# Are Activist Investors Really as Evil as CEOs Claim They Are?

*Fox Business*
By Matt Egan
August 22, 2013

Major splashes by activist investors tend to provoke dramatic and divergent reactions: shareholders cheer wildly, the media gets whipped into a frenzy and target CEOs quietly cringe.

But by throwing down wads of cash to acquire major stakes, do activists like Carl Icahn, Bill Ackman and Nelson Peltz help companies in the long run or actually do more harm than good by focusing too heavily on short-term returns?

Despite ample criticism of activist investors, a paper released last month that examined 2,000 interventions by activist hedge funds in a recent 13-year period found that operating performance meaningfully improves following activist interventions.

"Policymakers and institutional investors should not accept the validity of the frequent assertions that activist interventions are costly to firms and their long-term shareholders in the long term," the paper's authors concluded. "They should reject the use of such claims as a basis for limiting the rights and involvement of shareholders."

In recent months activist hedge fund investors have rocked the boats of companies as diverse as department store J.C. Penney (JCP) and nutrition company Herbalife (HLF) to electronics behemoth Sony (SNE).

Activists typically sink their money into underperforming companies and push for specific changes, including new management, strategic overhauls, enhanced shareholder payouts or a sale of part or all of the company. They sometimes resort to harsh negotiating tactics, including public letters critical of management and proxy fights aimed at kicking out the board.

**Stock-Price Spike**

While activist hedge funds in 1994 made just 10 13D regulatory filings, which are required when a person or group has acquired more than 5% of a company's shares, that number jumped up to 212 in 1997 and in 2007 stood at 272, the paper said.

The knee-jerk reaction on Wall Street is generally very positive. For example, a single Tweet from Icahn earlier this month disclosing a "large position" in Apple (AAPL) sent the former tech darling's stock surging almost 5%.

That's not an uncommon response. The paper, which was authored by Duke University professor Alon Brav, Harvard Law School's Lucian Bebchuk and Columbia Business School's Wei Jiang, found the average price jump is 6%.

“This market reaction is consistent with the view that hedge fund activists provide benefits to, rather than impose costs on, the targets of their campaigns,” the authors wrote.

While some believe this initial price jump is fleeting, the paper found that the “initial positive stock reaction is not reversed in the long term.”

**Bottom-Line Boost**

So what do companies’ earnings look like following an intervention by an activist hedge fund?

The paper finds that, on average, target companies enjoy significant operational improvements in each of the five years following the investment disclosure.

Target companies’ return on assets, which measures the ratio of earnings before interest, taxes, depreciation and amortization to the book value of assets, also increases in each of the five years following the intervention, the authors found. In fact, in the third, fourth and fifth years, average ROA is more than double compared with the year of the investment.

“We find that the activist intervention is followed by systematic improvement in operating performance relative to industry peers,” the paper said. “These improvements are both statistically significant and economically meaningful.”

To be sure, it makes sense that some target companies would enjoy financial improvements given that activists seek out underperforming businesses. There’s also no way to prove the hedge funds were the driving force behind the turnarounds.

“What would have happened if the activists hadn’t have come? Would the improvements have happened anyway?” said David Becher, a professor at Drexel University.

Still, the findings do cast serious doubt on the argument by opponents of activist investors that they are only seeking to maximize near-term returns at the risk of long-term growth.

“The notion they are only pushing short-term results suggests the long-term investors are idiots,” said Charles Elson, a corporate governance expert at the University of Delaware. “I’m not surprised by the study. It confirms what I thought: activist investors create a culture of accountability.

**Hits and Misses**

The paper’s authors said: “Invoking the long-term costs of activism has become a standard move in arguments for limiting the role, rights, and involvement of shareholder activists.”

Of course, activist investors, just like all investors, have both hits and misses.

For example, Ackman has been criticized for high-profile flops in J.C. Penney and Target (TGT), investments that have cost his Pershing Square Capital Management hundreds of millions of dollars.

“Clearly, retail has not been our strong suit,” Ackman wrote to investors on Tuesday. "Our batting average on our active long investments is 16 out of 19, or 84%, and 4 out of 5, or 80%, on the short side, with Herbalife in the undecided column."

The billionaire investor moved away from retail in his latest big bet: A $2.2 billion investment in industrial giant Air Products and Chemicals (APD).

**Enhanced Accountability**

So what is it about activist investors, if anything, that has tended to lead to operational and valuation improvements at their target companies?

“They’re shining the limelight. It’s a checks and balance system,” said Becher. “A lot of time these outsiders can help companies do what they’ve been unable to do internally.”

By holding management’s feet to the fire, they can prod companies to make decisions they might not otherwise make, such as returning cash to shareholders via a special dividend.

“When a company has excessive cash holdings or investment levels, management might refrain from taking actions that would reduce the size of the empire under its control,” the paper said.

Activist investors, who typically own a passive stake of just 6% to 7%, have also shown a willingness to round up other investors to stand behind them and achieve a majority.

“You know Nelson Peltz or some of these other guys will, if needed, spend the resources to win over the hearts and minds of the other shareholders,” said Brav, one of the paper’s authors.