Hedge Fund Activism

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Does Institutional Activism Increase Shareholder Wealth?

- Gillan and Starks (2007) review a large number of empirical studies on institutional activism. They conclude that,

  > *"The evidence provided by empirical studies of the effects of shareholder activism is mixed ... There is little evidence of improvement in the long-term operating or stock market performance of the targeted companies."*

- Similarly, Black (1998) argues that,

  > *"Best reading of currently available evidence is that institutional investor activism does not importantly affect firm performance."*

Hedge Funds vs. Other Institutions

1. Manager's incentives.
2. Fewer conflicts of interest.
3. Not subject to heightened fiduciary standards (ERISA) or "prudent man" investing standards.
4. Flexibility in using derivatives (e.g., swaps), shorting, large stakes in a few companies, use of leverage, less disclosure, and the use of "lock-ups."
5. Large increase in capital allocated to hedge funds.

Recent work

- Bratton (2007), Briggs (2007), Brav et al. (2008a), Brav et al. (2008b), Bradley et al. (2010), Clifford (2008), Klein and Zur (2009), Greenwood and Schor (2009), Bradley et al. (2010), Boyson and Mooradian (2010), Cheng et al. (2012), Gantchev (2012), Aslan and Maraachlian (2009), Huang (2010), Cohen (2012), Edmans et al. (2011), Klein and Zur (2011), Li and Xu (2009), Gantchev and Jotikasthira (2012), Aslan and Kumar (2013), Gantchev et al. (2013), Brav et al. (2013), Bebchuk et al. (2013), Bebchuk et al. (2014), Zhu (2014), Collin-Dufresne and Fos (2014)
- Becht et al. (2008), Bellini (2009), Mietzner and Schweizer (2011), Stokman (2007), Uchida and Xu (2008), Hamao et al. (2010), Becht et al. (2010)
- Harris and Raviv (2011), Cohn and Rajan (2012), Brav and Mathews (2011), Collin-Dufresne and Fos (2012), Katz and Owen (2013), Burkart and Dasgupta (2014)

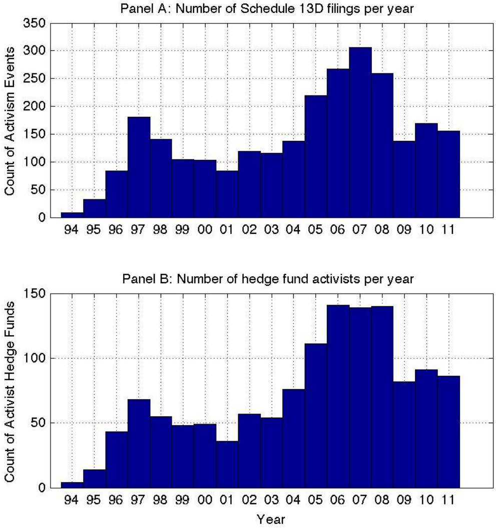
Hedge Fund Activism Data

- Section 13(d) of the 1934 Securities Exchange Act requires investors who are beneficial owners of over 5% of any class of publicly traded securities of a company, and who have an intention to influence corporate control, to disclose their ownership and intent within 10 days of crossing the 5% threshold.
  - Provides information about the identity of the filer, filing date, ownership and its changes, cost of purchase, and the purpose of the investment.
- Begin with all 13D filings over 1994-2011. Filter out banks, brokerage companies, regular corporations, foreign institutions, individuals, insurance companies, pension funds, trusts, and other miscellaneous categories.
- Search the internet and news articles and filter out non-hedge funds. For the remaining cases, try to call and ask for self-classification.

Hedge Fund Activism Data

- Retrieve all SEC filings and amendments made by the above hedge funds through EDGAR.
  - Exclude events in which the primary purpose of the filer is either to be involved in (1) the bankruptcy reorganization or the financing of a distressed firm; or (2) to engage in a merger and acquisition related risk arbitrage; or (3) the target is a closed-end fund or other non-regular corporation.
- After imposing these screens the number of events is 2,624.
  - Gather information via news searches on the hedge fund's motive, the target's response, and the development and resolution of the events .
  - Gather all 13F filings by the funds and identify all companies whose shares were held. Conduct individual news searches if (i) the company's market value was more than $1 billion, and (ii) the ownership by the hedge fund was greater than two percent.

