A Label for Activist Investors That No Longer Fits

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"Short-term shareholders" is one of those loaded phrases that embattled companies love to call troublesome activist hedge funds.

How real is the label? Well, it may actually be a myth. And a new study shows that so-called short-term hedge funds actually create long-term value.

You've heard this tale before: A well-known hedge fund takes an activist stake in the company and agitates for change. The company reflexively responds that the hedge fund is out to destroy the company, bent on immediate gains and "sacrificing the future for a quick buck." If you need an example, the recent campaign by Elliott Management at the energy company Hess is a good one. After more than a decade of poor returns, Hess's chief executive, John Hess, still had the temerity to accuse Elliott of pursuing a "short-term agenda" that would "destroy the long-term value of your investment." Mr. Hess then proceeded to adopt much of the same strategy recommended by Elliott. The parties eventually settled their dispute with Elliott appointing three of its "short-term" director nominees to the Hess board.

The Hess example shows that sometimes labeling shareholders short-termers is more a defensive tactic than real. For example, the takeover lawyer and board advocate Marty Lipton trumpeted the victory of AOL over a proxy contest initiated by Starboard Value, stating that AOL was "able to cut through the cacophony of shortsighted gains promised by activist investors touting short-term strategies."

The question really is whether this is all rhetoric.

The model of the short-term shareholder is out of the '80s. This is the corporate raider bent on acquiring a company and then liquidating it for the money, leaving the employees and the community with nothing. While the rhetoric is meant to invoke a Gordon Gekko archetype, this type of activism is as out of date as the clothes on "Miami Vice."

Instead, what is being labeled short term today is some type of aggressive corporate action that raises the company's value immediately, but not in the long term. This could be leveraging the company with debt to pay a big dividend to the shareholders, leaving the company struggling thereafter to repay the money. It could also be a proposal to spin off a division or sell the company just when it was about to make billions for shareholders.

These strategies may be risky, but is any of this really short-term conduct that will hurt shareholders in the end? Remember, the activist hedge fund has to exit its investment. If the fund destroys value, then presumably the potential buyers for the hedge funds' shares will realize this. Labeling this conduct short term may really be a way of saying that there are plenty of fools in the market.

This is why I am skeptical of the label. Granted, investors do stupid things on Wall Street, but after decades of this activity, you might think that these “fools” would realize they are being taken advantage of.

And these hedge funds do hold their shares for a not insignificant period of time. The average activist hedge fund actually holds shares in a company for 20 months, according to one study. Institutional investors, meanwhile, have been found to be active traders, making 7 percent of their buys and sales in less than a one-month period, according to another study. The research indicates that the hedge funds have to be looking to create some long-term value so that other investors will buy the shares.

Instead of short-term versus long-term goals, what instead appears to be going on in these disputes is a disagreement about risk and goals. Activist hedge funds often want to take more risk or push a more aggressive strategies. Boards will claim that they don’t see the need and want to continue the course.

Lost in all of this are regular shareholders. They don’t like excessive risk and prefer to simply sell in these situations. We’re seeing this in the battle over the proposed $24.4 billion buyout of Dell. The proxy advisory firm Institutional Shareholder Services has recommended that its client institutions take Michael S. Dell’s buyout offer because there is too much risk in staying public. I.S.S. is essentially telling its clients to let other investors take the risk. We see this time and again. When risk appears, the institutional shareholders flee while the hedge funds step in.

If this is the case, then the real question behind this rhetoric is whether hedge funds and other shareholders are pushing companies to make bad decisions, decisions that will harm the companies and shareholders in the long term or leave them without the full profits they could gain.

Mr. Lipton raised this question in a scathing post criticizing the recent activism aimed at Apple by David Einhorn’s Greenlight Capital, for being, you guessed it, short term. Mr. Lipton issued a clarion call for research on the effect of activism beyond a 24-month period.

Mr. Lipton’s sometime foil, Lucian A. Bebchuk, a shareholder governance activist at Harvard and columnist for DealBook, took up this challenge.

A recent paper by Mr. Bebchuk, Alon P. Brav and Wei Jiang examine more than 2,000 hedge fund activist events from 1994 to 2007. The authors found that in the short run, hedge fund interventions produced a 6 percent rise in stock prices. Over the longer term, a three-year period, these gains hold and the firms do not underperform. Looking at other measures of returns, like returns on assets, they found similar results. The long-term gains from activism holds even when the hedge funds advocate taking on leverage or other “quick buck” strategies.

Mr. Bebchuk’s paper is only one of several academic studies that have found that hedge fund activism in general does produce superior returns or at best is not destructive of value. April Klein and Emanuel Zur, for example, found that over a one-year period, activist shareholders produced “significantly positive returns.”

These studies in part challenge those who call hedge funds short-term investors and all that label encompasses, instead providing evidence that the idea of short-termism is a myth. It may well be that the risk that the hedge funds are taking is appropriate for these companies. Activist hedge funds are simply focusing on underperforming companies and making improvements.

Still, just because some funds in general do well for companies, it doesn't mean that all do. The course that the fund is advocating may simply not be right for the company. The Children's Investment Fund lost billions in its battle to change the railroad company CSX, for example.

In other words, we can borrow an argument from the critics of corporate governance activists (who largely overlap with the hedge fund critics). In that case, the corporate governance critics assert that corporate governance gurus are wrong to argue that one type of governance fits all companies.

Perhaps this is the case when it comes to hedge fund activism. Hedge funds advocate a different path and risk for the company. Sometimes the funds are right and sometimes they get caught up in gimmickry. Greenlight Capital, for example, was arguably a bit silly to advocate for a novel capital structure to unlock Apple's huge cash horde. But even so, Apple subsequently adopted a larger cash distribution strategy, announcing plans to give out $45 billion in dividends from borrowed money.

Maybe it's time to drop the rhetoric of short-term versus long-term shareholders. Instead, let's just call it what it is. A disagreement over what direction and risk the company should take — with the hedge funds sometimes being right.