The Second Wave of Hedge Fund Activism: The Importance of Reputation, Clout, and Expertise

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What are Hedge Funds? Why Are They Different From Institutional Investors?

• Hedge funds are lightly regulated pools of investment capital that engage in a wide variety of investment strategies, one of which involves shareholder activism.

• Why are Hedge Funds different from traditional institutional investors?
  • Large HF manager financial incentives – 20% of profits plus 2% management fees create strong profit motives.
  • Fewer conflicts of interest than many institutional investors – e.g. mutual funds are selling product to companies, but HF’s are not.
  • Flexibility, unregulated – HF’s face minimal legal barriers vs. many traditional institutional investors are constrained in their investment strategies, such as, prudent investor rules and mandatory diversification requirements.
A significant majority of activist campaigns involve companies with a market capitalization below $2 billion.
What Tactics Do Hedge Funds Use? (2001-2006)

- 52%: Communicate with Manager
- 26%: Seek board rep. w/o contest
- 17%: Public letter/SH proposal
- 8%: Threat of contest/law suit
- 16%: Proxy contest
- 8%: Litigation
- 6%: Takeover attempt
# How Big Are Activist Assets and Flows?

<table>
<thead>
<tr>
<th>Year</th>
<th>Assets Under Management ($MM)</th>
<th>Net Asset Flows ($MM)</th>
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</thead>
<tbody>
<tr>
<td>2003</td>
<td>$11,821</td>
<td>$921</td>
</tr>
<tr>
<td>2004</td>
<td>$19,465</td>
<td>$3,686</td>
</tr>
<tr>
<td>2005</td>
<td>$29,180</td>
<td>$3,432</td>
</tr>
<tr>
<td>2006</td>
<td>$47,548</td>
<td>$6,468</td>
</tr>
<tr>
<td>2007</td>
<td>$54,830</td>
<td>$3,507</td>
</tr>
<tr>
<td>2008</td>
<td>$32,268</td>
<td>($4,315)</td>
</tr>
<tr>
<td>2009</td>
<td>$36,214</td>
<td>($12,252)</td>
</tr>
<tr>
<td>2010</td>
<td>$46,802</td>
<td>$1,660</td>
</tr>
<tr>
<td>2011</td>
<td>$50,860</td>
<td>$3,776</td>
</tr>
<tr>
<td>2012</td>
<td>$65,509</td>
<td>$2,913</td>
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<tr>
<td>2013</td>
<td>$93,113</td>
<td>$5,276</td>
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<tr>
<td>YTD Q2 2014</td>
<td>$111,166</td>
<td>$9,425</td>
</tr>
</tbody>
</table>

Source: HedgeFund Research
Is Activism Desirable? It May Depend on Where You Sit

- Activists claim that increased share buybacks, dividends and higher debt prevent mgt. inefficient use of free cash flow
- Activists claim need to focus on the core business by selling/spinning off assets and get stock price up
- Activists claim need to replace poor management and improve mgt. incentives
- Activists often claim need to sell the firm

- Target claims that all of these actions reduce long run value by forcing them to reduce R&D, cut down on future capital investment, and increase bankruptcy risk
- Target claims that these actions result in diversion of wealth from other stakeholders to shareholders
- Target claims existing management is strong and pay reasonable
- Target wants to pursue long term business strategy
Data summary

• For each event, Schedule 13D/G filings
• 1,003 13D events
• 578 funds (2008-2014 is double 2001-2006)
• Larger targets ($1bn vs. $727MM market cap)
• Targets are unprofitable on average
• +7% CAR (-10,+10)
• Average ownership of 8.3%
“League Tables” of hedge funds

“Most Active” (learning?)
  1 if at least 5 interventions total during 2008-10, 0 otherwise

“Top Return” (skill?)
  1 if at least 10% and 3 interventions total during 2008-10, 0 otherwise

“Top Investor” (clout?)
  1 if top 10 aggregate dollar investments during 2008-10, 0 otherwise

These 3 are relatively pairwise uncorrelated (Active/Top Return -8%, Active/Top Investor 37%, Top Return Top Investor 25%)
“Top Investor”

- Target larger, more profitable firms
- Are older, greater assets under management, more portfolio companies, more board seats
- Significantly higher CARs (12.4% vs. 6.6%)
- Conclusion: on average these funds have more credible reputations based on the difficulty of their past interventions, and therefore they outperform
Changes at targets from “Top Investors”? 

• Significant increase in ROA, Sales, and R&D growth for four quarters 
• Targets are less likely to be liquidated for poor performance 
• Targets more likely to be sold 
• Top Investors” target firms with significantly higher “Aggregate Entrenchment Measure” than other HFs
Why do “Top Investors” succeed?

• Not capital structure, some dividend policy (for all 3)
• Greater “Director Replacement Intent”
• 3x more proxy fights
• 3x more proxy fight wins
• 2x more lawsuits
• 3x more board seats/success
• They are more aggressive in the media
Summary

• HF activism has increased
• But still positive returns
• “Top Investors” = financial clout and expertise