Number of Funds and Activism Events by Year: 1994-2011



Summary of Events by Hedge Funds' Stated Goals and Tactics

Panel A: Summary of Hedge Funds' Stated Objectives

	Full Sample Statistics		Subsample Statistics	
	Number of Events	% of Sample	% initially Hostile	% Ex-post Hostile
General undervaluation	1562	59.5	NaN	NaN
Capital structure	332	12.7	20.5	45.5
Business strategy	468	17.8	26.3	62.6
Sale of target company	398	15.2	22.6	56.5
Governance	813	31	24.1	59

Panel B: Summary of Hedge Funds' Tactics

Tactic categories	% of Events
1. The stake is for investment purposes. Alternatively, the intent is to communicate with the board/management to enhance shareholder value	43.1
2. The hedge fund seeks board representation without a proxy contest or confrontation with the existing management/board	12.9
3. The hedge fund makes formal shareholder proposals, or publicly criticizes the company and demands change	22.9
4. The hedge fund threatens to wage a proxy fight in order to gain board representation, or to sue the company for breach of fiduciary duty etc.	6.5
5. The hedge fund launches a proxy contest in order to replace the board	8.5
6. The hedge fund sues the company	3
7. The hedge fund intends to take control of the company, for example, with a takeover bid	3.1

– An event is classified as hostile if it involves open confrontation between the activist and the target management. Hostile activist events involve events in tactic categories $4 - 7$, or those that fall in the category 3 but involve a stated hostile intention.

– An event is classified as successful if the hedge fund achieves its main stated goal; a partial success if the hedge fund and the company reach some settlement that partially meets the fund's original goal. The total success rate, including partial success, for the hostile sample is higher than that for the non-hostile sample.

Hedge Funds' Capital Commitment and Investment Horizon

Panel A: Hedge Funds' Invested Capital								
	Full Sample				Hostile Subsample			
	Initial		Max.		Initial		Max.	
	Percent Ownership	Invested Cap' (in $1M)	Percent Ownership	Invested Cap' (in $1M)	Percent Ownership	Invested Cap' (in $1M)	Percent Ownership	Invested Cap' (in $1M)
5th	5	0.9	5.2	1.1	4.8	1.2	5.1	1.2
25th	5.4	4.4	7	5.8	5.7	3.9	7.3	5.2
Median	6.4	13.5	9.5	18.6	6.8	16.2	9.7	21
75th	9.4	41.3	14	54.7	9.6	54.3	13.8	67.7
95th	21.8	185.1	31	244.9	19.8	251.7	43.7	330.1
Average	9	55.4	12.9	70	8.8	65.5	14.4	87.7

– Hedge fund activism does not generally involve controlling blocks. Hostile cases exhibit greater capital commitments, especially at the higher percentiles of the sample.

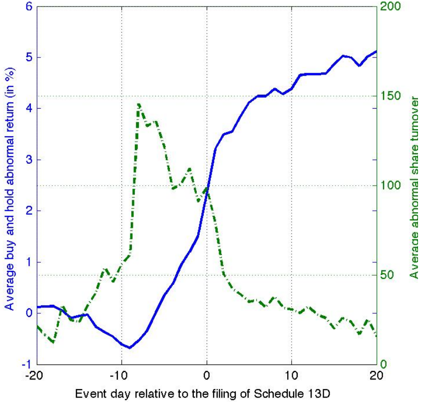
Panel B: Hedge Funds' Investment Horizon (in days)		
	Full Sample	Hostile Subsample
5th	34	13
25th	148	65
50th	348	179
75th	728	405
95th	1954	1143
Average	581	325
Not Completed as of Sep/2013	563	12
Total Number of Completed Events	2060	245

– Using the annual portfolio turnover rates of the activist hedge funds (based on their quarterly holdings disclosed in their 13F filings), find that the average holding period of a position is close to two years.

