European Corporate Governance Institute (ECGI)
ECGI Finance Working Paper No. 138

London Business School
Finance Working Paper Series Number – FIN 462

Returns to Shareholder Activism

Evidence from a Clinical Study of the Hermes U.K. Focus Fund

Marco Becht

ECARES, Université Libre de Bruxelles and ECGI

Julian Franks

London Business School Center for Corporate Governance, CEPR and ECGI

Colin Mayer

Saïd Business School, University of Oxford, CEPR and ECGI

Stefano Rossi

Stockholm School of Economics

Returns to Shareholder Activism

Evidence from a Clinical Study of the Hermes U.K. Focus Fund

March Becht
ECARES, Universite Libré de Bruxelles and ECGI

Julian Franks
London Business School, CEPR and ECGI

Colin Mayer
Saïd Business School, University of Oxford, CEPR and ECGI

Stefano Rossi
Stockholm School of Economics

Finance Working Paper Series Number – FIN 462

London Business School, Regent's Park, Sussex Place, London, NW1 4SA Tel: +44(0)20 7000 7000;
http://www.london.edu/centreforcorporategovernance.html

european corporate governance institute

Returns to Shareholder Activism

Evidence from a Clinical Study of the Hermes U.K. Focus Fund

Finance Working Paper N°. 138/2006
4 December 2006

Marco Becht
ECARES, Université Libre de Bruxelles and ECGI

Julian Franks
London Business School, CEPR and ECGI

Colin Mayer
Saïd Business School, University of Oxford, CEPR and ECGI

Stefano Rossi
Stockholm School of Economics

ECGI Working Paper Series in Finance

Returns to Shareholder Activism

Evidence from a Clinical Study of the Hermes U.K. Focus Fund

Working Paper N°. 138/2006

4 December 2006

Marco Becht
Julian Franks
Colin Mayer
Stefano Rossi

We acknowledge financial support from the London Business School's Centre for Corporate Governance and the European Corporate Governance Training Network under European Commission contract number MRTN-CT-2004-504799.

We are grateful to Hermes for having made data on their UK Focus Fund available and to current and former Hermes staff for their patience and support: Steve Brown, Tim Bush, Peter Butler, Michelle Edkins, David Pitt-Watson, Fatima Shaikh, Mike Weston and, in particular, Leon Kamhi. We are grateful to the London Business School's Centre for Corporate Governance for providing access to Factiva, Datastream, the London Share Price Database and the LBS annual reports collection. We are also grateful to Sarah Wilson and Tim Clarke at Manifest for data on shareholder proposals and to Bureau van Dijk Electronic Publishers for giving us access to their OSIRIS database. We would also like to thank the following for helpful comments: Lucian Bebchuk, Brian Cheffins, Paul Coombes, Xavier Gabaix, Andrew Metrick, Raman Uppal, Paolo Volpin, Ivo Welch and seminar participants at the NBER Corporate Governance Meetings 2006, London Business School, INSEAD, and The Berne University Conference on Family Business. Leonardo Cordeiro provided excellent research assistance.

Abstract

This study reports a unique analysis of private engagements by an activist fund. It is based on data made available to us by Hermes, the fund manager owned by the British Telecom Pension Scheme (BTPS), on engagements with management in firms targeted by its U.K. Focus Fund (HUKFF). In contrast with most previous studies of activism, we report that the fund substantially outperforms benchmarks and estimate that the abnormal returns are largely associated with engagements rather than stock picking. The study categorizes the engagements and measures their impact on the returns of target companies and the fund. We find that Hermes frequently seeks significant changes in the company's strategy including large asset sales, divestments, reductions in capital expenditure and changes to payout policy. Hermes also seeks and achieves major changes to executive management including the replacement of the CEO or chairmen.

Keywords: Shareholder activism, institutional investors

JEL Classifications: G32

Marco Becht*
European Center for Advanced Research in Economics and Statistics
(ECARES), Université Libre de Bruxelles
Ave. Franklin D Roosevelt, 50
C.P. 114, B-1050 Brussels, Belgium
phone: +32 2 650 4466 , fax: +32 2 650 2149
e-mail: mbecht@ulb.ac.be

Julian Franks
Professor of Finance
Director, London Business School's Centre for Corporate Governance
Institute of Finance and Accounting
Sussex Place - Regent's Park
London NW1 4SA, United Kingdom
phone: +44 20 7262 5050 x3449 , fax +44 20 7724 3317
e-mail: jfranks@london.edu

Colin Mayer
Peter Moores Professor of Management Studies (Finance)
University of Oxford - Said Business School
Park End Street
Oxford OX1 1HP, United Kingdom
phone: +44 1865 288919 , fax: +44 1865 288805
e-mail: colin.mayer@sbs.ox.ac.uk

Stefano Rossi
Assistant Professor of Finance
Stockholm School of Economics
SE-113 83 Stockholm,
Sweden
e-mail: stefano.rossi@hhs.se

*Corresponding Author

INTRODUCTION

Shareholder activism by institutional investors is controversial.[1] To some, activism holds the promise of resolving monitoring and incentive problems in widely-held companies, thereby improving corporate performance (Black 1992). To others, shareholder activists lack the skills and the experience to second guess the target firms' management (Lipton and Rosenblum 1991), with fund managers replacing corporate managers in the pursuit of private benefits and their own agenda (Romano 1993). As a result, activism is often described as disruptive, opportunistic, misguided and at best as ineffective. For example, Black (1998) declares, "A small number of American institutional investors, mostly public pension plans, spend a trivial amount of money on overt activism efforts. …. Institutions achieve the effects on firm performance that one might expect from this level of effort – namely, not much."

Current empirical evidence, summarized in surveys by Karpoff (2001), Gillan and Starks (1998), and Black (1998), finds that U.S. institutional investors engage in little activism and even when they do, there is little or no link between activism and performance. The much celebrated "CalPERS effect" associated with the fund's own activism programme (Nesbitt 1994, Smith 1996, Anson, White and Ho 2004) is reported to be very small or non-existent (English, Smythe and McNeil 2004). The same holds for activism by other public pension funds (Del Guercio and Hawkins 1999), the Council of Institutional Investors (Opler and Sokobin 1995) and the United Shareholders Association (Strickland, Wiles and Zenner 1996). Karpoff (2001) concludes, "Most evidence indicates that shareholder activism [in the United States] can prompt small changes in target firms' governance structures, but has negligible impact on share values and earnings."

These repeated failures to link activism to performance are often blamed on three elements: inadequate monitoring due to free riding, legal and institutional obstacles to activism, and incentive problems amongst institutional investors in the United States. With respect to the first, fund managers often hold relatively small stakes in listed companies particularly in the case of diversified index funds. Pension

[1] Shareholder activism refers to a range of actions taken by shareholder to influence corporate management and boards. Actions range from threatening the sale of shares ("exit"), letter writing, meetings with management and board, to asking questions at shareholder meetings and the use of corporate voting rights. Under a common definition an activist shareholder is a shareholder "who tries to change the status quo through "voice", without a change in control of the firm" (Gillan and Starks 1998).

fund trustees and fund managers will not spend sufficient resources on shareholder activism, because there is no market mechanism for internalising the benefits of activism; the benefits accrue to all shareholders, also those who did not bear the cost of activism.

Secondly, the major U.S. institutional investors are said to face conflicts of interest (Black 1998; Romano 2000). For example, the fund managers of mutual funds hold stakes in companies where they also have a pension fund mandate which might be at risk if they were to engage. Also, company pension funds are not run independently of corporate management, while union pension funds are sometimes instruments of the struggle between organized labour and management. Public pension funds are under the influence of politicians who are elected by constituencies whose interest are not identical to those of the pension fund beneficiaries.

Thirdly, the U.S legal and regulatory system limits the anti-director rights of shareholders. Black (1990) notes that "[..] legal obstacles are especially great for shareholder efforts to nominate and elect directors, even for a minority of board seats" (pg. 531). As a result, activism in the US is often confined to public "naming and shaming" via focus lists and filing non-binding shareholder proposals in proxy statements. Highly regulated private intervention is mild and usually takes the form of letter writing (Carleton, Nelson and Weisbach 1998).

In contrast, Black and Coffee (1994) argue that the U.K. is an ideal institutional setting for shareholder activism, because it provides more legal tools than the US to institutional investors. Bebchuk (2005) observes that "U.K. law gives shareholders [..] powers that enable them to have greater influence on the board than their U.S. counterparts usually have without passing a resolution requiring a supermajority" (pg. 849).

The principal legal differences relate to shareholder meetings (see Table 1). At annual general meetings, the statutory rule in the U.K. is cumulative majority voting, meaning that each and every director must receive a majority of the "yes" votes cast to be elected (excluding abstentions). A director coming for [re]election might be removed from the board without an alternative director being proposed or appointed. In the U.S. where state law rather than Federal law applies, the default rule in Delaware is plurality voting, meaning that in board elections the candidate receiving the highest number of votes wins. Thus a candidate does not need the majority of votes cast to be elected, as in the U.K., nor is it possible to cast votes against candidates; institutional investors can only register their disapproval by abstaining or voting for another candidate.[2] The U.S. legislation is therefore more favourable to incumbent management.

Outside of Annual General Meetings, in the UK, shareholders can call extraordinary general meetings with 10% or more of the voting share capital, and put forward propositions to remove any and all directors and if more than 50% of the votes cast are in favour of such a resolution then the director(s) is required to resign. In Delaware unless there are specific provisions in corporate charters, shareholders cannot call extraordinary meetings and therefore removing directors becomes much more difficult, particularly where there are staggered boards. Kraakman et al (2004) conclude that in the U.K. unlike the U.S., company law "gives the shareholder majority a strong non-waivable right to remove directors without cause" mid-term between annual general meetings. (page 37)

These legal differences are also discussed by practitioners. For example, Bob Monks, the U.S. shareholder activist who was instrumental in setting up the HUKFF said, "I fully acknowledge that the U.S. is in a far worse state than the U.K. ... The U.K. market benefits [..] from a clause in the Companies Act, stating that 10 per cent of shareholders can requisition a meeting to dislodge any or all of the directors of a company at any time" (Monks 2005:15). Because of this, when in the U.K. activists write letters to the management of under-performing companies, the recipients are aware of the tools at the investors' disposal for changing management. Moreover, institutions are well organized in the U.K. and frequently act collectively through, for example, the Association of British Insurers (ABI), and the National Association of Pension Funds (NAPF).[3] The largest institutional investors also have specialised employees and/or departments who maintain a direct relationship ("core engagement") with the boards of the companies in their portfolios.[4]

---

[2] In addition to plurality voting, the New York Stock Exchange listing rules contain a provision that results in shares held by brokers but no voting instructions being cast for the management on proposals classified as routine. There is evidence that these "broker votes" matter for voting outcomes and that management actively seeks to influence the classification (Bethel and Gillan 2002). The New York Stock Exchange has published a special report on broker votes (NYSE 2006) but postponed a final decision to a later date (Global Proxy Watch 2006, Vol. X No 33).

[3] The Institutional Shareholders' Committee, the association of the four U.K. institutional shareholder associations, has issued a statement of principle on institutional activism; see Appendix 2 for a facsimile.

[4] The need for core engagement is most acute for large index tracking funds because the "exit" option is not available. The "core engagement" programmes typically seek to ensure compliance with the U.K.'s Combined Code and the funds' own corporate governance and other principles, for example its

This paper studies an experiment initiated by the trustees of one U.K. pension fund, the Hermes U.K. Focus Fund, to overcome free riding problems in an institutional environment that is friendly to activist shareholders. The investment correspondent of The Financial Times has characterised the Fund as a "mix of traditional investor, private equity firm and hedge fund" (Tucker 2005).[5]

The Focus Fund increases the stakes in companies that Hermes is already invested in through its index tracker fund; thereby the Focus Fund internalises the cost of its activism. The paper studies targeted, high-intensity shareholder activism over the period 1998-2004 by the Hermes U.K. Focus Fund (HUKFF), and takes advantage of unprecedented access to the entire records of the fund's activity from its inception. As a result, we were able to construct a private and comprehensive dataset of the fund's letters, memos, minutes, presentations, transcripts and recordings of telephone conversations, and client reports. To our knowledge, this is the first such database.[6] The Hermes Focus Fund has been very successful in generating returns for its investors, measured by both annual raw returns net of fees of 8.2%, and abnormal returns net of fees of 4.9% a year against the FTSE all-shares index over the period 1998-2004. We estimate that around 90% of such fund returns is due to activist outcomes.

To estimate the contribution of activism to performance, we develop a novel methodology for understanding and documenting the characteristics of shareholder activism, link them to the target companies' performance, and ultimately to the fund's returns. We begin by reporting the stated objectives of Hermes interventions under

---

executive remuneration policies. Core engagement also acts as an early warning system that can trigger higher intensity engagement, often in collaboration with other institutions. There is little available evidence on core engagement. Faccio and Lasfer (2002) examine occupational pension funds, and conclude that "the value added of these [pension] funds is negligible and their holdings do not lead companies to comply with the Code of Best Practice or outperform their industry counterparts. Overall, our results suggest that occupational pension funds are not effective monitors."

[5] The recent U.S. literature has stressed the difference between traditional shareholder activism and hedge fund activism. Kahan and Rock (2006) argue that hedge-funds are very promising activists because they face fewer regulatory barriers, political constraints and conflicts of interest than traditional investors. Partnoy and Thomas (2006) argue that hedge fund activists have more radical objectives than traditional activists, for example board changes and restructuring. The Hermes Focus Fund has more in common with this "new" U.S. hedge fund activism than with traditional institutional investor activism.

