How to Profit From Today's Shareholder Activism

Barron's
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November 30, 2013

Activist investing has entered a new golden age that could yield benefits for ordinary investors as well as the Wall Street pros.

Now that more mutual and pension funds are supporting hedge funds' efforts to improve corporate management and enhance shareholder returns, companies under scrutiny see little choice but to unbolt their boardroom doors. Their increased willingness to work with outside agitators, even if they don't always relish the job, has enhanced the potential for positive change and in many cases, led to befits for all investors.

Few companies, it seems, are immune to such pressures. Almost a sixth of the members of the Standard & Poor's 1500 have faced activist campaigns since 2006, and the number of large-cap companies being targeted by activists has tripled since 2009, according to a recent Citigroup report. Targets have included some of America's best-known companies, such as Apple (ticker: AAPL), and Microsoft (MSFT), as well as Dell, Hess (HES), Sotheby's (BID) and Procter & Gamble (PG).

The results have been impressive: An index of 17 prominent activist hedge funds has returned 19% since 2009, versus 12% for the Standard & Poor's 500 and 7.5% for all hedge-fund strategies, according to the Citigroup report. Positions taken by star practitioners such as Carl Icahn and Ralph Whitworth of Relational Investors have smoked the competition in recent years. Icahn's fund, Icahn Capital, was up 26% this year through Sept. 30. Whitworth's fund is up 34% year to date, while the S&P 500 has gained 27%.

"There has never been a better time for activist investing," Icahn wrote in his third-quarter report to investors.

The strategy has risks, too; just ask Bill Ackman, head of Pershing Square Capital Management, whose success in foisting a new chief executive with a flawed business plan on J.C. Penney (JCP) led to steep losses.

But it's the winners investors remember when they hand over money to activist funds and they have handed over billions in recent years. Activist vehicles managed $89 billion as of the end of the third quarter, up from $36 billion in 2009, reports Hedge Fund Research. That 146% growth rate, reflecting net inflows and investment gains, dwarfs the 57% increase in all hedge-fund assets in the comparable period. Investors pumped a net $7.2 billion into activist funds through September 2013, more than twice last year's haul.

Such numbers ought to render moot the long-running debate on Wall Street about whether activism is a force for good or evil in the economy and the corporate world. Certainly, today's version looks to be a more wholesome variant of the corporate campaigns of the 1980s, when managements and boards routinely were stalked by raiders who sought a quick killing without

providing much longer-term value. Worse, many "greenmailed" companies into paying them to go away.

To run successfully with today's activist crowd, or at least alongside it, investors need to understand the new landscape. Successful, high-profile meddlers like Icahn, Ackman, and Third Point's Daniel Loeb continue to dominate the conversation, but other activist hedge-fund managers, including the five spotlighted nearby, and on the following page, also boast outstanding returns. Ackman protege Richard "Mick" McGuire, of Marcato Capital Management, for example, forced auto-parts maker Lear (LEA) to boost its stock-buyback program and add a Marcato affiliate to its board. Lear's shares have risen more than 60% since McGuire revealed his stake in the company in February.

Today's activist investors have been employing multiple strategies to achieve their goals. Firms such as Blue Harbour Group and Engaged Capital focus on "constructive" activism, acting more like consultants or private-equity managers to enhance the value of brands, and their campaigns typically take place behind the scenes. If an activist's holdings exceed 5% of a company's shares, the investor must file a 13D statement with the Securities and Exchange Commission, announcing the size of his stake and his intentions.

Blue Harbour CEO Clifton S. Robbins says companies have been much more open to activists' overtures since the financial crisis. "When we started the business 10 years ago, we'd call companies and their lawyers would call back," he says. "Today, if I call a CEO and say I have an idea to get the stock up 30% to 50%, there would be no CEO who wouldn't want to meet."

It might be tempting to jump into the shares favored by activists when a campaign is revealed, but experts caution patience. Targeted stocks typically rise 6% in the days just before and after an activist move is publicized, notes Lucian Bebchuck, a professor at Harvard Law School. Often, however, those gains don't hold. "Impatience and fatigue set in," says Gregory Taxin, an activist investor at Clinton Group. "That's an attractive time to buy."