Characteristics of Targeted Firms

- Target firms are generally smaller than non-target firms.
- Hedge funds resemble "value investors."
- Target firms tend to be low-growth firms but significantly more profitable than comparable firms.
- Target firms' dividend payout is significantly lower relative to peers.
- Targets also have higher institutional ownership.
- Target companies exhibit higher trading liquidity than comparable firms.
- Target firms tend to have more takeover defenses (or weaker shareholder rights).

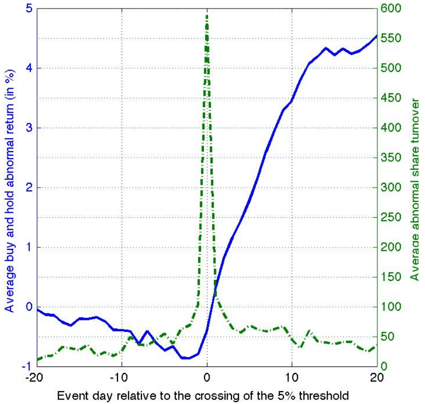
Abnormal Return Centered Around the Filing of Schedule 13Ds



– The solid blue line (left axis) plots the average buy-and-hold return around the filing of the Schedule 13D, in excess of the buy-and-hold return of the value-weight market, from 20 days prior the 13D file date to 20 days afterwards.

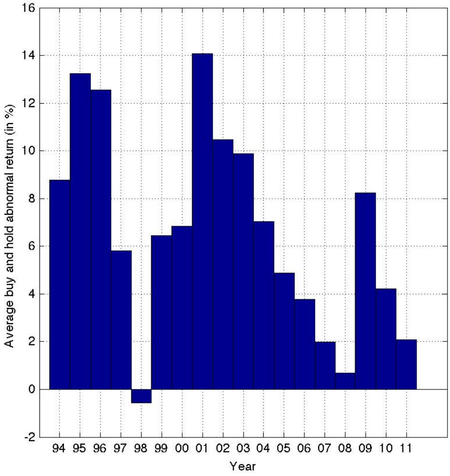
– The dashed green line (right axis) plots the increase in percentage points of the share trading turnover during the same time window compared to the average turnover rate during the preceding (-220, -21) event window.

Abnormal Return Centered Around the Date that Triggers the Requirement to File the Schedule 13D

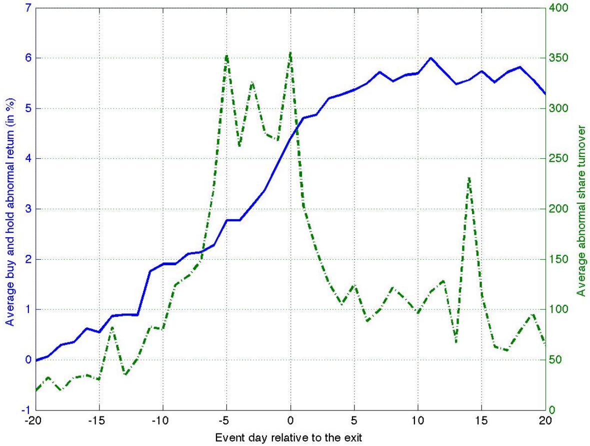


–Wall Street Journal, March 26 2014, "Activist Investors Often Leak Their Plans to a Favored Few, Strategically Placed Tips Help Build Alliances for Campaigns at Target Companies," By susan Pulliam, Juliet Chung, David Benoit, and Rob Barry.