[6] Carleton, Nelson and Weisbach (1998) examine the correspondence between TIAA-CREF and their target firms to study the negotiation process in connection with the filing of proxy statements. Brav, Jiang, Partnoy and Thomas (2006) and Klein and Zur (2006) study hedge fund activism using publicly available information. In addition to the correspondence with target firms, our approach allows us to identify all the internal organization processes of a shareholder activist fund, from initial research into potential targets, to investment objectives and outcomes, allowing us to estimate precisely the connections between activist's actions and policies and stock returns.

the headings of board changes (both executive and non-executive directors), financial goals of selling unfocused businesses and unprofitable assets, restricting capital expenditure, increasing payouts and changing capital structure. We then classify the interventions under the headings of engagement with management, engagement with other shareholders, public meetings and other public interventions. Based upon target companies' responses to activism by Hermes we classify these interventions as collaborative or confrontational or a mixture of the two. Using different categories of engagement objectives and the degree of hostility, we relate outcomes to measured abnormal returns to shareholders through an event study.

We record very different results from those previously reported. We find that shareholder activism is predominantly executed through private interventions as opposed to shareholder proposals at a company's annual meeting, or filings of proxy statements. HUKFF invested in forty-one companies, and engaged with thirty of them. These engagements involved numerous meetings and telephone calls with Chairmen, CEOs and CFOs. In more than half of the cases HUKFF also engaged with other executives such as divisional managers, heads of investor relations, and with non-executive board members. HUKFF also privately contacted other institutional shareholders, with a view to communicating its engagement objectives and soliciting support for its activities. Strikingly, engagement rarely took a public form. From the cases we have seen we believe that this in part reflects the potent threat of the Fund requisitioning an extraordinary shareholders' meeting (EGM), alone or with others.

What were the engagements objectives that gave rise to these events? We find that HUKFF's engagement objectives seek to bring about substantial changes in the governance structure of target companies. In 28 out of 30 engagement cases HUKFF aims at a substantial restructuring of the operations of diversified firms in order to provide more focus, for example by selling non-core divisions and assets, and by limiting diversifying investments and acquisitions. In more than half of the cases, HUKFF explicitly aims at replacing the CEO or the Chairman, with a view to appointing new executives who are more willing to implement the required business restructuring of the target firm. Finally, in more than half of the cases HUKFF seeks an increased cash payout to shareholders, often related to proposed divestment policies.

One of the most important objectives of the paper is to determine if these engagement objectives are ultimately value increasing. We find that when the fund's engagement objectives lead to actual outcomes, there are economically large and statistically significant positive abnormal returns around the announcement date of the change. When events with confounding information such as earnings announcements or profit warnings are excluded, the mean abnormal returns are 5.30% in the seven-day window around the announcement date (median 3.69%). The largest mean excess return, 6.6%, is associated with restructuring activities, including sales of assets and divisions. Changes of CEO and chairmen give rise to large and positive excess returns of 6.0%, often in connection with prospective restructurings.[7] Further analysis of the company's restructuring shows that the size of assets and the number of employees are substantially lower post-Hermes intervention, and the return on assets is higher one year after the intervention. However, the latter results are only based on one half of the sample because some interventions are sufficiently recent that not enough time has elapsed for post-intervention performance to be observable.

The question arises whether the changes in the target companies would have occurred in the absence of shareholder activism by the HUKFF. Three recent U.K. papers provide a measure of excess returns from restructuring and from board turnover. Menon, Balachandran, Faff and Love (2004) study voluntary sell-offs over the period 2000 to 2002, Dedman and Lin (2002) study CEO departures over the period 1990 to 1995, and Dimopoulos (2006) examines the excess returns around the announcement of board changes of under performing companies, including CEO and Chairmen. The first two studies find zero or slightly negative announcement returns, while the third finds negative and significant returns, after adjusting for confounding events. Although these samples might not represent ideal control groups, they suggest that the returns to activism in our sample would not have accrued from a passive buy-and-hold investment strategy.

We therefore find very different results from previous studies in three respects: first there is a large amount of active engagement, second these

[7] For example, when Company AAA announced the appointment of a new Chairman, the Financial Times wrote: "Mr X's appointment was welcomed in the City providing the first sharp upward movement in the group's shares in months. Yesterday AAA shares closed up almost 19 per cent at 57p. Current and former colleagues said he would not run away from making the difficult decisions required at AAA." (New Chief fuels recovery hopes, Financial Times, 2003). Note: Names omitted. This example illustrates that the market associates the change of the Chairman with the prospect of significant restructuring activities, and that this translates into large and positive announcement returns.

engagements have a substantial effect on corporate activities, and third the returns to activism are large. There are a number of important qualifications to our results. First, they are for one fund only, and we cannot generalize to other shareholder activist funds in the U.K. Second, we provide evidence that the fund's trading activity gives rise to a risk profile that is significantly changing over time, both in the systematic and in the idiosyncratic component. This may raise the issue of appropriate benchmarks for calculating abnormal returns. Third, in our event study we do not capture the extent to which the market could have been updating its expectations of successful activism prior to the actual engagement outcomes. These arguments imply that our methodology may actually *understate* the true impact of activism on stock returns. Finally, we are not in a position to compare the welfare costs of shareholder activism vis-à-vis other governance mechanisms. It could very well be the case that for example takeovers or electing large shareholder representatives to the board are less costly from the perspective of the various corporate constituencies.

In Section I we describe the data, in Section II the results and Section III concludes.

I. Description of the Fund and Dataset

A. About the Focus Fund

We study the Hermes UK Focus Fund that is part of the Hermes Group, an investment management group owned by the British Telecommunication Staff Superannuation Scheme.[8] Hermes manages the assets of the BT Scheme and the Post Office Staff Superannuation Scheme, two of the largest four pension funds in the UK. In addition since 1997 Hermes has been offering management services to third party clients. At the moment Hermes has £61 billion under management.[9]

The Hermes asset split is heavily geared to equities, with 64% of total assets held in UK and other equities at the end of 2005. A large fraction of the UK equity is invested in index tracking funds, 28.5% of total assets versus 5.3% that were actively

[8] Since the establishment of the Hermes Focus Fund in 1998 as the first experiment of shareholder activism in the U.K., one of the authors tried to convince the Hermes' staff to grant us access to their internal records. When they finally did grant us such access in 2004, they were certainly aware of their funds' performance, but they had not devised, or even attempted, a methodology to link their funds' performance to shareholder activism – as opposed to other determinants such as for example stock picking.

[9] http://www.hermes.co.uk/about/investment_style.htm consulted on 14 March 2006.

managed. It follows that the Hermes index fund alone represents approximately one percent of the total U.K. market capitalisation.[10]

The Hermes UK Focus Fund was created as a response to the problem of free-riding in institutional activism as perceived by the BT pension fund trustees. The trustees felt that the cost of higher-intensity activism could not be sufficiently internalised through core engagement and it was therefore necessary to overweight the Fund's position in underperforming stocks that were to be engaged more intensively.[11]

The first Hermes UK Focus Fund was established on 30 September 1998, as a joint venture with Lens Focus Management LLP of the United States.[12] In addition to the BT Pension Scheme and LENS, there are several other investors, including several UK local authority (public) pension funds, another company pension fund, a Canadian public pension fund and a Japanese Life Insurance company.[13] The composition of the Focus Fund's investor base improves its independence from the sponsoring company of its main investor. In addition there was a shareholder agreement between Hermes and LENS that ensured the independence of decision making relating to investments and engagements in the Fund vis-à-vis the Hermes Group management. The agreement included the appointment of directors independent from the Hermes Group and the executives of the Focus Fund.[14]

The Focus Fund gives high-power incentives to its managing directors and other fund staff. The Focus Funds are established as partnerships, where the senior managers are special partners in the fund, receiving a share in the total payout. They also have a shadow equity stake in the fund management company. In addition, managing directors and other key fund staff are on bonus schemes. Hence the

---

[10] According to the London Stock Exchange December Factsheet the total market capitalisation was £1,781.4 on 30 December 2005.

[11] Statement of A. Ross-Goobey at a Journal of Applied Corporate Finance Roundtable, LBS, 9 February 2006.

[12] The Lens fund had been founded in 1991 by veteran shareholder activists Robert A.G. Monks and Nell Minow.

[13] In practice the UK Focus Fund today consists of three separate funds that have been set up as limited partnerships. For legal reasons the maximum number of partners (investors) each fund could accommodate was 20. This legal requirement has recently changed. The partnerships are managed jointly and each partnership holds an equal amount of shares in each target company, so for practical purposes they act as and we refer to them as a single fund.

[14] When LENS sold its 25% stake in the management company to the Hermes Group. At this point the shareholder agreement was replaced by a Memorandum of Understanding between the board of the new Hermes Focus Asset Management Limited, the manager of the Focus Fund, and the Hermes Group, designed to ensure the continued independent decision making of the Fund. Bob Monks and the other independent directors continued to serve on the Focus Fund board.

remuneration of the fund staff is tied directly and substantially to the cumulative outperformance of the Fund. The incentive scheme could reward executives with seven-figure bonuses in years when performance was good.[15].

B. The Focus Fund Activism Approach

The Hermes UK Focus Fund (HUKFF) applies a triple investment criterion, asking whether the company is under-performing, if the fund believes it can engage the company successfully, and whether the fund expects to obtain at least 20% more value over current share-price. Only if the answer is a triple “yes” does the fund invest with a view to bringing about governance changes (Figure 1).

Once the fund is invested, it begins the engagement process by presenting the changes it seeks to the target management and/or board. Depending on the reaction of the target three stylised engagement scenarios evolve. In the event the target reacts positively by accommodating the fund’s requests, the fund monitors the implementation of the changes, awaits the changes to be released to the market, so that the market re-evaluates the target’s shares and the fund can realize a gain and exit.[16] If the target reacts negatively, the engagement may become confrontational and a range of actions are taken to press changes on the company. We report the frequency and nature of these actions below. Finally, if the company adopts a neutral attitude, discussions continue and the nature of the engagement turns either positive or negative.

C. Data Collection

The Hermes UK Focus Fund provided full access to amounts invested, net-asset values and fees, and all internal and external documents including letters, memos, minutes, presentations, transcripts/recordings of telephone conversations, and client reports. Fund staff coded additional information from agendas, personal notes and memory. External data collected includes stock prices from Datastream and the London Stock Price Database (LSPD), news flow from Factiva regarding all board changes, takeovers, divestitures, and payout policies at target firms.

---

[15] “The complex pay packages comprised a relatively low base salary […], benefits, an annual bonus triggered by better performance, payments from a long-term incentive plan and a share of profits under a "carried interest" plan.” (Tucker 2004)

[16] Note that the Hermes index tracker fund stays invested.

The Fund has invested in a total of 41 companies between October 1, 1998 and December 31, 2004. The portfolio is dynamic. There are 4-8 new investments per year with a median duration of 517 trading days (Figure 3 and Table 3).

We collect data on significant holdings for each of the 41 HUKFF investments. From (confidential) internal documents we know the date the fund first invested. This information is not observed by the market. From a Regulatory Information Service we obtain notifications of significant holdings after the date of first purchase.[17] Under U.K. listing rules, investors having a material interest in 3% or more in the shares of a listed company should disclose such an interest to the market.[18] In addition to immediate notification through a Regulatory Information Service[19] the U.K. Listing Rules stipulate that companies must use these notifications to disclose the distribution of significant holdings in the annual report. We collect these data to analyse the distribution of blocks.

In Table 2 we show statistics on the ownership stakes of the Hermes Group that includes the index trackers and the U.K. Focus Fund. The mean stake is almost 4% (maximum of 13.5%) based on private information obtained from the Fund for all investments.[20]

Out of the 41 investments, 30 companies were actively engaged, 3 companies were invested in shortly before December 31, 2004, and engagement had therefore not yet started. The remaining 8 companies were sold relatively shortly after investment before the engagement had started, and after a sudden upward movement in stock prices prompted by exogenous events such as for example unsolicited takeover bids.

Engagements can be further classified into collaborative, mixed and confrontational. In collaborative engagements the target agreed with the changes sought by the fund and implemented them in cooperation with Hermes. In confrontational engagements there was disagreement about the Fund's objective from

[17] We use the Hemscott Premium news database, that collates information from all Regulatory News Services.
[18] Major holdings in a listed company incorporated in the United Kingdom must be notified under sections 198 to 208 of the Companies Act 1985. To be more precise, section 199 states a material interest in three percent or more of the nominal share value of any one class of shares must be notified. It also states that a 10% or larger holding must be notified even when no material interest exists leading to notifications by large custodians, for example.
[19] The leading service is the Regulatory News Service of the London Stock Exchange (RNS).
[20] In the U.K. under The Companies Act 1985, investors must disclose stakes greater than 3% to the market. Not all investor stakes reached 3%.

the outset and it was often necessary to remove the CEO and / or the Chairman for the Fund's objectives to go through. In mixed engagements, the attitude was not collaborative but not out rightly confrontational. In Appendix I we illustrate the difference in attitudes with excerpts from letters, meeting memos and press cuttings.[21]

As one would have expected, ownership by the Hermes Group varies with the engagement attitude and is at its highest at 6.9% on average in confrontational engagements compared with 3.2% in collaborative engagements (medians of 7.5% vs. 2.4%).

In Panel B of the same table, we report various statistics on the largest outside stakes. The concentration of ownership is an important issue for Hermes and other activist funds since they must work with other large shareholders to bring pressure on the target management for change, if needed. The median size of the three largest outside shareholders with holdings of at least 3% is 19.7%, and Hermes is one of the three largest in 13 out of the 41 cases. The median size of the top 3 stakes is much larger in confrontational investments (27.3%) that in collaborative (12.6%) or mixed (16.8%). Similar results hold if one considers the sum of all stakes greater than 3%.

Panel C shows that the major U.K. institutional investors are frequent holders of outside stakes in Hermes' targets, for example the Legal and General Group has a stake greater than 3% in 15 out of 41 Hermes' targets. The Prudential holds a similar stake in 9, and Barclays and Fidelity in 7 cases. These statistics on outside stakes show that it would be relatively easy to gather 10% of the votes to call an EGM in the face of a recalcitrant management.

In Table 3, we provide statistics on the duration of the investment and how it varies with the engagement attitude. Collaborative investments, where the changes are implemented in collaboration with the target management are shorter, a median of 469 trading days. Confrontational engagements take longer to resolve with a median duration of 1284 trading days.

