Welcome to the golden age of activist investors

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Carl Icahn moves stocks with tweets now.

Yesterday Icahn tweeted that he had taken a position in Apple. The stock immediately was bid upward.

This much is clear: we're living in the golden age of activist investors.

Almost every day there's a new story that runs like this: hedge fund manager "X" has purchased a stake in an iconic American company that he thinks will be worth more—if only the company will follow his plan. It's now a familiar part of the Wall Street landscape.

The names are familiar to anyone reading the financial headlines: David Einhorn of Greenlight Capital. Nelson Peltz of Trian Partners. Dan Loeb of Third Point. Paul Singer of Elliot Management. Bill Ackman of Pershing Square.

It wasn't always like this, of course.

Just 10 years ago, activist hedge funds had less than $12 billion under management. Today that number tops $65.5 billion, according to the *Wall Street Journal*. Much of this growth has come from investments by large institutional investors, including pension funds and university endowments. Activism has gone mainstream.

Icahn was once frequently called a "corporate raider."

Gordon Gekko, the villain of Oliver Stone's "Wall Street," was in part based on Icahn. In the film, Gekko plots to take over an airline that he secretly intends to dismantle. Icahn took control of TWA, sold off some of its most valuable assets, and ushered the company into bankruptcy less than a decade after gaining control.

Icahn never liked—actually viscerally hated—the term corporate raider. And that phrase has mostly been banished to the ash heap of history.

Icahn now almost universally is referred to as an "activist investor." He is considered the godfather of activist investors, some of whom half-jokingly call him "Uncle Icahn."

Why has activism grown so much?

Nelson Peltz, the activist investor at the helm of Trian Partners, recently put forth the idea that investors were being pushed into activism by market efficiency. The idea is that taking advantage of pricing discrepancies doesn't work in the era of high-frequency trading, where algorithms relentlessly and swiftly push mean reversion in all liquid assets.

So investors seeking superior returns have to try something new—talking their way to gains.

(Read also: Activist investors could add buzz to summer market)

"The markets have gotten too efficient. Instead of trying to figure out what's going to happen, we're buying stock, and our goal is to get that company to do something that's in the best interest of shareholders," Peltz told *Businessweek* in a recent interview.

In other words, instead of speculating about future performance, the activists are trying to change future performance.

The growth has reshaped the way activist investors operate.

Once the targets of activists tended to be smaller firms, often in serious financial difficulty. Now, armed with far more financial firepower, activists regularly target very large companies.

As of April, almost 30 percent of the companies targeted for a board seat by activists had market caps of more than $1 billion, according to FactSet SharkRepellent. These are household names, global corporate titans: Sony, Pepsi, Apple, Microsoft, Hess.

The track record of activism has been pretty good.

Last month, Harvard shareholder governance expert Lucian Bebchuk, professor Alon P. Brav of Duke University's Fuqua School of Business, and professor Wei Jiang of Columbia Business School published a paper that looked at 2,000 interventions by hedge fund activists from 1994 to 2007. They found that in the short run, stocks tend to rise around 6 percent when activist investors get involved.

More interestingly, their research showed that the gains were not temporary.

In the five-year period after an activist investor shows up on the scene, the stock prices of companies targeted by activists tended to hold onto those gains. What's more, this is true even when the activism employs hostile tactics, demands that companies increase leverage, or urges bigger payouts to shareholders.

The findings confound the long-held view that activists look for short-term gains at the cost of the long-term health of companies.

The leading proponent of that view, Marty Lipton of the law firm Wachtell, Lipton, Rosen & Katz, earlier this year penned a memo saying that the activists were "looking for opportunities to demand a change in a company's strategy or portfolio that will create a short-term profit without regard to the impact on the company's long-term prospects."

"The activist-hedge-fund attack on Apple—in which one of the most successful, long-term-visionary companies of all time is being told by a money manager that Apple is doing things all wrong and should focus on short-term return of cash—is a clarion call for effective action to deal with the misuse of shareholder power," Lipton wrote.

(Read more: Eliot Spitzer as an activist investor)

Even without the evidence marshaled by Bebchuk, Brav and Jiang, Lipton's complaint was always a bit far-fetched. It turns on the view that markets are just too stupid to understand that the activists are destroying long-term value.

James Kwak of Baseline Scenario explains that this just doesn't make sense:

> The theory that activist investors are good in the short term but bad in the long term, while appealing, rests on the premise that there is something you can do that will help a company's stock price in the short term but not in the long term. The problem with this premise is that a company's stock price at any moment incorporates market expectations about how it will perform for the rest of time, so it is already a long-term measure. To pull off such a trick, you would have to do something that the market doesn't know about or understand properly.

To put it differently, let's imagine that Carl Icahn succeeds in getting Apple to pay out a dividend so high that it damages the long-term prospects of the company. This would immediately attract the attention of other hedge funds who would short the stock to take advantage of this new weakness.

The value of the shares Icahn had purchased would fall by precisely the market view of the weakness introduced by Icahn's dividend. In our highly liquid equities market, all this would take place almost immediately.

This helps explain why the initial pop following the announcement of activist intervention doesn't typically fade in the subsequent years. The market effectively and efficiently evaluates the outcome of the activist plans as being good for the company—period. Good in the short term. Good in the long-term.

Another reason the Bebuck and company findings aren't surprising is that hedge funds aren't really short-term investors.

"The average activist hedge fund actually holds shares in a company for 20 months, according to one study. Institutional investors, conversely, 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," Steven Davidoff wrote in a recent column in the *New York Times*' DealBook.

Of course, as everyone on Wall Street knows, past performance is not a guarantee of future results. The success of activist investing may undermine the strategy over time.

For one thing, it's possible the low-hanging fruit—the companies for whom investor activism is most successful—has been picked. And the growth of activist funds puts pressure on them to seek out bigger targets than they historically targeted.

The fiasco at JCPenney may illustrate the limits of activism. Activist investor Bill Ackman had sought to remake Penney under the leadership of former Apple executive Ron Johnson. The company performed terribly under Johnson and he was eventually shown the door.

Ackman recently resigned from his seat on JCPenney's board after a renewed attempt at public activism was rebuffed by other board members.

Stephen Bainbridge, a professor at UCLA's law school, argues in a recent paper that activists may be going too far when they advocate operational changes in the way companies do business.

Hedge funds may be able to detect when dividends should be raised, assets should be sold, or acquisitions embraced or rejected. But financiers who second-guess management about the details of company operations may be over-reaching.

"[D]o we really think a hedge fund manager is systematically going to make better decisions on issues such as the size of widgets a company should make than are the company's incumbent managers or directors?" Bainbridge asks in a recent paper.

Here's how Bainbridge answered that question:

> Because the hedge fund manager inevitably has less information than the incumbents and likely less relevant expertise (being a financier rather than an operational executive), his decisions on those sorts of issues are likely to be less sound than those of the incumbents. It was not a hedge fund manager who invented the iPhone, after all, but it was a hedge fund manager who ran TWA into the ground.

If not all activism is created equal, the next chapter of the tale of activist investors may be contests between them. We've already seen public fights between Icahn and Ackman, and between Ackman and Loeb. This may become a far more common occurrence as activists, their funds swollen with institutional funds even while opportunities for activism diminish, find themselves trying to prove that their activism is better than the other guys.

Golden ages are typically brief, followed by decline and sometimes civil war. Activist investors may want to take note.