Short-run Market Reaction By Year



Buy-and-Hold Abnormal Return Around Activists' Exit



Long-term Abnormal Returns

Panel A: Target firm four-factor model regressions						
	Holding period (in months)					
	[-36,-25]	[-24,-13]	[-12,-1]	[+1,+12]	[+13,+24]	[+25,+36]
α	-0.68	-1.19	-1.40	0.04	0.04	0.40
	-2.95	-5.08	-5.47	0.17	0.22	1.55
$\beta_{p,RMRF}$	1.00	0.97	1.00	0.94	1.06	0.87
	17.42	17.33	16.77	17.09	23.62	14.91
$\beta_{p,SMB}$	0.62	0.46	0.36	0.49	0.44	0.67
	9.00	6.57	4.81	6.94	7.61	8.98
$\beta_{p,HML}$	-0.06	0.16	0.41	0.45	0.29	0.08
	-0.79	2.17	5.06	5.96	4.77	0.99
$\beta_{p,MOM}$	-0.11	-0.17	-0.12	-0.11	0.02	0.00
	-2.49	-3.76	-2.46	-2.38	0.64	0.05
R^2	0.74	0.7	0.66	0.69	0.8	0.7
N	211	211	211	211	200	188

Panel B: "Small" target firms			
	Holding period (in months)		
	[+1,+12]	[+13,+24]	[+25,+36]
α	0.45	-0.04	0.40
	1.58	-0.13	1.07
$\beta_{p,RMRF}$	0.73	0.77	1.01
	11.27	11.53	11.59
$\beta_{p,SMB}$	0.95	1.06	1.14
	11.40	12.49	10.20
$\beta_{p,HML}$	0.32	0.28	0.23
	3.64	3.09	1.99
$\beta_{p,MOM}$	-0.15	-0.08	0.14
	-2.87	-1.59	2.12
R^2	0.64	0.68	0.65
N	205	193	181

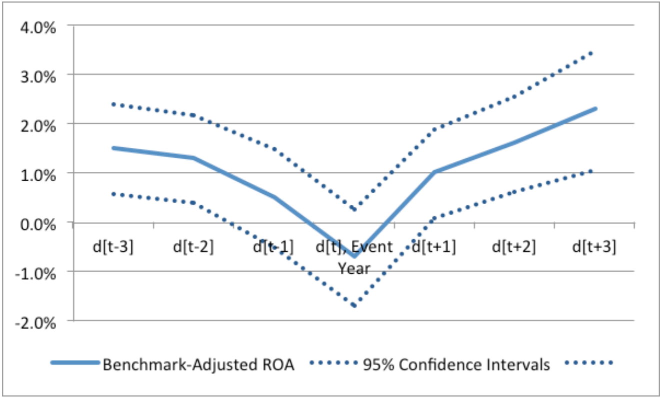
Panel C: "Large" target firms			
	Holding period (in months)		
	[+1,+12]	[+13,+24]	[+25,+36]
α	0.06	0.08	0.40
	0.23	0.36	1.50
$\beta_{p,RMRF}$	0.97	1.09	0.81
	16.93	22.06	13.13
$\beta_{p,SMB}$	0.43	0.37	0.71
	5.93	5.92	8.82
$\beta_{p,HML}$	0.47	0.29	0.07
	6.03	4.34	0.90
$\beta_{p,MOM}$	-0.10	0.02	-0.04
	-2.12	0.52	-0.82
R^2	0.68	0.77	0.68
N	206	194	180

