Do Hedge Funds Create Sustainable Company Growth?

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RESEARCH: Hedge funds get a bad press but are they really a negative force? Looking at their public face, on the one hand we see so the called 'vulture' funds that this month forced Argentina into a $1.5bn default, on the other hand we recall that the UK's largest private charitable donation, £466 million, was made by hedge fund wizard Chris Cooper-Hohn. Looking beyond the headlines the key question is, do hedge funds improve corporate performance and generate sustainable economic growth or not?

Researchers at Columbia Business School, Duke Fuqua School of Business and Harvard Law School looked at this most important question and discovered that despite much hype to the contrary the long-term effect of hedge funds and 'activists shareholders' is largely positive. They tested the conventional wisdom that interventions by activist shareholders, and in particular activist hedge funds, have an adverse effect on the long-term interests of companies and their shareholders and found it was not supported by the data.

Their detractors have long argued that hedge funds force corporations to sacrifice long-term profits and competitiveness in order to reap quick short-term benefits. The immediate spike that comes after interventions from these activist shareholders, they argue, inevitably leads to long-term declines in operating performance and shareholder value.

Three researchers, Lucian Bebchuk of Harvard Law School, Alon Brav of Duke Fuqua School of Business, and Wei Jiang of Columbia Business School argue that opponents of shareholder activism have no empirical basis for their assertions. In contrast, their own empirical research reveals that both short-term and long-term improvements in performance follow in the wake of shareholder interventions. Neither the company nor its long-term shareholders are adversely affected by hedge fund activism.

Their paper published in July 2013 reports on about 2,000 interventions by activist hedge funds during the period 1994-2007, examining a long time window of five years following the interventions. It found no evidence that interventions are followed by declines in operating performance in the long term. In fact, contrary to popular belief, activist interventions are followed by improved operating performance during the five-year period following these interventions. Furthermore the researchers discovered that improvements in long-term performance, were also evident when the intervention were in the two most controversial areas – first, interventions that lower or constrain long-term investments by enhancing leverage, beefing up shareholder pay-outs, or reducing investments and, second, adversarial interventions employing hostile tactics.

There was also no evidence that initial positive share price spikes accompanying activist interventions failed to appreciate their long-term costs and therefore tend to be followed by negative abnormal returns in the long term; the data is consistent with the initial spike reflecting correctly the intervention's long-term consequences.

‘Pumping-and-dumping’ (i.e. when the exit of an activist is followed by long-term negative returns) is much sited by critics. But no evidence was found of this. Another complaint, that activist interventions during the years preceding the financial crisis rendered companies more vulnerable, was also debunked, as targeted companies were no more adversely affected by the crisis than others.

In light of the recent events in Argentina it is salutary to recall this important research. The positive aspect of activist hedge fund activity that it reveals should be born in mind when considering the ongoing policy debates on corporate governance, corporate law, and capital markets regulation. Business leaders, policy makers and institutional investors should reject the anti-hedge fund claims often used by detractors as a basis for limiting the rights and involvement of shareholders, and should support expanding rather than limiting the rights and involvement of shareholders. Boards and their executives should carefully monitor these debates in order to prepare for corporate governance’s evolving policy environment.