Table 4 reports performance prior to investments by the Hermes Focus Fund. The large majority of Hermes' targets were performing poorly, with more than 40%

[21] The attitude classification is subjective and we asked former and current fund staff to rank the attitude towards the Fund by the CEO and the Chairman separately on a scale from 1 to 10, were one was fully collaborative and ten very confrontational. There was little disagreement about the classification of the most confrontational engagements. The distinction between collaborative and mixed is more subjective; see Appendix 1.

in the bottom quintile of performance in the six months prior to investment by Hermes.

II. Results

In this section we report three sets of results. First, we examine the types of engagement activities initiated by HUKFF and the extent to which they take a private or public form. Second, we report the fund's engagement objectives and evaluate the extent to which they are translated into outcomes. Third, using these outcomes we construct an event study to measure the effect of shareholder activism on stock prices.

A. Types and frequency of engagement activities

Table 5 reports the type of engagement activities entered into by HUKFF for the thirty companies in the portfolio in which they were engaged. Panel A examines contacts with management of target companies and shows that in all thirty cases HUKFF had numerous meetings with CEOs, Chairmen and CFOs. It also met with other executives including the Head of Investor Relations, the Senior Independent Director, and the Chairman of the Executive Remuneration Committee. HUKFF met target companies' executives repeatedly over the course of the engagements, on average 9.73 times (median 7) per company with a maximum of 48. In 60% of cases, HUKFF had contacts with non-executive directors, whether by letter, telephone or in person. In more than half of the cases HUKFF also sent representatives to visit the headquarters and operations sites of target companies.

Panel B examines contacts with other shareholders and other parties and reports that in more than 80% of cases HUKFF contacted other institutional shareholders so as to communicate its engagement objectives and to solicit support for its activities, although this resulted in joint actions in only three cases, a meeting or letter to the target board. HUKFF contacted company brokers in more than 70% of cases and head hunters in 26.6% percent of cases with a view to helping target firms select suitable alternative candidates for senior executive positions. In no case did HUKFF contact banks or bondholders to solicit support for its activities.

Panel C examines HUKFF activities in connection with shareholder meetings. For annual general meetings, we found that in only one case did HUKFF pose a question or add an item to the agenda, and in only two cases did HUKFF solicit votes against the management. For extraordinary general meetings three meetings were planned, but not a single EGM was requisitioned : One EGM was planned by the Focus Fund itself, one was planned by another shareholder, and one by the Chairman of the target company.

Panel D examines U.S. and U.K.-style litigation and we observe only one U.S.-style class action. The action was neither initiated nor joined by the HUKFF.[22] Panel E examines higher intensity actions such as threats to block rights issues, press campaigns and takeover attempts. HUKFF threatened twice to block a rights issue and was successful in both cases. Of the seven press-campaigns that occurred in our sample, only two were initiated by HUKFF. Finally, none of the 4 observed takeover attempts were induced or facilitated by HUKFF.

In summary, Table 5 shows that engagement by HUKFF tends to take a private rather than public form – a lot of letters, meetings, site visits, soliciting of support from other investors and some press campaigns but few interventions at public meetings.

B. Engagement objectives and outcomes

Table 6 examines objectives and outcomes of HUKFF's engagement policy. In a large majority of cases HUKFF seeks to restructure the business, for example, selling non-core divisions by diversified firms is an objective sought in 28 cases, with an achieved outcome in 15.5 cases.[23] Selling non-core assets is an objective in 10 cases and is achieved in 6 of these. HUKFF also tries to stop diversifying acquisitions (10) and limit capital expenditures (7), and in more than 90 and 80 percent of the cases, respectively, target management agrees with the fund's demands. In 6 cases HUKFF seeks to reduce the discount on Net Asset Values of investment trusts and property, and always achieves such a result.

HUKFF seeks also to bring about substantial board changes including replacing the CEO and the Chairman, an objective sought in 14.5 and 18.5 cases,[24] respectively, and achieved in more than 80% and 75% of the cases, respectively.

[22] Actually, the Focus Fund supported management, taking the view that the class action was not in the best interest of the Focus Fund investment.

[23] If the objective is mentioned in the Hermes investment committee report prior to investment, we code a dummy variable equal to one if the outcome is confirmed as fully achieved on FACTIVA, 0.5 when the outcome was partially achieved, and zero otherwise.

[24] We add one-half when the objective is not board change *per se*, but it is welcomed as it facilitates other objectives such as for example restructuring.

These figures for CEO and Chairman turnover compare with those reported by Dimopoulos (2006), who finds that in a sample of U.K. poorly performing companies CEO turnover occurs in 11% of the cases, and Chairman turnover occurs in 10% of the cases (see also Qiu (2005)). This comparison suggests that the high level of top management turnover observed in our sample would not have occurred without activism by the HUKFF. In more than half of the cases HUKFF also seeks to replace or add non-executive directors, and strengthen the "independent element" of the board, often in conjunction with other top-executives appointments. Appointment of non-executives and independent directors were part of Hermes' objectives and are observed in more than 60% of the cases.

HUKFF also seeks to change financial policies such as promoting new equity issues by rights in two cases, and increasing cash payout to shareholders in 17 cases. We observe three rights issues, the third being unwelcome to HUKFF. By contrast, the objective of increasing cash payout is achieved in 11 cases, often combined with restructuring activities.

In addition to restructuring, changing boards and financial policies HUKFF's other objectives included the improvement of operational management and investor relations in 8 and 9 cases, respectively, and stopping unequal treatment of shareholders in 2 cases. Outcomes consistent with these objectives were observed in a majority of cases.

In sum, HUKFF seeks to restructure a large number of firms, focusing their activities, limiting acquisitions and capital expenditure, changing boards – CEOs, chairmen, non-executive and independent directors – and altering financial policy, in particular raising cash payouts.

C. Returns to disclosure of activist stakes.

We analyse the market reaction to disclosure of stakes at least as large as 3% consistent with company law disclosure rules. In a review of the sample of engagements we found either that there was no notification (because the stake was below the 3% threshold), the disclosure was made by the BriTEL trustees for the Hermes Group without the Focus Fund being mentioned specifically, or the notification was made by the BriTEL trustees or another Focus Fund investor revealed that the Focus Fund had acquired an interest.

We find negative market reactions to notifications of the Hermes Group (the BriTEL trustees) and the Focus Fund (Table 7). For the window [-5,+5] days we find statistically significant and negative returns of -2.7%.

There are four potential explanations for this finding. One, the market does not expect that the observable engagements will deliver positive price relevant outcomes. Two, the market has already priced in the effects of prior purchases of share stakes before the announcements, a price pressure effect; as a result, positive abnormal returns might have accrued prior to the disclosure. Three, the market does not react to the disclosure of the HUKFF stake because it already reacted to the prior disclosure of the purchase of a stake by another activist fund. Four, because the HUKFF targets poorly performing companies, its initial low/negative returns may just reflect the fact that the HUKFF is buying when its targets' performances are still deteriorating.[25]

The first explanation is surprising, given the ex post performance of the fund. It is conceivable that the Focus Fund was not well known at inception but unlikely. The Hermes Focus fund was set up by experienced and well-known activist investors. We think the other three non-mutually-exclusive explanations are more likely, and in particular the fourth one.

D. Event study on outcomes.

To examine whether the HUKFF engagement program is value increasing, we examine whether the fund's engagement objectives give rise to abnormal stock returns. To measure this, we examine a sub set of engagement objectives that by their nature lead to announcement events, such as restructuring, board changes and increases in payout policy. Over the engagement period, we identify 98 such events, an average of slightly more than three events for each of the thirty engaged firms.[26] For each event, we construct an event window and measure the abnormal returns over the event window, after adjusting for the FTSE-All index. The event window varies from three to eleven days around the announcement date of the engagement outcome.

[25] The Fund's management suggests a momentum argument that they tend to buy when prices are falling.

[26] Regarding board changes, there are often two event dates for the same position, for example when the previous CEO announces intention to step down, and subsequently when the board announces the name of the newly appointed CEO. The same is true for some restructuring events, when for example a company announces an equity spin-off, and when the subsequent IPO takes place. There are two carve-outs in our sample.

Table 8 reports the results of such an event study. Depending on the window, mean CARs range from 3 to 4% (medians from 1.9 to 3.4%) for the three-day window [-1,+1] to the eleven-day window [-5,+5]; all are statistically different from zero using a variety of tests. Focussing on the seven-day window [-3,+3] we find a mean cumulative abnormal return (CAR) of 4% (median 2.9).

Frequently these events coincide with other announcements such as a profit warning or an earnings announcement. As a result, the announcement returns include both the effect of the engagement as well as other changes to the performance of the company. When events with confounding information such as earnings announcements or profit warnings are excluded, the mean abnormal returns increase and average 5.30% in the seven-day window [-3,+3] around the announcement date (median 3.69%). The largest excess returns, 6.6%, are associated with restructuring activities, including sales of assets and divisions. Changes of CEO and chairmen also give rise to large and positive excess returns, 6.0%. These are often accompanied by prospective restructurings. Cumulative abnormal returns for changes of non-executives directors are negative and insignificant.[27]

In sum, there are substantial share price reactions to engagement outcomes. There are particularly large gains associated with restructuring, CEO and chairmen turnover.

Table 9 partitions the share price reactions to engagement outcomes by engagement attitudes. Of the 98 engagement outcomes events, 96 occur in the 30 companies that are the targets of actual engagement by the HUKFF, and 66 events occur in the absence of confounding information, that is, an average of 2.2 events per company. Focussing on the seven-day window [-3,+3] for events without confounding information we find a mean cumulative abnormal return (CAR) of 5.22% (median 3.5%). These figures may then be combined into an estimate of 11.5% “agency costs” for the Hermes HUKFF target companies, that is, abnormal returns of 5.22% per event times an average of 2.2 events per company. Such estimated “agency costs” are largest in mixed engagements (12.7%, that is abnormal returns of 6.8% times 3.3 events per company), intermediate in collaborative engagements (11.5%, that is 4.04% times 2.9) and smallest in confrontational engagements (9.9%, that is 3.21% times 3.1).

[27] In about a dozen cases, announcement of CEO or Chairman changes is associated with appointment of non-executives. These events are classified as CEO or Chairman changes.

E. Operating Performance

In this sub-section we provide a limited analysis of the operating performance of the target companies in the Hermes portfolio before and after Hermes engagement. If focus fund activism is successful we would expect to observe poor pre-engagement operating performance and improved performance after a completed intervention. Table 10 reports operating performance pre- and post the Hermes UK Focus Fund engagements and two measures of restructuring intensity. Given the limited sample size none of the reported differences in operating performance are statistically significant, but the changes in the numbers are economically large.

Panel A reports that the median return on assets is significantly higher one year after completed engagements. It rises from 7.6% on average across medians in the two years prior to the engagement to 9% the year after the completed engagements. The difference in means is even larger. However, note that a matched measure of returns on assets is only available for 20 of the 30 companies; the remaining 10 investments are too recent (compare Figure 3).

Panel B reports restructuring intensity. The value of total assets is somewhat smaller one year after the completed engagements than in any of the two years prior to the intervention. The decline in assets is understated because in several cases the total of assets post-engagement includes the merged company. The decline in the number of employees is more pronounced, with the median number of employees being 44% lower in the year after completed engagements than in the two years leading up to the engagement. This finding is consistent with the Fund's main restructuring objective – more focus (compare Table 6).

Panel C reports statistics from Datastream on the market-to-book ratio Hermes' targets, both prior and subsequent to Hermes' engagement. The market-to-book ratio shows a sharp decrease from year -2 to -1, and a strong increase by the first year after Hermes engagement, consistent with the restoration of market valuations to the levels prior the decline in performance.

F. Case Studies

We describe in this sub section two case studies. The first case illustrates a collaborative engagement by the Hermes Focus Fund. The second case illustrates how an EGM can bring about board changes, and why the threat of an EGM can give "real authority" over the target board and management (see Aghion and Tirole, 1997). We find that the threat of an EGM may be as effective as its actual execution as a way of forcing management to accept the proposed change, very much in the same way as the threat of a cram down in Chapter 11 bankruptcies may force dissenting classes of creditors to vote for a proposed restructuring plan.

Case 1: Smith and Nephew

Smith and Nephew is an early collaborative engagement of the Focus Fund. The Fund supported a new CEO's conglomerate transformation strategy while insisting on board transformation and cash-payouts.

In 1998 Smith and Nephew was a healthcare conglomerate with five divisions: wound management, casting, orthopaedic, endoscopy and consumer products. The Focus Fund invested in October 1998. Prior to making the investment the Fund had identified a number of changes they felt could reduce the conglomerate discount.

In December 1998 the Focus Fund met with the new CEO to discuss his strategic plans and vision for the road ahead. The Fund found that the restructuring plans of the new CEO and its own broadly coincided. However, the Fund still had concerns about the pending Chairman succession and excess free-cash flow. These views were expressed in a letter to the CEO dated 31 December 1998.

The future course of the engagement followed the general line set out in this initial letter. In 1999, Smith and Nephew divested its bracing and support systems as well as its cotton and wool business. In November the Chairman retired and was succeeded by an outsider. The ten day abnormal returns around the announcement dates for these events are positive, but not very large; 4.7%, 1.1% and 3.1% respectively. At the beginning of 2000 the announcement of the Iruxol product from BASF resulted in a negative abnormal return of -13.8%. On 29 June the company announced the sale of the female hygiene and toiletries division to an MBO, the sale of Elastoplast to Beiersdorf and plans to return £415m to shareholders. This announcement resulted in a 21% abnormal return over a -5 to +5 day window.

On 4 July 2000 the Fund wrote another letter to the CEO, congratulating him on completing the first the first stage of the transformation into a more focused company. alance sheet structure. In a final letter date 17 August 2001 the Focus Fund informed the CEO that it had divested from the company. The Fund also confirmed that Hermes would retain an overweight position in the stock in its mainstream portfolios. According to the Focus Fund's own calculations, the internal rate of return of the Smith and Nephew investment (across all Hermes funds) was 46.77%, compared to an IRR of 2.99% had the same cash flows been invested in the FTSE All-Share index.