Target Firm Performance in Years Before and After Targeting

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Dependent Variable	ROA	Leverage	Cash	Capex	Div. Yield	Payout Yield	CEO Turnover	Pay-for-Performance
Event year -3	0.016	0.020*	0.009*	-0.002	-0.002***	0.001	0.003	0.022*
	(1.62)	(1.84)	(1.65)	(-0.89)	(-3.30)	(0.74)	(0.21)	(1.68)
Event year -2	0.011	0.011	0.011**	-0.005**	-0.002***	0.002	0.024	-0.001
	(1.31)	(1.16)	(1.97)	(-2.17)	(-4.32)	(1.61)	(1.52)	(-0.11)
Event year -1	0.001	0.008	0.007	-0.006***	-0.002***	0.003**	0.019	0.016
	(0.10)	(0.82)	(1.34)	(-2.68)	(-3.50)	(2.51)	(1.28)	(1.34)
Event year	-0.010	0.022**	0.005	-0.005*	-0.002***	0.006***	0.035**	0.010
	(-1.07)	(1.97)	(1.02)	(-1.86)	(-3.19)	(3.64)	(2.29)	(0.82)
Event year +1	0.008	0.024*	0.007	-0.010***	-0.002**	0.008***	0.078***	0.042***
	(1.07)	(1.92)	(1.26)	(-4.09)	(-2.54)	(4.21)	(4.18)	(3.43)
Event year +2	0.026***	0.045***	0.008	-0.012***	-0.002***	0.004**	0.101***	0.044***
	(4.00)	(3.45)	(1.22)	(-5.94)	(-3.13)	(2.13)	(4.99)	(3.58)
Event year +3	0.028***	0.040***	0.004	-0.007***	-0.001	0.005**	0.037**	0.019
	(3.80)	(2.96)	(0.59)	(-2.89)	(-1.10)	(2.50)	(2.14)	(1.49)
ln(MV)	0.040***	-0.003***	-0.003***	0.007***	0.001***	0.002***	-0.005***	0.061***
	(39.74)	(-2.59)	(-5.10)	(27.02)	(23.13)	(20.07)	(-3.25)	(29.70)
ln(Age)	0.045***	0.017***	-0.038***	-0.025***	0.001***	0.003***	0.018***	-0.021***
	(18.74)	(7.68)	(-28.36)	(-38.03)	(9.97)	(14.81)	(7.92)	(-6.90)
BM	-0.000	-0.001*	-0.000***	-0.000	0.000	-0.000***	-0.002	-0.003**
	(-0.91)	(-1.84)	(-3.03)	(-1.09)	(0.95)	(-2.75)	(-0.57)	(-2.00)
R-Squared	0.137	0.124	0.353	0.222	0.307	0.126	0.021	0.297
Observations	123,514	127,552	128,072	125,061	127,566	117,171	30,298	30,070

$$y_{i,t} = \sum_{j=-3}^{3} \gamma_j D_{i,j} + \beta_1 ln(MV_{i,t}) + \beta_2 ln(Age_{i,t}) + \beta_3 B/M_{i,t} + \alpha_{SIC3} + \alpha_t + \epsilon_{i,t}$$

Target Firm ROA before and after Activists Intervention



Brav, Jiang and Kim (2013)

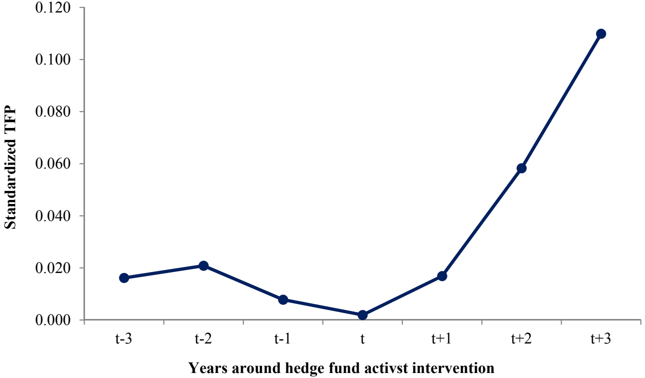
DISCLAIMER:

Any opinions and conclusions expressed herein are those of the author(s) and do not necessarily represent the views of the U.S. Census Bureau. All results have been reviewed to ensure that no confidential information is disclosed.

Brav, Jiang and Kim (2013)

1. The source of fundamental improvement
    - Plant-level productivity before and after the intervention
    - Interaction with product market competition
2. Efficiency gains for assets in place vs. capital reallocation
    - Continuing vs. sold plants
3. Effects on labor
4. Compustat-driven attrition bias
5. Extent to which the effects are causal

Brav, Jiang and Kim (2013), Target Plant Productivity in Years Before and After Targeting by Hedge Fund Activists



Returns to Activist hedge funds

- If hedge fund activism benefits shareholders in the target companies, does it generate superior returns for the funds themselves?
  - Hedge fund data: CISDM and HedgeFund.net. Match 103 funds with at least 12 months of return data for the period January 1995 - June 2007
  - Performance estimates: Average one- and four-factor monthly alphas of the sample activist hedge funds are 0.71% and 0.64%, as compared to 0.41% and 0.39% for the full sample of hedge funds
  - Activists factor loadings show a tilt towards "small" and "value." Low loading on the market portfolio

