The Case For And Against Activist Hedge Funds

ValueWalk
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Activist hedge funds can count on a number of supporters in academia and in the media rising up in defense of their actions. No doubt activist hedge funds have found their most persistent academic supporters in Professor Lucian Bebchuk of the Harvard Law School and his co-authors. In several papers, but most particularly in the Bebchuk, Brav and Jiang (2013) paper, the authors make several claims, which are summarized in Bebchuk's op-ed piece in the Wall Street Journal:

"Our comprehensive analysis examines a universe of about 2,000 hedge fund interventions during the period of 1994-2007 and tracks companies for five years following an activist's arrival. We find that:

- During the five-year period following activist interventions, operating performance relative to peers improves consistently through the end of the period;
- The initial stock price spike following the arrival of activists is not reversed in the long term, as opponents assert, and does not fail to reflect the long-term consequences of activism;
- The long-term effects of hedge fund activism are positive even when one focuses on the types of activism that are most resisted and criticized – first, those that lower or constrain long-term investments by enhancing leverage, beefing up shareholder payouts, or reducing capital expenditures; and second, adversarial interventions employing hostile tactics;
- The "pump-and-dump" claim that activists bail out before negative stock returns arrive is not supported by the data; and
- Contrary to opponents' beliefs, companies targeted by activists in the years preceding the financial crisis were not made more vulnerable to the subsequent downturn."
  (Wall Street Journal, August 8th, 2013)

Basically, Bebchuk et al's argue that their vast base of empirical data does not support the claims made by opponents of activist hedge funds.

Other academic researchers have also produced studies somewhat supportive of hedge fund activism. (See for instance Gow et al (2014)4, Zhu (2013)5, Krishnan, Partnoy and Thomas (2015), and for an exhaustive survey Denes, Karpoff and McWilliams (2015).

Then, The Economist in its February 7th 2015 issue imagines a dystopian world where corporate managers and boards of directors are generally incompetent, most investors are lazy and activist
hedge funds have become “a force for good”, “capitalism’s unlikely heroes” and “the saviors of public companies”. However, these claims are but weakly supported in their piece.

Shortly afterwards the AIMA, the “Alternative Asset Management Association”, essentially the hedge funds’ advocacy group, issued a long detailed paper, purporting to show how activist hedge funds (or “alternative asset managers” as they prefer to be called) are “unlocking value”.

But here is the best case that can be made for these hedge funds:

- These activists push companies to make a more disciplined use of cash and capital. Activist hedge funds demand that boards and management be much more disciplined in their use of company resources and their allocation of capital; they believe boards of directors are often poor at enforcing discipline in the use of cash and capital; they urge companies to return any excess cash to shareholders by buying back their shares or paying special dividends; they advocate for effective capital structure, raising leverage where appropriate to reduce the company’s cost of capital, using the cash generated thus for additional buy back of shares; they push companies to sell-off or spin-off assets/ divisions/subsidiaries with mediocre returns on investment; they urge companies to “simplify” their structure, to shun diversification; they push for the sale of the whole company when they believe a prospective buyer would pay a substantial premium to put its hands on the company; all of these moves, hedge funds claim, make for a more efficient industrial structure, a better allocation of capital overall.

- They bring an external, uncompromising perspective on a company’s “strategic” options; unhindered by the company’s tradition, history and values; they may call for a radical change in the company’s course, question its leadership, its level and form of executive compensation; their single-minded objective is to quickly maximize the return for shareholders; typical boards tend to factor in the interests of other stakeholders and to show some deference to the CEO, to the tradition and the values of the company, a complacency in the eyes of activists that only postpones the day of reckoning for the company.

- They act on the (for them) incontrovertible premise that shareholders are the "owners" of the company and therefore their interests should take precedence in the management of the company. Activist Carl Icahn founded The Shareholders' Square Table (SST) as "a platform from which we can unite and fight for our rights as shareholders and steer towards the goal of real corporate democracy". Activist hedge funds, they claim, give "voice" to passive, dispersed shareholders, and, in particular, to the holders of shares in indexed funds of which the targeted company is a component.

- They are pointing out, and capitalizing on, the limitations of current governance practices. Ever since Sarbanes-Oxley (and even earlier), "good" corporate governance has been defined by the strict observance of fastidious, punctilious rules and principles, foremost among them the obsession with the immaculate independence of a majority of board members.

Indeed, over the last fifteen years, institutional investors pursued policies of "soft activism" urging boards to eliminate the staggered election of board members, to separate the chair and CEO positions, etc. Eventually, faced with what they perceived as the inability or unwillingness of boards to rein in executive compensation, they supported "say-on-pay" initiatives (which then became law in the U.S.). They bought the services of proxy advisors, which thrived on ever expanding rules for "good" governance.

As a result, board members, generally honest, responsible, dedicated people, operate in a framework of governance prescriptions which actually consolidate the board's dependence on management's vastly superior information, expertise, and experience. Activist hedge funds have tapped into this governance "imperfection"11. They believe that management, unless prodded, will not propose the sort of radical, shareholder centric, measures hedge funds advocate. They also believe that boards of directors are generally ill-equipped, and unlikely, to pressure management to implement these kinds of measures. As institutional investors came to believe this argument, boards gradually lost their trust and confidence.

Increasingly, institutional investors have come to side with, and support with their money, the hard activism of hedge funds in their battles with corporate boards and management. A recent study by FTI Consulting shows that 76% of institutional investors had favorable views of shareholder activism, and 84% of them believed that activism did add value to a target company.