition that can be tested using data about companies' financial performance. While opponents of activism have been making this claim with confidence and passion, they have failed to analyze the data and to back up their rhetoric with evidence.

Disclosure filings indicating the arrival of hedge-fund activists are commonly accompanied by stock-price increases. Opponents of activism view these stock price spikes as merely reflecting inefficient market pricing in the short term. Mr. Lipton, for example, has argued that what is most important for companies subject to hedge-fund activism is "the impact on their operational performance and stock price performance relative to the benchmark, not just in the short period after announcement of the activist interest, but after a 24-month period."

Meeting this challenge, we undertook a comprehensive empirical investigation of the long-term consequences of activist interventions. Our study uses a data set consisting of the full universe of approximately 2,000 interventions by activist hedge funds from 1994–2007. We identify for each activist effort the "intervention month" in which the activist initiative was first publicly disclosed, and we follow the company for the subsequent five years.

The evidence indicates that activist interventions tend to target underperforming companies, not well-performing ones. During the three years preceding the intervention month, the operating performance of companies targeted by hedge fund activists significantly trails industry peers, and the companies' stock returns are abnormally negative. This slide tends to reverse following activists' interventions.

During the five-year period following the intervention month, operating performance relative to peers improves consistently. On average, the companies targeted by activists close two-thirds of their gap with peers in terms of return-on-assets and two-fifths of this gap in terms of "Tobin's q," a standard measure of how effectively companies turn book value into shareholder wealth.

We also examined whether, as opponents claim, the initial stock-price spike accompanying interventions, which we find to be approximately 6%, is reversed in the long term. The data show no such reversal. Contrary to the belief that the market fails to appreciate the long-term consequences of activism, long-term shareholders don't suffer any negative abnormal returns during the subsequent five-year period.

To investigate the "pump-and-dump" claim that activists bail out before negative stock returns arrive, we examined the three-year period following an activist's cashing out its stake to below the 5% disclosure threshold. We found that remaining shareholders don't experience any negative abnormal stock returns during this period.

Two types of activist interventions are most resisted and criticized—first, those that lower or constrain long-term investments by enhancing leverage, beefing up shareholder payouts, or reducing capital expenditures; and second, adversarial interventions employing hostile tactics. When limiting the analysis to each of these sets of interventions, we find that none of them validates opponents' concerns: In both samples, interventions are followed by significant improvements in operating performance through the end of the subsequent five-year period.

Finally, we examined claims that activist interventions during the years preceding the 2008 financial crisis made the targeted companies more vulnerable to the subsequent downturn. We found, however, that these companies fared as well as peer companies during the crisis years.

Our findings indicate that policy makers and institutional investors should not accept assertions that activist interventions are detrimental in the long term. Such claims should be rejected as a basis for limiting the rights and powers of public-company shareholders.

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