Case 2: Brazit

The Brazilian Smaller Companies Investment Trust, better known as Brazit, was a closed end fund managed by a subsidiary of Foreign and Colonial Management Limited. It had about $40 millions under management. Hermes started a campaign for change in late 1996 which came to a head in 1997. The Hermes Focus Fund was not yet established and this activism campaign was initiated by the index tracker fund. The case is important because it showed to Hermes that the requisitioning of EGMs was a powerful threat when management refused to engage. It also established the authority of the individuals who made up the original Focus Fund team in 1998.

Hermes had three objections to the way Brazit was managed. It had significantly under performed the main relevant indexes, the board of the investment trust was dominated by members of the management company or individuals closely associated with it, and the service contract was unusually long at three years, although it was subsequently reduced to two.

Hermes and another large shareholder in Brazit engaged with the board of the management company to bring about change. When prolonged negotiations failed the two shareholders requisitioned an EGM, with a proposal to dismiss the entire board of the target. 70% of shareholders voted and 97% voted to dismiss the board. The new board eventually agreed to liquidate the investment trust. The ramifications of this engagement were felt throughout the investment trust industry. The parent company with many other investment management companies changed their rules barring their employees serving on boards of investment trusts and allowed service contracts of only one year.

G. Performance of HUKFF and the gains to activism

In this section, we examine the performance of the fund and the contribution of activism to the performance.

Table 11 reports statistics for the fund over the 6 years and three months, until December 2004. From Hermes' detailed records we reconstruct the complete cash flows of the fund, including inflows, dividends and outflows. We then use such cash flows, together with the fund's market valuations at the end of each month, to compute the fund's monthly IRRs. Raw returns, net of fees, average 8.2% per year, and 4.9% after adjustment for the FTSE All Share Index. These returns do not adjust for other factors such as size, book-to-market and momentum. Table 12 provides some response to this problem by reporting performance attribution regressions. The fund's monthly alpha is positive in all four regressions, and is significant or marginally significant in three of them, including the CAPM, momentum and the four-factor model. The fund's alpha is always economically large and is largest when controlling for momentum. The momentum factor is negative (and strongly significant in regression 3), indicating that the fund's performance is associated largely with reversal of the performance of previously under performing companies.

Table 12 still does not adjust for potential issues arising from the dynamic trading strategy used by the fund. Figure 4 provides evidence that the risk profile of the HUKFF portfolio changes over time. The portfolio's beta changes from less than 0.6 to 1.2. However, much of this variation occurs over the first year of the fund, when the fund was invested in only eight companies or less. For the remaining period the beta of the fund varies from slightly less than 1 to 1.2. The pattern of idiosyncratic risk is similar to that of systematic risk and ranges between 20 and 30%. The resulting monthly Sharpe Ratio of the fund is around 0.125, reflecting the risk of shareholder activism.

Next, we link the event returns to the fund's overall performance. For each outcome in the event study we compute the Sterling return of the fund for each event window.[28] We then sum up these Sterling returns and compare them to the total Sterling return on the Fund between inception and 31 December 2004.[29] We find that 92% of the HUKFF's sterling return is accounted for by the Sterling excess returns of

[28] We can do this because the Fund gave us complete access to its portfolio holdings at any moment in time, so we exactly know how many shares were held over each event window.

[29] The Sterling return for the Fund as a whole is the sum of annual returns Hermes computes for remuneration purposes; the numbers are audited.

the event study. Splitting up the total Sterling return in the event study by engagement attitude, we find that 14.4% comes from engagements that we have previously described as collaborative, whereas 30.5% occurs in engagements that are described as confrontational. The largest contribution to the overall fund return comes from the mixed engagements, that contributed 55.1% of the Sterling return in the event outcomes. Thus, hostility is related to higher gains than collaboration, but the highest returns come from mixed engagements, that were tense of had short spells of hostility. This result compares to the gains to hostile versus friendly takeovers, measured by target bid premia, which are far larger in hostile transactions (Franks and Mayer (1996)). It also stands in sharp contrast to the evidence on bidder returns in takeovers, with bidders earning very small or negative returns in friendly and hostile takeovers; the returns of the Focus Fund from the engagement outcomes are positive throughout.

H. Returns to free-riding on the Focus Fund

Table 13 attempts to determine if other investors could have earned the same return as Hermes by buying into the engaged companies at the time of the first public announcement of a block purchase by the Hermes Group. If shareholders had bought shares in target firms on the date of the public disclosure of the stake purchases of the HUKFF, they would have earned a 12.58% raw return per year if they had rebalanced in the same way as Hermes, or a 14.25% if they had not rebalanced but simply kept the shares until December 2004.[30] This compares with a raw-return on the Fund of 8.2% annually.

The crude comparison suggests that public shareholders would have done better than Hermes by buying at the public announcements of the disclosed stakes. However, there are important qualifications to this comparison. First, some stakes are not disclosed, therefore the composition of the Fund in the two cases is different. Second, the duration of the investments in the two Funds is different since Hermes purchases prior to the disclosure dates. Third, as a result of different fund compositions the abnormal returns will also be different.

To address these issues, we examine the returns that shareholders would have earned if they had invested on the *private* information of Hermes' first day (first week and first month, respectively) investments in target companies, and then failing to

[30] These portfolios are reported in Table 13 under the heading "Public Info Portfolio".

rebalance afterwards. That is, we assume that (minority) shareholders have heard the "rumour" that Hermes had invested, but then did not have the subsequent information of Hermes' rebalancing activity. We find that such shareholders would have earned an annual return of about 10%, that is slightly better than the Fund's annual return of 8.2%. These results confirm that Hermes' returns are unlikely to be associated with trading on private information.[31]

Taken together, the findings confirm that when its stakes are disclosed the Focus Fund generates positive externalities. They also suggest that the Fund does not invest because it has insider information. It takes positions before starting the engagement process and – as we showed in Table 7 – takes small losses when its initial stakes are disclosed. Ex-post the fund more than recovers these initial losses from positive abnormal returns on publicly observable outcomes.

I. Comparison with U.S. Hedge Fund Activism Evidence

Two U.S. studies (Brav, Jiang, Partnoy, Thomas (2006) and Klein and Zur (2006)) analyze how stock prices react to the announcement that a hedge fund has acquired a significant holding of 5% or more in a listed target company (13D filing). They also investigate what kind of company is targeted, the stated objective of the engagement and its outcome.

BJPT identify 110 activist hedge funds in 2004 and 2005 that disclose 374 block holdings in 339 targets. They find that these announcements generate positive shareholder returns for the target totalling 6% (median 4.8%) over a twenty one day window straddling the announcement.

KZ examine similar filings between 1 January 2003 and 31 December 2005. They identify 102 different hedge funds that engage 155 target firms disclosing 194 block holdings. They find abnormal returns of 7.3% for a window beginning 30 days prior to the announcement and 5 days after the announcement.

Whereas BJPT are positive about the activities of hedge funds, KZ are more sceptical, observing that hedge funds target companies that outperformed the market

[31] The evidence is also consistent with the Fund Management's view that it tends to build up its initial stake when the share price has negative momentum.

prior to the engagement.[32] Moreover, accounting measures of performance decrease one year after the engagement. Both studies document significant levels of CEO/Chairman removal following the block disclosure. They also find that hedge fund activists often seek and obtain board positions. KZ find the activists achieve their goals more often when they bring or threaten a proxy fight.

A related set of studies present evidence that hedge funds use stock lending to enhance their voting power over their ownership stake; they also engage in swap and other derivative transactions to alter the relationship between their economic interest and voting power in the target companies (Hu and Black 2006; Christoffersen et. al. 2006).

III. Conclusions

In contrast to much of the previous literature, this paper has reported substantial effects and benefits associated with shareholder activism in the form of private engagements by an activist fund. HUKFF intervenes in the face of poor corporate performance where it believes that there is a significant probability of intervention being successful and resulting in substantial share price gains. It engages in meetings with board members, often seeking the support of other institutional investors, sometimes mobilizing press campaigns but rarely relying on resolutions at shareholder meetings. It seeks corporate restructurings, changes to the boards of firms, and restrictions on corporate policies, for example on takeovers and investments, sometimes requiring changes in financial policy, particularly dividend distributions. A high proportion of the interventions is successful and results in substantial shareholder gains, particularly in response to restructurings and board changes. These successful outcomes account for a large proportion of the significant out-performance of the focus fund relative to a variety of benchmarks over the sample period.

[32] KZ observed that hedge fund activists "appear to extract cash from the firm through increasing the debt capacity of the target firm and paying themselves higher dividends. The latter result, coupled with the positive stock price reaction surrounding the 13D filing date, suggests that stockholders perceive benefits to reducing agency costs associated with excess cash and short-term investments" (Klein and Zur 2006, pg. 36).

In sum, this study provides the first substantive evidence of gains to shareholder activism and suggests that well focused engagements can result in substantial public returns to outside shareholders as well as to those actually involved in the engagements. This suggests an interesting line of research that the legal environment might have a significant impact on the activism by institutional shareholders.

REFERENCES

Aghion, Philippe and Jean Tirole, 1997, Formal and real authority in organizations, *Journal of Political Economy* 105, 1-29.

Anson, Mark, Ted White and Ho Ho, 2004, Good governance works: More evidence from CalPERS, *Journal of Asset Management*, Vol. 5, 149-156.

Bebchuk, Lucian, 2005, The case for increasing shareholder power, *Harvard Law Review*, Vol. 118, No. 3, 833-917.

Becht, M. and J. Bradford Delong 2005, 'Why Has There Been So Little Blockholding in America?', in R. Morck (ed.), A History of Corporate Governance Around the World, pp. 613–66, NBER, University of Chicago Press

Bethel, Jennifer E. and Stuart L. Gillan 2002, The Impact of the Institutional and Regulatory Environment on Shareholder Voting, *Financial Management*, 31 (4), pp. 29-54

Black, Bernard S. 1990, "Shareholder Passivity Reexamined" Michigan Law Review, Vol. 89, pp. 520-608, 1990 Available at SSRN: http://ssrn.com/abstract=366820

Black, Bernard S., 1992, Agents watching agents: The promise of institutional investor voice, UCLA Law Review, Vol. 39, 811-893

Black, Bernard S. 1998, "Shareholder activism and corporate governance in the U.S.", in: P. Newman, ed.,The New Palgrave Dictionary of Economics and the Law (Macmillan Reference Limited, London and Basingstoke).

Black, Bernard S., and John C. Coffee, Jr., 1994, Hail Britannia? Institutional investor behavior under limited regulation, *Michigan Law Review* 92, 1997-2087.

Brav, Along, Wei Jiang, Frank Partnoy and Randall Thomas (2006), "Hedge Fund Activism, Corporate Governance, and Firm Performance", Vanderbilt University, Mimeo.

Carleton, Willard T., James M. Nelson, and Michael S. Weisbach, 1998, The influence of institutions on corporate governance through private negotiations: Evidence from TIAA-CREF, *Journal of Finance* 53, 1335-1362.

Christoffersen, Susan Kerr, Geczy, Christopher Charles, Musto, David K. and Reed, Adam V., "Vote Trading and Information Aggregation" (January 20, 2005). AFA 2006 Boston Meetings Paper Available at SSRN: http://ssrn.com/abstract=686026

Cocco, Joao F. and Volpin, Paolo F. 2005, "The Corporate Governance of Defined Benefit Pension Plans: Evidence from the United Kingdom" (March). ECGI - Finance Working Paper No. 76/2005 Available at SSRN: http://ssrn.com/abstract=670685

Davis, Stephen, Jon Lukomnik and David Pitt-Watson 2006. The New Capitalists: How Citizen Investors are Reshaping the Corporate Agenda, Harvard Business School Press

Dedman, Elisabeth, and Stephen W. J. Lin, 2002, Shareholder wealth effects of CEO departures: Evidence from the U.K., Journal of Corporate Finance 8, 81-104.

Del Guercio, Diane, and Jennifer Hawkins, 1999, The motivation and impact of pension fund activism, Journal of Financial Economics 52, 293-340.

Dimopoulos, Theodosios 2006, Does Firing Top Management Improve Firm Performance? Evidence from the UK, Mimeo, London Business School.

English, Philip C., Thomas I. Smythe, and Chris R. McNeil, 2004, The "CalPERS effect" revisited, Journal of Corporate Finance 10, 157-74.

Faccio, Mara, and M. Ameziane Lasfer, 2000, Do occupational pension funds monitor companies in which they hold large stakes? Journal of Corporate Finance 6, 71-110.

Florence, P. Sargant, 1947. Proceedings of the First Ordinary Meeting of the Session, 1946-47, held on November 27th, 1946, The President, The Rt. Hon. Lord Woolton, P. C., C. H., in the Chair. Journal of the Royal Statistical Society 110, 1-26.

Franks, Julian R., and Colin P. Mayer, 1996, Hostile takeovers and the correction of managerial failure, Journal of Financial Economics 40, 163-181.

Franks, Julian R., Colin P. Mayer and Luc Renneboog, 2001, Who disciplines management in poorly performing companies? Journal of Financial Intermediation 10, 209-248.

Gillan, Stuart L., and Laura T. Starks, 1998, A survey of shareholder activism: Motivation and empirical evidence, Contemporary Finance Digest 2, 10-34.

Hu, Henry T.C. and Black, Bernard S., "Empty Voting and Hidden Ownership: Taxonomy, Implications, and Reforms" (April 2006). U of Texas Law, Law and Econ Research Paper No. 70 Available at SSRN: http://ssrn.com/abstract=887183

Institutional Shareholders' Committee 2005, The Responsibilities Of Institutional Shareholders and Agents – Statement Of Principles, Updated 2005, London : Institutional Shareholders' Committee

Jensen, Michael C., 1993, The modern industrial revolution, exit, and the failure of internal control systems, Journal of Finance 48, 831-880.

