In praise of activist investment

Reuters
By James Saft
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Here is a sentence I never thought I'd write: Hedge funds, activists to be specific, are a very good thing.

There has been a boomlet of activist investing headlines, good and bad. Bill Ackman quit the board of his money-losing project JC Penney after a battle over leadership on Tuesday, the same day BeaconLight Capital tore into management of Jos. A. Bank and Carl Icahn announced on Twitter that he had taken a position in Apple and was seeking a bigger share buyback program.

A mixed bag, to be sure, with plenty of ammunition for activists and also for their critics, who often accuse them of coming in for a short-term pop in shares and then leaving behind weakened companies.

A new study, however, shows that not only do activist hedge funds prompt short-term gains in the shares of the companies they pressure, they do it without hurting longer-term returns and while improving long-term operating performance.

The data is good enough, and the idea compelling enough, that the technique of holding managements' feet to the fire by investors may turn out to be the great hope of the besieged actively managed investment industry. In other words the take-away may not be for all of us to pile into activist hedge funds but instead to push our existing pension and mutual funds to adopt the same tactics.

The study, by Lucian Bebchuk of Harvard, Alon Brav of Duke, and Wei Jiang of Columbia, looked at the data from about 2,000 interventions by activist hedge funds between 1994-2007, looking not just at performance before and just after, but for five years from the date of the intervention. (here)

The data tells a pretty good story for the activists. In the 20 days either side of an SEC filing revealing that an activist had taken a position in a stock, the shares get more than 6 percent abnormal, or extra, return. That effect has been known for a while, but where the study really is compelling is in upending claims that activists somehow achieve short-term gains at the expense of longer-term underperformance.

"Measuring the third, fourth and fifth year following the start of an activist intervention, operating performance tends to be better, not worse, than during the pre-intervention period," the authors write.

HOW TO PLAY IT

Perhaps even better, using a classic Capital Asset Pricing Model to estimate out-performance, the study found that firms which were the target of an intervention actually outperformed by a small but significant amount during both the three and five years after the month of the SEC filing.

That compares to a CAPM underperformance during the three years before. The study also found no evidence that activist investors were pumping and dumping, as returns tended to stay positive after partial sales of the hedge funds' stakes.

What seems to be true is that a disproportionate part of the stock market outperformance comes in the initial short period after an activist makes its investment public. That might possibly be because the market is discounting better future shareholder-friendly behavior, or might be because of some of the tactics activists use, such as pushing for special dividends.

So the big question is: if we can agree that activist investors improve overall company performance and stock market returns, then how best should an individual play this?

I am uncomfortable recommending investing in activist hedge funds for a variety of reasons. Costs are high and the best ones, like Carl Icahn, probably won't take your money anyway.

But why should shareholder activism have to be the special preserve of hedge funds anyway? It doesn't. California Public Employees' Retirement System (CalPERS) has been doing this for decades, and has pushed for more cooperative pressure with other pension funds.

Last November, California State Teachers' Retirement System (CalSTRS) cooperated with activist Relational Investors LLC to call for diversified manufacturer Timken Co to split its steel and bearings businesses into separately traded companies.

And while the risks are high - just look at JC Penney - there is nothing about this business that would preclude a traditional mutual fund from engaging in it.

Too many actively managed funds are closet indexers with high costs, trying to beat the index by picking stocks. If, as some predict, we are in an extended period of structurally low returns in financial markets, the small gains wrung from shareholder activism will prove all the more valuable.

And remember, a pension or endowment might be able to take a different attitude towards activism, pushing for better treatment of shareholders with a long-term view, rather than seeking to unlock value and move on.

Paying for activist management of company management, as opposed to active fund management which simply votes with its feet by buying and selling, might be a long-term trend with big scope for growth.