Tests for causality

- Interested in the question whether the target firm's performance would have changed had it not been for the HFs' effort (rather than whether HF activism affects firm performance if funds were assigned randomly to targets)
  - An IV for exogenous termination of HF intervention would help, but it is not necessary to show the conditional treatment effect
  - The conventional IV approach which is predicated on finding exogenous shocks in targeting is not applicable – even if there are exogenous shocks that make targeting easier, HFs are still going to select among candidates that are now made easier to be targeted
- From earlier work we know that activists tend to hold concentrated stakes in target firms for an average holding period of two years. Undiversified positions together with costly engagements cannot be justified based on a pure stock picking story (Gantchev (2011))
  - Openly hostile activism generates higher announcement returns than non-confrontational events (Klein and Zur, 2009)

Tests for causality

1. Target would have "self-cured" even in the absence of activist hedge funds
    - Placebo test: Define "events" as firms that are not targeted but experience a similar deterioration in productivity as the target firms.
2. The target firm would have implemented the changes without hedge fund's intervention
    - Focus on hostile events only
        - Confrontational events account for 25% of the sample
        - Involve actual or threatened proxy contests or law suits and shareholder campaigns of a confrontational nature

Tests for causality

3. Hedge funds are targeting firms best positioned to benefit from positive industry shocks (e.g., consolidation)
    - Look at real effects on plants that belong to primary vs. non-primary segments of target
        - A peripheral industry segment is defined as one with shipments accounting for less than 25% of total shipments of the firm
4. Hedge funds have superior ability to select targets ("stock-picking") that are expected to experience positive changes
    - Look at hedge funds switching from a Schedule 13G, filed for passive investment purposes, to a Schedule 13D. Benchmarked to hedge funds' filing of Schedule 13Gs.
      13D (stock picking + potential intervention) vs. 13G (stock picking only)

Does hedge fund activism create value?

- Consistent with the 5% short-run abnormal return and the ex-post improvement in operating performance and TFP
- Some alternative hypotheses:
  1. Can the short-run return be an over-reaction?
     * No. Calendar time portfolios generate insignificant (positive) abnormal returns subsequent to the filing of the 13D
  2. Can it reflect stock-picking ability or information?
     * No. (i) The subsample of events where the hedge fund had revealed a significant ownership (13F and 13G filing) prior to the filing of a Schedule 13D still shows significant announcement-window returns comparable to those for the full sample. (ii) Hostile deals are, by definition, resisted by the firm managers, but the announcement returns are higher, (iii) High positive correlation between the length of time that shares are held by the funds and the decision to exit based on stated goals

Does hedge fund activism create value?

3. Can it reflect wealth transfer from bondholders?
   * Evidence is mixed. (i) The coefficient of the abnormal return on leverage is insignificant. (ii) The subsample of no-debt targets has a *higher* abnormal return (insignificant), (iii) No evidence of a change in existing bond yields (iv) more recent evidence shows that impact on bond yields depends on the nature of the intervention
4. Can it reflect wealth transfer from management?
   * Yes. (i) Total CEO compensation (salary, bonus, and stock and option grants) is higher than that of the peers up to the event year but turns indistinguishable from peer levels one year after the hedge fund intervention. (ii) Pay-for-performance sensitivity (the percentage of CEOs total compensation that comes from equity-based incentives including both shares and options) increases two years after the event year compared to the year before the event, (iii) One year after targeting, the CEO turnover rate among the surviving target companies increases significantly compared to one year prior to intervention

Current State of Research on Hedge Fund Activism

- Impact on rival firms as well as customers and suppliers
- Preventive actions by non-targets
- Impact on corporate innovation
- Impact on corporate culture
- Use of derivatives
- Wolfpacks
- Liquidity
- Causality

- Martin Lipton of Wachtell, Lipton, Rosen & Katz:

  "I think its a terrible thing for corporate America. I think what were seeing is a replay of the attempt to drive American business to short-term results instead of long-term values"

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