Kahan, Marcel and Rock, Edward B. (2006) "Hedge Funds in Corporate Governance and Corporate Control" (July). U of Penn, Inst for Law & Econ Research Paper No. 06-16 Available at SSRN: http://ssrn.com/abstract=919881

Karpoff, Jonathan M., 2001, The impact of shareholder activism on target companies: A survey of empirical findings, Mimeo, University of Washington.

Klein, April and Emanuel Zur (2006), "Hedge Fund Activism", New York, Stern School of Business, Mimeo

Kraakman, Reinier, Paul Davies, Henry Hansmann, Gerard Hertig, Klaus Hopt, Hideki Kanda, Edward B. Rock. 2004. The Anatomy of Corporate Law, A Comparative and Functional Approach. Oxford : Oxford University Press.

Lipton, Martin and Steven A. Rosenblum, 1991, A new system of corporate governance: The quinquennial election of directors, University of Chicago Law Review 58, 187-253.

Means, Gardiner C. 1931, The Separation of Ownership and Control in American Industry, The Quarterly Journal of Economics, Vol. 46, No. 1, pp. 68-100.

Menon, Andrew, Balasingham Balachandran, Robert Faff and Roger Love, 2004, Announcements of voluntary corporate sell-offs: A comparative country analysis, Mimeo, University of Monash, Australia.

Monks, Robert A.G. 2005, Stock in Tirade, Reach. The Financial Communications Quarterly from the Exchange, Edition 8, April, London, London Stock Exchange.

Monks, Robert A.G. and Nell Minow, 2005, Corporate Governance, Oxford, UK: Blackwell.

Myners, Paul 2004, Review of the impediments to voting UK shares, Report by Paul Myners to the Shareholder Voting Working Group (http://www.manifest.co.uk/myners/04-02-04%20Final%20SVWG%20Report.pdf)

Nesbitt, S.L., 1994, Long-term rewards from shareholder activism: A study of the "CalPERS" effect. Journal of Applied Corporate Finance 6 (Spring): 75-80.

New York Stock Exchange 2006, Report and Recommendations of the Proxy Working Group to the New York Stock Exchange, June 5, New York (http://www.nyse.com/pdfs/REVISED_NYSE_Report_6_5_06.pdf)

Opler, Tim C. and Sokobin, Jonathan S. 1995, "Does Coordinated Institutional Activism Work? An Analysis of the Activities of the Council of Institutional Investors" . Dice Center For Research In Financial Economics, Working Papers Series 95-5. Available at SSRN: http://ssrn.com/abstract=46880

Pension and Investment Online 2005, The P&I/Watson Wyatt 300: The largest pension funds, Special Report, Sept. 19, 2005 (http://www.pionline.com/page.cms?pageId=529)

Qiu, Lily, 2006, Which institutional investors monitor? Evidence from acquisition activity, Mimeo, Brown University.

Roe, Mark 1992, “Strong Managers, Weak Owners”, Princeton University Press

Romano, Roberta, 1993, Public pension fund activism in corporate governance reconsidered, Columbia Law Review 93, 795-853.

Romano, Roberta, 2000, Less is more: Making shareholder activism a valued mechanism of corporate governance (May 14). Yale Law & Economics Research Paper No. 241; and Yale ICF Working Paper No. 00-10; Yale SOM Working Paper No. ICF - 00-10.

Smith, Michael P., 1996, Shareholder activism by institutional investors: Evidence from CalPERS, Journal of Finance 51, 227-252.

Stapledon, G., Bates, J., 2002. Institutional shareholders and corporate governance: The case of UK pension funds. In: McCahery, J., Moerland, P., Raaijmakers, T., Renneboog, L. (Eds.), Corporate Governance Regimes: Convergence and Diversity. Oxford University Press, Oxford.

Strickland, Deon, Kenneth W. Wiles, and Marc Zenner, 1996, A Requiem for the USA: Is Small Shareholder Monitoring Effective? Journal of Financial Economics 40, 319-38.

Randall Thomas S. and Partnoy, Frank (2007), "Gap Filling, Hedge Funds, and Financial Innovation" . Brookings-Nomura Papers on Financial Services, Yasuki Fuchita, Robert E. Litan, eds., Brookings Institution Press, Available at SSRN: http://ssrn.com/abstract=931254

Tucker, Sundeep 2005, Putting Focus Funds under the spotlight, Financial Times, March 28.

Wilshire Associates 2006, CalPERS Performance Analysis, March 31, 2006 (http://www.calpers.ca.gov/eip-docs/about/board-cal-agenda/agendas/invest/200606/item03-01.pdf)

Table 1- A Comparison of the U.S. and U.K. Legal and Institutional Shareholder Activism Environment

Shareholder Powers	U.S.	U.K.
Ordinary General Meetings	- under Delaware Corporate Law, Subchapter VII, (2) (b) annual meetings deal with the election of directors and are called as set out in the bylaws	- Ordinary General Meetings must be called each year for the election of directors (Section 366 (1) Companies Act 1985.
Extraordinary General Meetings	- special Meetings can be called under Delaware Corporation Law, Subchapter VII, (2) (d), but shareholders cannot call these meetings, unless the certificate of incorporation or the bylaws state otherwise. Thus, company's bylaws can deprive the shareholder of the right to call special meetings.	- under the Companies Act 1985, Section 368, a shareholder, or group of shareholders, commanding at least 10% of the company's paid up voting capital can requisition an Extraordinary General Meeting (EGM) ; the company's Articles cannot deprive the shareholders of this right.
Shareholder Proposals	- shareholders can ask the company to add proposals to the company proxy under SEC Rule 14a-8, but this excludes all issues relating to elections; in general proposals receiving a majority of votes under this rule are not binding on the board; the cost is borne by the company - shareholder proposals – also on board appointments - can be made under SEC Regulation 14A via a full proxy solicitation; the cost of the solicitation is borne by the shareholder	- At Ordinary Meetings, under the Company's Act 1985 Section 376 a shareholder, or group of shareholders, commanding 5% of the total voting rights of all members or 100 or more shareholders (each of whom have paid more than £100 of paid up capital) can compel the company to put a resolution to the Annual General Meeting and to circulate a statement of not more than 1000 words prior to the meeting. - At EGMs resolutions of shareholders requisitioning the meeting must be voted upon.
Appointment / Removal of Directors		
Through board election	- the voting rules set out in state law apply; in practice these are determined by the bylaws; under Delaware law by default plurality voting applies; this means that the votes in favour are counted for each candidate; the candidates who receive most votes (not necessarily a majority of the votes attending) win; in a hostile vote, if there are say six candidates for three board positions to be filled, the candidates with the three highest vote counts win	- under the Companies Act 1985 election of directors must be by separate resolution for each director; (cumulative) majority voting applies. - A director can always be removed by ordinary resolution (see above) regardless of how he was appointed and irrespective of provisions in the articles (Section 303 Companies Act 1985).
by other means	- under Delaware Corporation Law, Subchapter VII, (2) (b) shareholders can appoint directors (remove the board) by written consent, but this decision must be unanimous (a director holding one share could refuse to sign) and the bylaws can state otherwise	
Tenure	- under Delaware Law it is possible to stagger the terms of directors, ensuring that only 1/3rd come up for election each year	- a director's term of office is usually determined by the articles, but shareholders can always move to remove a director (see above).
Restrictions on Voting Power Concentration	- under Delaware Law it is possible to issue shareholder rights plans ("poison pills") that limit the ability of shareholders to concentrate voting power beyond certain thresholds, typically 10-15%; there is no mandatory bid requirement	- poison pills are largely absent from the UK.; there is a mandatory bid requirement at 30%

Table 2 – Ownership in Hermes' Targets

The Table reports descriptive statistics of ownership stakes in Hermes' targets and the breakdown by engagement attitude. Engagement attitude can be collaborative, mixed or confrontational. Panel A reports statistics about ownership by the Hermes Group, including the index tracker and the U.K. Focus Fund. Panel B reports statistics about large outside stakes in the 41 Hermes' targets. Panel C lists the most frequent holders of outside stakes larger than 3% in the 41 Hermes' targets.

Panel A – Ownership by Hermes Group

	Investments		Engaged by attitude		
	All	Engaged	Collaborative	Mixed	Confrontational
Mean	4.0	4.8	3.2	3.9	6.9
Median	2.5	3.9	2.4	3.3	7.5
Min	1.0	1.0	1.1	1.0	1.0
Max	13.5	13.5	8.4	9.4	13.5
No Companies	41	30	7	12	11

Panel B – Large Stakes in Hermes' Targets

		Investments		Engaged by attitude		
		All	Engaged	Collaborative	Mixed	Confrontational
Top 3 Stakes in Hermes' Targets	Mean	19.9	18.9	13.3	15.5	25.6
	Median	19.7	19.6	12.6	16.8	27.3
	Min	3.1	3.1	3.1	4.0	3.1
	Max	45.2	45.2	24.8	23.1	45.2
	Hermes Top 3?	13	12	1	5	6
Sum of the Stakes>3% in Hermes' Targets	Mean	26.1	26.1	18.3	22.6	34.3
	Median	24.3	22.6	17.5	16.9	36.6
	Min	3.1	3.1	3.1	4.0	3.1
	Max	60.9	60.9	34.4	60.9	52.6
Top Stake >3%?	Count	35	28	7	10	11
Hermes Stake > 3%?	Count	18	17	3	6	8
No of Stakes>3% in Hermes' Targets	Mean	4.4	4.6	4.3	4.4	5.1
	Median	4.0	4.0	4.0	3.0	5.0
	Min	1.0	1.0	1.0	1.0	1.0
	Max	12.0	12.0	6.0	12.0	10.0
Companies	Count	41	30	7	12	11

Panel C – Most Frequent Holders of Stakes Greater than 3% in Hermes' Targets

Investor	No Stakes > 3% in Hermes' Targets
Legal & General Group	15
Prudential	9
Barclays	7
Fidelity	7
AXA	6
Schroeder	6
Sanford C. Bernstein	5
Standard Life	5
M&G	4
Capital Group	3
Silchester	3
UBS	3
Franklin	2
Halifax	2
Phillips & Drew	2
Popeshead	2

Table 3 – Duration of Investments

The Table reports descriptive statistics of the duration of HUKFF investments for all 41 companies invested between October 1, 1998 and December 31, 2004, computed as the number of calendar days from date of first purchase to the earliest between date of last sale and December 31, 2004. Statistics are reported for all 30 engagements, and separately for different engagement attitudes. Engagement attitudes are based on the target companies' response and can be collaborative, mixed or confrontational.

	Investments		Engaged by attitude		
	All	Engaged	Collaborative	Mixed	Confrontational
Mean	691.4	873.7	526.6	811.8	1162.1
Median	517	958	469	930	1284
Min	1	104	104	180	197
Max	1744	1744	1043	1433	1744
No Companies	41	30	7	12	11

Table 4 – Performance Prior to Investment by HUKFF

The Table reports performance prior to investment by HUKFF. Panel A reports the target companies' relative performance to FTSE all shares index prior to investment by HUKFF. Columns 2 and 3 of Panel A report the number of target companies by performance decile based on a 6-months and 12-months period prior to investment by HUKFF. Panel B reports mean 6-months and 12-months excess returns prior to investment by HUKFF.

Panel A – Relative performance prior to investment by HUKFF

Performance Deciles	6 Months Prior	1 Year Prior
1	1	0
2	0	0
3	1	1
4	1	3
5	6	5
6	6	6
7	4	8
8	4	5
9	10	7
10	6	4
No Companies	39	39

Panel B – Excess returns over FTSE-All-Share prior to investment by HUKFF

	Investments		Engaged by attitude		
	All	Engaged	Collaborative	Mixed	Confrontational
6 Months Prior	–2.54	–2.36	–0.94	–2.78	–2.55
12 Months Prior	–2.22	–2.02	–1.60	–1.92	–2.32
No Companies	39	28	5	12	11

Table 5 – Activism Tactics

The Table reports various engagement actions by Hermes Focus Fund. Panel A reports the number [percent] of cases whereby Hermes had meetings with and wrote letters to various people within the organization. Panel B reports the number [percent] of cases of contact and cooperation with relevant third parties. Panel C reports the number [percent] of cases of intervention at shareholders general meetings. Panel D reports the number [percent] of cases of litigation in court. Panel E reports the number [percent] of cases of high-intensity actions such as threats to block rights issues, hostile takeover attempts and press campaigns.

Panel A – Contact with Management

	Meetings	Letters	Total
CEO	30 [100.0%]	30 [100.0%]	
Chairman	30 [100.0%]	30 [100.0%]	
CFO	29 [100.0%]		
COO	8 [26.7%]		
Division Manager	17 [56.7%]		
Head of Strategy	11 [36.7%]		
SID	19 [63.3%]		
Head of IR	22 [73.3%]		
Chairman Executive Remuneration Committee	15 [50.0%]		
Non-Executive Directors			18 [60.0%]
Site Visits			19 [63.3%]

Panel B – Contact and Cooperation with Other Shareholders and Relevant Parties

	Other Shareholders				Banks and Bondholders	Headhunters	Company Brokers
	Calls/Meetings	Solicit Support	Joint Letter	Joint Meetings	Solicit Support	Any Contact	Any Contact
No observed	26	25	2	3	0	8	22
[% of sample]	86.7%	83.3%	6.7%	10.0%	0.0%	26.7%	73.3%

Panel C – Shareholders General Meetings

	Annual General Meeting			Extraordinary General Meeting				
	Pose Questions	Add Item	Solicit hostile votes	Planned	Requisi tioned	Planned by Hermes	Planned by other Shareholders	Planned by Company Chairman
No observed	1	1	2	3	0	1	1	1
[% of sample]	3.3%	3.3%	6.7%	16.7%	0.0%	3.3%	3.3%	3.3%

Panel D – Litigation

	U.K. Litigation		U.S. Class-Action			
	Observed	Hermes Induced	Observed	U.S. Lawyer Induced	Shareholder Induced	Hermes Induced
No observed	0	0	1	1	1	0
[% of sample]	0.0%	0.0%	3.3%	3.3%	3.3%	0.0%

Panel E – High-Intensity Actions

	Threaten Blockage Rights Issue	Hostile Takeover Attempt		Press Campaign		
		Observed	Hermes Induced	Observed	Shareholder Induced	Hermes Induced
No observed	2	4	0	7	4	2
[% of sample]	6.7%	13.3%	0.0%	23.3%	13.3%	6.7%

Table 6 – Governance Objectives and Outcomes

The table reports the governance objectives and outcomes in firms in the Hermes portfolio. Column 1 lists the possible governance issues. Column 2 reports the cases in which Hermes set out the governance issue as an objective in their investment committee papers: It adds one for firms in which the objective was set as primary, one-half for firms in which the objective was set as not primary, and zero otherwise. Column 3 reports the number of cases in which the governance objective was achieved: It adds one for firms in which the governance issue was both set as an objective in the investment committee papers, and we could establish, based on a Factiva search, that the outcome was fully achieved, one-half for firms in which the outcome was partially achieved, and zero otherwise. Column 4 reports the percent conditional outcomes.

	Objective	Outcome	Outcome
Restructuring		(Conditional)	(% Conditional)
Restructure Diversified Firms to More Focus	28.0	15.5	55.36
Restructure Non-Diversified Firms through Asset Sales	10.0	6.0	60.00
Stop Acquisition	10.0	8.5	85.00
Discipline Capital Expenditures	7.0	6.0	85.71
Reduce Discount on NAV	6.0	6.0	100.00
Board Changes			
Change CEO	14.5	12.0	82.76
Change Chairman	18.5	14.0	75.68
Change Non-Executive Directors	17.0	10.0	58.82
Strengthen “Independent” Element on Board	15.0	7.0	46.67
Change Remuneration Policy	4.0	1.0	25.00
Financial Policies			
Rights Issue	2.0	2.0	100.00
Increase Cash Payout to Shareholders	17.0	11.5	0.64
Other Policies			
Improve Operational Management	8.0	4.0	50.00
Stop Unequal Treatment of Shareholder	2.0	1.5	75.00
Improve Investor Relations	9.0	4.0	44.44

Table 7 – Effect of Disclosure of Hermes' Stake on Stock Prices

The Table reports mean and median cumulative abnormal returns (%) in various windows around the disclosure dates of Hermes' ownership stakes.

Window	Mean (%)	t-stat	Median (%)	z-stat	% Positive	N
			Entire Sample			
[–1; +1]	–0.65	–1.08	–0.95	–1.49	26.32	19
[–2; +2]	–0.82	–1.06	–0.95	–1.33	31.58	19
[–3; +3]	–1.48	–1.74	–1.79	–1.57	36.84	19
[–5; +5]	–2.66	–2.48	–3.42	–2.13	26.32	19

Table 8 – Effect of Governance Outcomes on Stock Prices

The Table reports mean and median cumulative abnormal returns (%) in various windows around the announcement dates of Hermes' engagement outcomes.

Window	Mean (%)	t-stat	Median (%)	z-stat	% Positive	N
Panel A – All Investments						
[–1; +1]	2.97	4.21	1.86	3.95	68.37	98
[–2; +2]	3.92	5.07	3.02	4.61	68.37	98
[–3; +3]	3.99	4.58	2.94	4.17	61.22	98
[–5; +5]	3.94	4.03	3.38	3.95	66.33	98
Panel B – All Investments Excluding Events with Confounding Information						
[–1; +1]	3.72	4.49	2.15	4.38	74.63	67
[–2; +2]	4.60	4.96	3.20	4.42	68.66	67
[–3; +3]	5.30	4.93	3.69	4.33	64.18	67
[–5; +5]	5.74	4.67	4.17	4.41	71.64	67
Panel C – Restructuring						
[–1; +1]	3.57	3.13	2.27	2.90	68.89	45
[–2; +2]	5.22	4.41	4.79	3.75	71.11	45
[–3; +3]	5.39	4.10	3.23	3.44	64.44	45
[–5; +5]	4.97	3.05	3.32	3.00	68.89	45
Panel D – Restructuring Excluding Events with Confounding Information						
[–1; +1]	4.58	3.85	2.59	3.51	77.14	35
[–2; +2]	5.86	4.67	5.16	3.83	74.29	35
[–3; +3]	6.59	4.55	3.69	3.67	68.57	35
[–5; +5]	6.66	3.69	4.98	3.33	74.29	35
Panel E – CEO and Chairman Turnover						
[–1; +1]	2.83	2.12	1.16	1.88	67.86	28
[–2; +2]	4.00	2.44	3.46	2.64	71.43	28
[–3; +3]	4.22	2.18	4.48	2.23	64.29	28
[–5; +5]	3.95	2.07	3.57	2.16	71.43	28
Panel F – CEO and Chairman Turnover Excluding Events with Confounding Information						
[–1; +1]	3.71	2.13	1.65	2.27	73.68	19
[–2; +2]	5.21	2.69	3.85	2.78	73.68	19
[–3; +3]	6.09	2.55	4.58	2.50	68.42	19
[–5; +5]	5.92	2.37	3.61	2.50	78.95	19
Panel G – Payout						
[–1; +1]	3.30	2.24	3.18	2.22	81.25	16
[–2; +2]	2.97	2.62	3.08	2.17	75.00	16
[–3; +3]	2.44	1.70	3.02	1.34	62.50	16
[–5; +5]	2.81	1.64	2.77	1.40	62.50	16
Panel H – Non-Executive Directors' turnover						
[–1; +1]	–0.23	–0.15	–0.23	–0.06	44.44	9
[–2; +2]	–1.09	–0.56	–3.01	–0.77	33.33	9
[–3; +3]	–0.89	–0.56	–1.86	–0.53	33.33	9
[–5; +5]	0.82	0.44	–0.02	0.53	44.44	9

Table 8 cont. – Effect of Governance Outcomes on Stock Prices

Window	Mean (%)	t-stat	Median (%)	z-stat	% Positive	N
			Panel E1 – Chairman Turnover			
[–1; +1]	4.92	1.56	1.46	1.68	80.00	10
[–2; +2]	6.59	1.93	3.91	2.09	80.00	10
[–3; +3]	7.44	1.73	3.81	1.48	60.00	10
[–5; +5]	6.01	1.33	3.52	1.38	80.00	10
			Panel E2 – CEO Turnover			
[–1; +1]	1.67	1.49	0.54	1.18	55.55	18
[–2; +2]	2.56	1.51	3.16	1.72	66.66	18
[–3; +3]	2.42	1.35	4.48	1.46	66.66	18
[–5; +5]	2.81	1.70	3.75	1.68	66.66	18
			Panel E3 – CEO Turnover Excluding Events with Confounding Information			
[–1; +1]	2.37	1.88	1.65	1.42	55.55	9
[–2; +2]	3.68	2.23	3.85	1.96	66.66	9
[–3; +3]	4.58	2.51	4.58	2.07	77.77	9
[–5; +5]	5.82	2.92	6.61	2.07	77.77	9

Table 9 – Effect of Governance Outcomes on Stock Prices

The Table reports mean and median cumulative abnormal returns (%) in various windows around the announcement dates of Hermes' engagement outcomes, partitioned by engagement attitude. Engagement attitude can be collaborative, mixed or confrontational.

Window	Mean (%)	t-stat	Median (%)	z-stat	% Positive	No Events	No Obs.
Panel A – All Engagements							
[–1; +1]	2.96	4.12	1.86	3.84	66.67	96	30
[–2; +2]	3.91	4.95	3.02	4.47	67.70	96	30
[–3; +3]	3.94	4.44	2.94	4.04	60.41	96	30
[–5; +5]	3.89	3.90	3.38	3.83	65.63	96	30
Panel B – All Engagements Excluding Events with Confounding Information							
[–1; +1]	3.68	4.38	2.12	4.27	72.73	66	30
[–2; +2]	4.58	4.86	3.11	4.31	68.18	66	30
[–3; +3]	5.22	4.79	3.46	4.21	63.64	66	30
[–5; +5]	5.65	4.53	3.89	4.32	71.21	66	30
Panel C – Collaborative							
[–1; +1]	3.26	2.08	1.98	1.83	65.00	20	7
[–2; +2]	4.11	2.95	4.31	2.54	70.00	20	7
[–3; +3]	4.04	3.18	5.40	2.76	65.00	20	7
[–5; +5]	1.92	1.19	3.12	1.60	70.00	20	7
Panel D – Collaborative Excluding Events with Confounding Information							
[–1; +1]	4.30	2.05	2.40	1.89	80.00	10	7
[–2; +2]	3.58	1.72	4.70	1.68	60.00	10	7
[–3; +3]	4.16	2.04	5.40	1.68	60.00	10	7
[–5; +5]	2.51	0.90	3.21	1.27	70.00	10	7
Panel E – Mixed							
[–1; +1]	2.45	2.37	1.68	2.28	65.00	40	12
[–2; +2]	3.82	3.05	2.41	2.78	67.50	40	12
[–3; +3]	3.80	2.43	2.48	2.16	60.00	40	12
[–5; +5]	4.79	2.92	3.39	2.68	65.00	40	12
Panel F – Mixed Excluding Events with Confounding Information							
[–1; +1]	3.68	3.12	2.21	3.33	73.33	30	12
[–2; +2]	5.37	3.83	3.60	3.50	76.67	30	12
[–3; +3]	6.00	3.34	3.08	3.18	70.00	30	12
[–5; +5]	7.23	3.87	5.19	3.67	76.67	30	12
Panel G – Confrontational							
[–1; +1]	2.76	2.30	1.84	2.18	67.65	34	11
[–2; +2]	3.10	2.36	2.79	2.18	64.71	34	11
[–3; +3]	3.21	2.33	2.11	1.96	55.88	34	11
[–5; +5]	3.30	1.92	3.50	1.99	61.76	34	11
Panel H – Confrontational Excluding Events with Confounding Information							
[–1; +1]	2.60	1.99	1.29	1.77	66.67	24	11
[–2; +2]	2.92	2.06	1.53	1.66	58.33	24	11
[–3; +3]	3.62	2.37	1.53	1.99	54.17	24	11
[–5; +5]	4.15	2.01	3.50	2.06	62.50	24	11

Table 10 – Restructuring and Operating Performance

The Table reports measures of restructuring and operating performance of targets of HUKFF engagement for selected years pre- and post- engagement. Panel A reports mean and median return on assets and total assets, and Panel B reports number of employees and Panel C reports market-to-book ratios. The data was taken from OSIRIS.

Panel A – Return on Assets

		Pre-HUKFF Years		Post-HUKFF Years
		Year –2	Year –1	Year +1
Return on Assets	(Mean)	12.40	8.68	9.19
	(Median)	8.21	6.91	9.00
No Observations		20	20	20

Panel B – Restructuring

		Pre-HUKFF Years		Post-HUKFF Years
		Year –2	Year –1	Year +1
Total Assets (£M)	(Mean)	5,214.39	5,575.42	3,502.58
	(Median)	1,854.91	1,944.14	1,698.35
No Observations		20	20	20
Employees	(Mean)	18,570	20,791	14,148
	(Median)	13,002	12,253	7,014
No Observations		17	17	17

Panel C – Market-to-Book

		Pre-HUKFF Years		Post-HUKFF Years
		Year –2	Year –1	Year +1
Market-to-Book	(Mean)	2.95	1.69	2.64
	(Median)	1.82	1.42	1.96
No Observations		22	22	22

Table 11 – Performance Hermes UK Focus Fund, 10/1/1998 to 12/31/2004

The Table reports performance of the Hermes Focus Fund asset management. Panel A reports the fund's buy-and-hold return, net of management and performance fees. Panel B reports the fund's fee structure.

Panel A – Raw returns and CAPM alpha over the sample period

	Hermes UK Focus Fund (Raw Returns)	FTSE All	Hermes UK Focus Fund (Excess Returns)
IRR monthly	0.660	0.270	0.390
IRR annual	8.209	3.285	4.925
Total Return	63.741	22.385	41.356

Panel B – Fee structure of Hermes UK Focus Fund

Year	Management Fees	Performance Fees
1998	100.0%	0.0%
1999	100.0%	0.0%
2000	100.0%	0.0%
2001	25.6%	74.4%
2002	31.0%	69.0%
2003	100.0%	0.0%
2004	45.6%	54.4%
Average	71.7%	28.2%

Table 12 – Performance Attribution Regressions

The dependent variable is the monthly internal rate of return net of both management and performance fees of the Focus Fund Hermes portfolio in excess of the risk-free rate, as proxied by the U.K. Gilts rate. Factor regressions of value-weighted monthly returns are then estimated and the results reported below. The table reports the raw monthly return, the intercept α and the coefficients (factor loadings) on the explanatory variables RMRF, SMB, HML and Momentum. These variables are the returns to zero-investment portfolios designed to capture market, size, book-to-market and momentum effects, respectively. SMB and HML are computed by Alan Gregory for the U.K. using the methodology of Fama and French (1993) and Carhart (1997); Momentum is computed by Chui, Titman and Wei (2005) for the U.K. using the methodology of Jegadeesh and Titman (1993, 2001). The sample period is from October 1998 to December 2004 (75 monthly observations) for the dependent variable. P-values are reported in parenthesis.

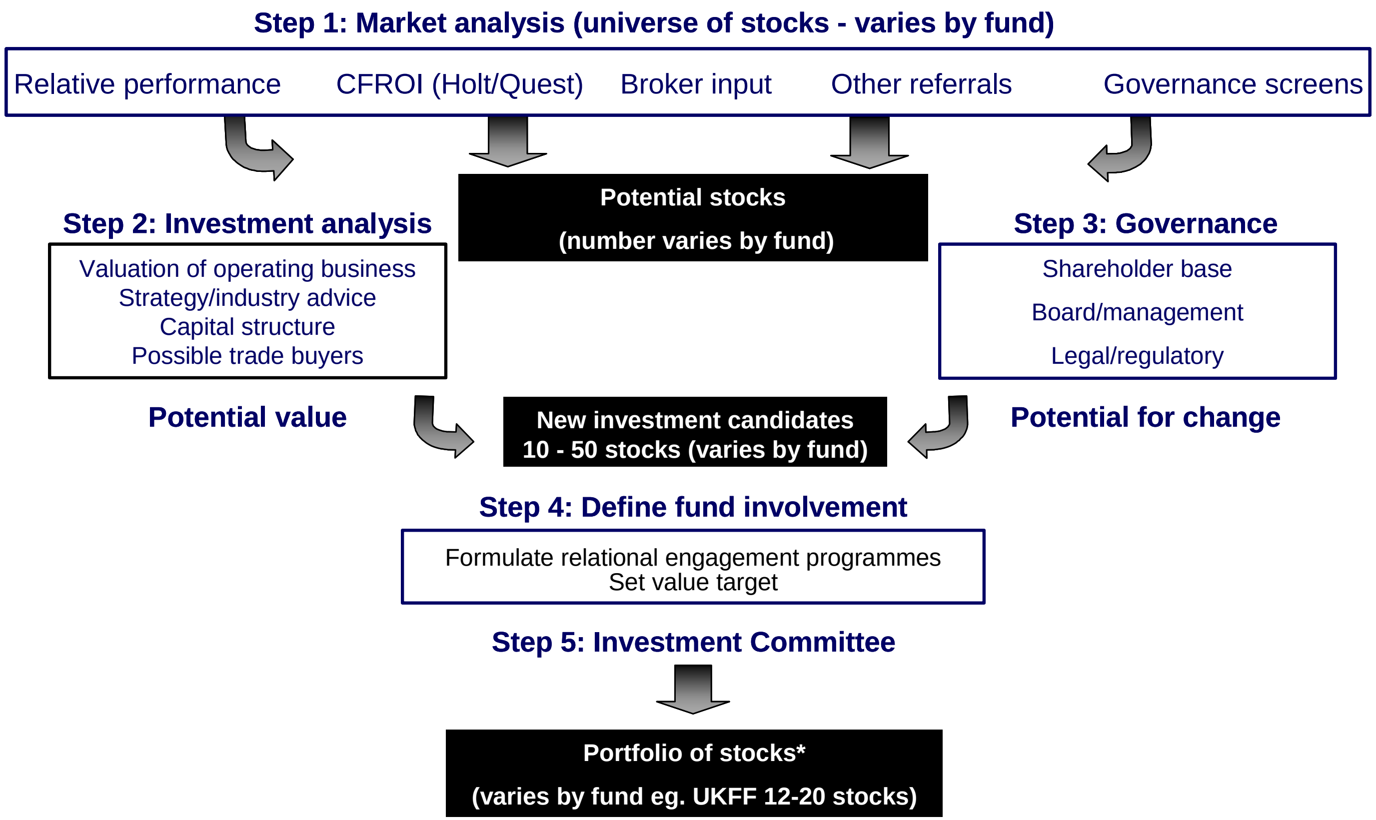
	CAPM (1)	FF (2)	Mom (3)	FF + Mom (4)
α	0.73	0.37	1.38	0.83
	(.11)	(.36)	(.02)	(.11)
RMRF	1.14	1.11	1.01	1.02
	(.00)	(.00)	(.00)	(.00)
SMB		0.41		0.42
		(.00)		(.00)
HML		0.33		0.32
		(.00)		(.00)
Momentum			–0.35	–0.15
			(.01)	(.21)
No observations	75	75	57	57

Table 13 – Returns to Various Replicating Portfolios

The Table reports annual raw returns to trading strategies designed to replicate Hermes' trading strategy, based on private or public information, with or without rebalancing. Returns to Hermes' actual portfolio, net and gross of fees, are reported as a benchmark.

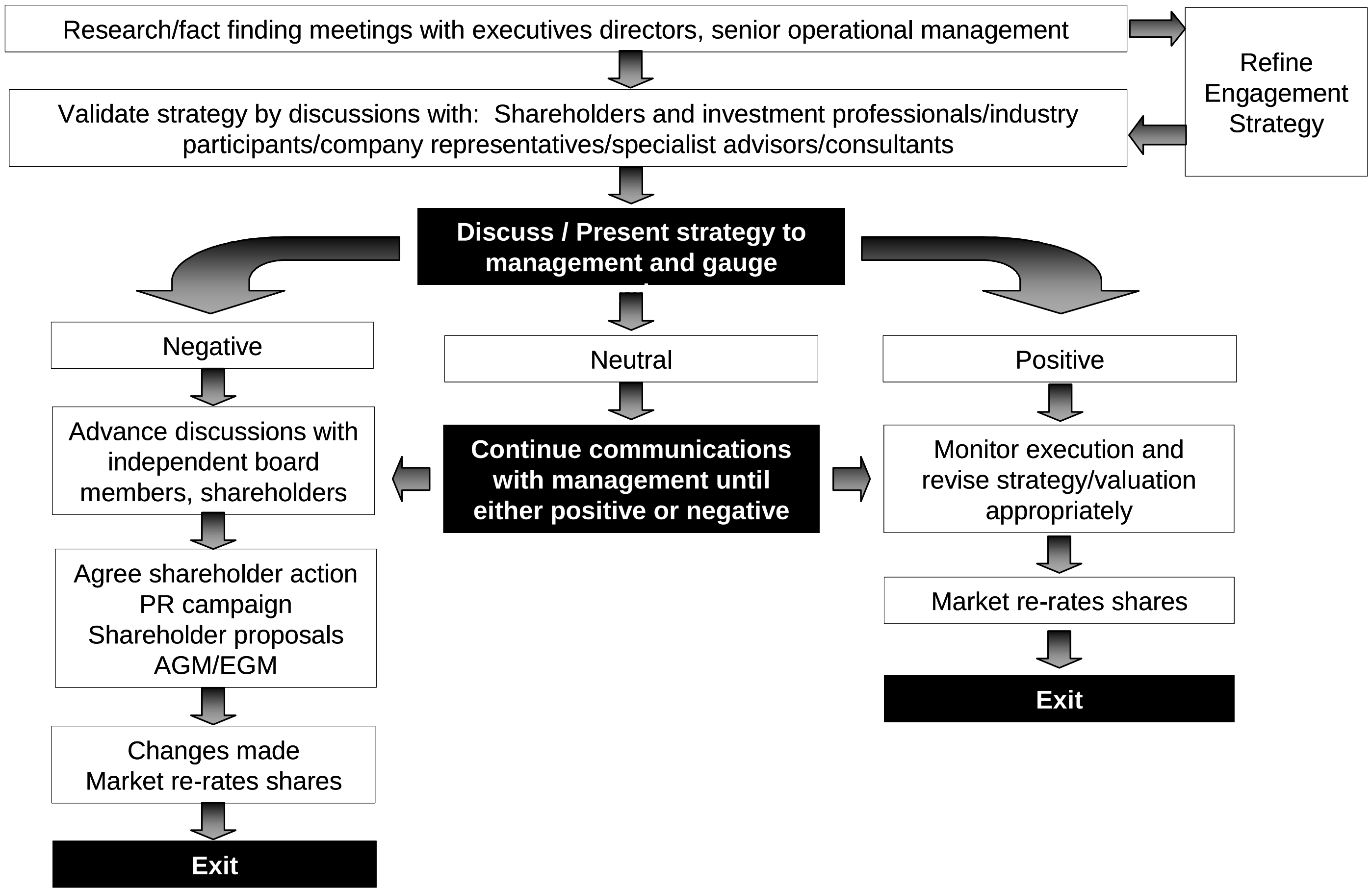
Replicating Portfolio	Rebalancing?	Annual Raw Return
Hermes' Net of Fees	Yes	8.21%
Hermes' Gross of Fees	Yes	10.07%
Private Info (1st day)	No	9.65%
Private Info (1st week)	No	10.65%
Private Info (1st month)	No	10.17%
Public Info	Yes	12.58%
Public Info	No	14.25%

Figure 1 – Hermes UK Focus Fund Investment Process



Source : Hermes UK Focus Fund Client Presentation

Figure 2 – Hermes UK Focus Fund Engagement Process



Source : Hermes UK Focus Fund Client Presentation

Figure 3 – Timing and Duration of Investments

The Figure reports the timing and the duration of the 41 HUKFF portfolio investments that were made between the inception of the fund and 31 December 2004.

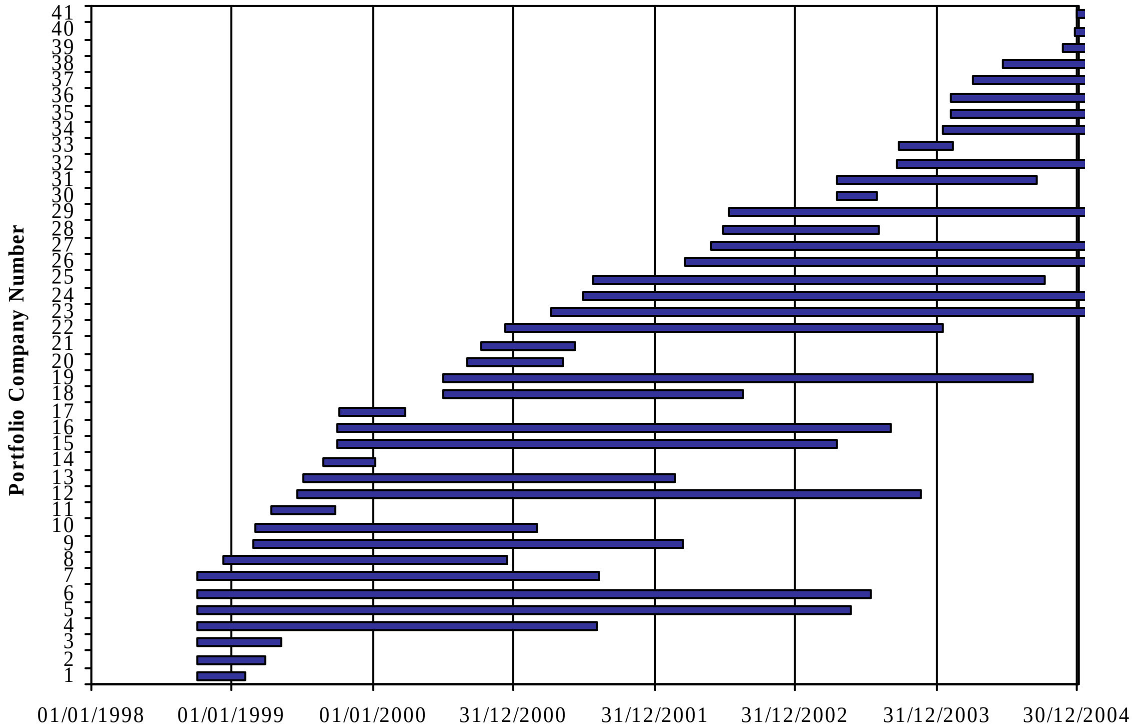
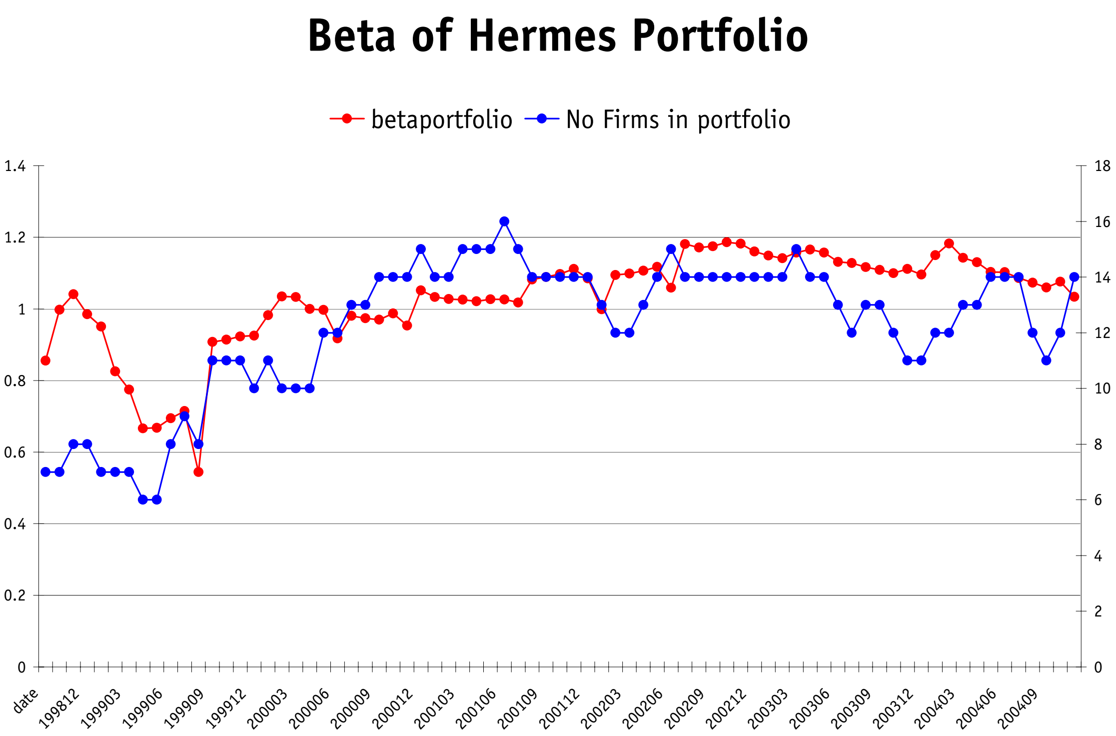
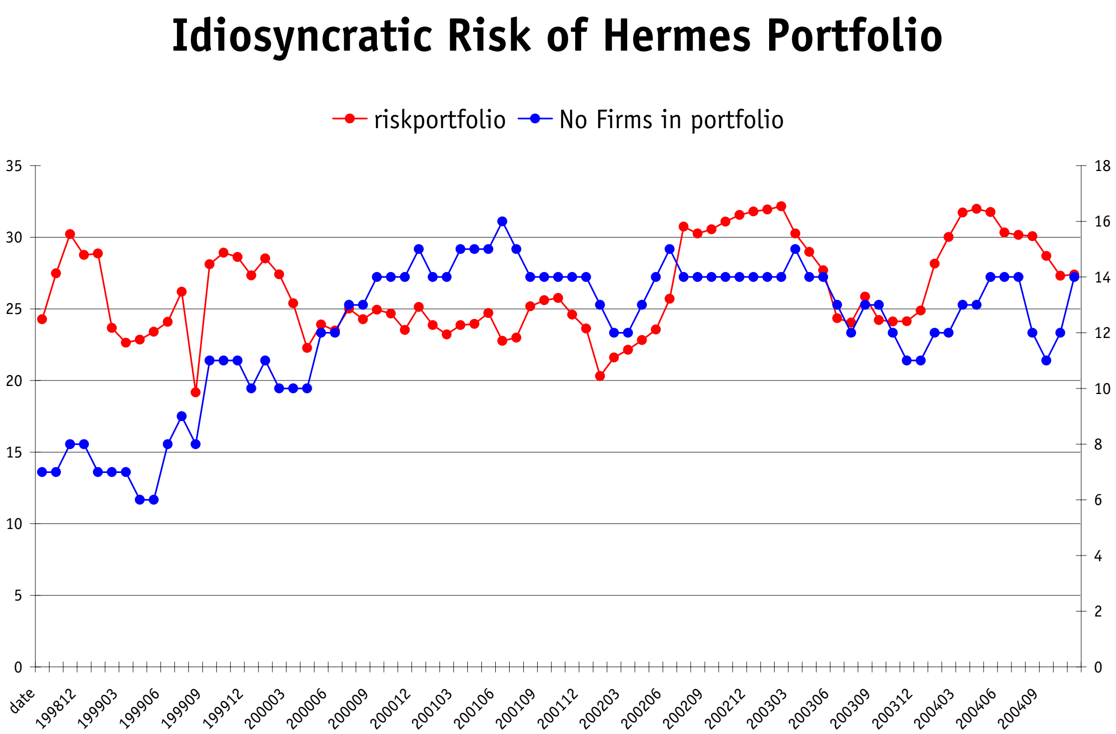


Figure 4 – Risk Profile of Hermes Portfolio
A – Systematic component



B. Idiosyncratic component



Appendix 1: Classification of Engagement Attitude

The attitude of engagements was classified into confrontational, mixed and collaborative. The classification is based on the subjective judgement of current and former fund staff and was corroborated by the authors using letters, memos of meetings and telephone conversations and press reports.

For each of the 30 companies that were engaged, we asked the staff to classify the attitude towards the fund at the beginning of the engagement, recording the attitude separately for the Chairman and the CEO (when the roles were split). The attitude was ranked using a score from 1 to 10, ranging from totally collaborative (1) to very confrontational (10). A score of 1 was never assigned, but a score of 2 was in several cases. A score of 10 was only assigned once.

Confrontational

Engagements were classified as confrontational when the target CEO initially rejected the proposals for change that were put to the company by the Focus Fund and this attitude did not change, or did not change voluntarily, throughout the engagement period. Engagements where the fund sought to replace the CEO and/or the Chairman against their own will were also classified as confrontational. The confrontational attitude finds clear expression in the exchange of letters between the Focus Fund and the company and, often more clearly, in meeting notes. The following examples provide illustrations of confrontational cases. Two were 'very confrontational' and were publicly hostile.

Case 1: The Focus Fund tried (and failed) to oust the Chairman of the target company A and replace him with an independent outside chairman. The Chairman and the target company resisted these changes. Press reports described the engagement as a "battle" or "storm", another wrote "Company A launched a blistering attack on two of its largest institutional investors yesterday, who had proposed the [company] be broken up in a radical restructuring".

Case 2: The Focus Fund and other institutions worked with a blockholder to oust family members, who were considered to be responsible for the underperformance of the target company. One newspaper observed : "the battle for control of company B, [....], is now pitting some of the City's richest and most prominent names against each other and threatening to spill some very blue blood on the carpet."

The following are less obvious examples of confrontational cases:

Case 3: A letter from the Fund to a non-executive director of a target company: "The purpose of this letter is to formally express our dissatisfaction with the performance of Company A Plc and advise that the current board can no longer rely on Hermes support as a representative of shareholders. Hermes believes that non-executive directors must be held accountable for long term destruction of shareholder value. We therefore support significant and early changes to the executive and non-executive components of the board and wish to see the process of restructuring completed before the end of the year."

Case 4: A letter to the Executive Chairman of the board of a company where the Fund sought a change in CEO: "To recap, it seems sensible to leave any major strategic moves until the new CEO is appointed and to allow him, or her, to own the way forward. As you said, it is many years since there was any new thinking in the business. Having said that I think it is fair to say that I suspect shareholders will need a lot of convincing that only the operations need to change, not the shape of the business."

Mixed

In the mixed engagements the demands of the Focus Fund were implemented reluctantly or grudgingly.

The following is a typical example of a mixed attitude engagement :

Case 5 : Passage taken from the last paragraph of a letter written to the Finance Director: "Thank you once again for a fascinating day. We were very impressed by XX, and by the progress and effort which has characterised the last few years. However, as this letter has outlined, there are some areas where we have concerns, and these may be reflected amongst investors generally."

The mixed category is less extreme and therefore more subjective than either confrontational or collaborative.

Collaborative

In the vast majority of the collaborative engagements there is no doubt about the attitude of the engagement.

A letter from the Focus Fund sent to the group CEO of a collaborative engagement towards the end of the engagement: "I remember when we first met, you talked about your early days at Company XY, when the future of British industry looked bleak and you were negotiating your way around daft restrictive practices. I'm sure that if you had told people then, that you would end up creating a British based [...] company, employing over 30,000 people, which was a global leader in its field, they would never have believed it. It is a fantastic achievement."

Appendix 2. Institutional Shareholders’ Committee Statement on Institutional Activism

Institutional Shareholders’ Committee

Updated September 2005

The Responsibilities Of Institutional Shareholders And Agents – Statement Of Principles

1. Introduction and Scope

This Statement of Principles has been drawn up by the Institutional Shareholders' Committee.[33] It develops the principles set out in its 1991 statement "The Responsibilities of Institutional Shareholders in the UK" and expands on the Combined Code on Corporate Governance of June 1998. It sets out best practice for institutional shareholders and/or agents in relation to their responsibilities in respect of investee companies in that they will:

• set out their policy on how they will discharge their responsibilities - clarifying the priorities attached to particular issues and when they will take action - see 2 below;

• monitor the performance of, and establish, where necessary, a regular dialogue with investee companies - see 3 below;

• intervene where necessary - see 4 below;

• evaluate the impact of their engagement - see 5 below; and

• report back to clients/beneficial owners - see 5 below.

In this statement the term "institutional shareholder" includes pension funds, insurance companies, and investment trusts and other collective investment vehicles. Frequently, agents such as investment managers are appointed by institutional shareholders to invest on their behalf.

This statement covers the activities of both institutional shareholders and those that invest as agents, including reporting by the latter to their institutional shareholder clients. The actions described in this statement in general apply only in the case of UK listed companies. They can be applied to any such UK company, irrespective of market capitalisation, although institutional shareholders' and agents' policies may indicate de minimis limits for reasons of cost-effectiveness or practicability. Institutional shareholders and agents should keep under review how far the principles in this statement can be applied to other equity investments.

The policies of engagement set out below do not constitute an obligation to micro-manage the affairs of investee companies, but rather relate to procedures designed to ensure that shareholders derive value from their investments by dealing effectively with concerns over under-performance. Nor do they preclude a decision to sell a holding, where this is the most effective response to such concerns.

Fulfilling fiduciary obligations to end-beneficiaries in accordance with the spirit of this statement may have implications for institutional shareholders' and agents' resources. They should devote appropriate resources, but these should be commensurate with the benefits for beneficiaries. The duty of institutional shareholders and agents is to the end beneficiaries and not to the wider public.

2. Setting out their policy on how they will discharge their responsibilities

Both institutional shareholders and agents will have a clear statement of their policy on engagement and on how they will discharge the responsibilities they assume. This policy statement will be a public document. The responsibilities addressed will include each of the matters set out below.

• How investee companies will be monitored. In order for monitoring to be effective, where necessary, an active dialogue may need to be entered into with the investee company's board and senior management.

• The policy for meeting with an investee company's board and senior management.

[33] In 1991 the members of the Institutional Shareholders' Committee were: the Association of British Insurers; the Association of Investment Trust Companies; the British Merchant Banking and Securities Houses Association; the National Association of Pension Funds; and the Unit Trust Association. In 2005, the members are: the Association of British Insurers; the Association of Investment Trust Companies; the National Association of Pension Funds; and the Investment Management Association.

• How situations where institutional shareholders and/or agents have a conflict of interest will be minimised or dealt with.

• The strategy on intervention.

• An indication of the type of circumstances when further action will be taken and details of the types of action that may be taken.

• The policy on voting.

Agents and their institutional shareholder clients should agree by whom these responsibilities are to be discharged and the arrangements for agents reporting back.

3. Monitoring performance

Institutional shareholders and/or agents, either directly or through contracted research providers, will review Annual Reports and Accounts, other circulars, and general meeting resolutions. They may attend company meetings where they may raise questions about investee companies' affairs. Also investee companies will be monitored to determine when it is necessary to enter into an active dialogue with the investee company's board and senior management. This monitoring needs to be regular, and the process needs to be clearly communicable and checked periodically for its effectiveness. Monitoring may require sharing information with other shareholders or agents and agreeing a common course of action.

As part of this monitoring, institutional shareholders and/or agents will:

• seek to satisfy themselves, to the extent possible, that the investee company's board and sub-committee structures are effective, and that independent directors provide adequate oversight; and

• maintain a clear audit trail, for example, records of private meetings held with companies, of votes cast, and of reasons for voting against the investee company's management, for abstaining, or for voting with management in a contentious situation.

In summary, institutional shareholders and/or agents will endeavour to identify problems at an early stage to minimise any loss of shareholder value. If they have concerns and do not propose to sell their holdings, they will seek to ensure that the appropriate members of the investee company's board are made aware of them. It may not be sufficient just to inform the Chairman and/or Chief Executive. However, institutional shareholders and/or agents may not wish to be made insiders. Institutional shareholders and/or agents will expect investee companies and their advisers to ensure that information that could affect their ability to deal in the shares of the company concerned is not conveyed to them without their agreement.

4. Intervening when necessary

Institutional shareholders' primary duty is to those on whose behalf they invest, for example, the beneficiaries of a pension scheme or the policyholders in an insurance company, and they must act in their best financial interests. Similarly, agents must act in the best interests of their clients. Effective monitoring will enable institutional shareholders and/or agents to exercise their votes and, where necessary, intervene objectively and in an informed way. Where it would make intervention more effective, they should seek to engage with other shareholders.

Many issues could give rise to concerns about shareholder value. Institutional shareholders and/or agents should set out the circumstances when they will actively intervene and how they propose to measure the effectiveness of doing so. Intervention should be considered by institutional shareholders and/or agents regardless of whether an active or passive investment policy is followed. In addition, being underweight is not, of itself, a reason for not intervening. Instances when institutional shareholders and/or agents may want to intervene include when they have concerns about:

• the company’s strategy;

• the company’s operational performance;

• the company’s acquisition/disposal strategy;

• independent directors failing to hold executive management properly to account;

• internal controls failing;

• inadequate succession planning;

• an unjustifiable failure to comply with the Combined Code;

• inappropriate remuneration levels/incentive packages/severance packages; and

• the company's approach to corporate social responsibility.

If boards do not respond constructively when institutional shareholders and/or agents intervene, then institutional shareholders and/or agents will consider on a case-by-case basis whether to escalate their action, for example, by:

• holding additional meetings with management specifically to discuss concerns;

• expressing concern through the company's advisers;

• meeting with the Chairman, senior independent director, or with all independent directors;

• intervening jointly with other institutions on particular issues;

• making a public statement in advance of the AGM or an EGM;

• submitting resolutions at shareholders' meetings; and

• requisitioning an EGM, possibly to change the board.

Institutional shareholders and/or agents should vote all shares held directly or on behalf of clients wherever practicable to do so. They will not automatically support the board; if they have been unable to reach a satisfactory outcome through active dialogue then they will register an abstention or vote against the resolution. In both instances it is good practice to inform the company in advance of their intention and the reasons why.

5. Evaluating and reporting

Institutional shareholders and agents have a responsibility for monitoring and assessing the effectiveness of their engagement. Those that act as agents will regularly report to their clients details on how they have discharged their responsibilities. This should include a judgement on the impact and effectiveness of their engagement. Such reports will be likely to comprise both qualitative as well as quantitative information. The particular information reported, including the format in which details of how votes have been cast will be presented, will be a matter for agreement between agents and their principals as clients.

Transparency is an important feature of effective shareholder activism. Institutional shareholders and agents should not however be expected to make disclosures that might be counterproductive. Confidentiality in specific situations may well be crucial to achieving a positive outcome.

6. Conclusion

The Institutional Shareholders' Committee believes that adoption of these principles will significantly enhance how effectively institutional shareholders and/or agents discharge their responsibilities in relation to the companies in which they invest. To ensure that this is the case, the Institutional Shareholders' Committee will monitor the impact of this statement with a view to further reviewing and refreshing it, if needs be, in 2007 in the light of experience and market developments.

1In 1991 the members of the Institutional Shareholders' Committee were: the Association of British Insurers; the Association of Investment Trust Companies; the British Merchant Banking and Securities Houses Association; the National Association of Pension Funds; and the Unit Trust Association. In 2005, the members are: the Association of British Insurers; the Association of Investment Trust Companies; the National Association of Pension Funds; and the Investment Management Association.

Source : http://www.ivis.co.uk/pages/gdsc6_5.html

Electronic Access to the Working Paper Series

The full set of ECGI working papers can be accessed through the Institute's Web-site (www.ecgi.org/wp) or SSRN:

Finance Paper Series	http://www.ssrn.com/link/ECGI-Fin.html
Law Paper Series	http://www.ssrn.com/link/ECGI-Law.html