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Hedge Fund Activism: A Review

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Abstract

This monograph reviews shareholder activism by hedge funds. We first describe the nature and characteristics of hedge fund activism, including the objectives, tactics, and choices of target companies. We then analyze possible value creation brought about by activist hedge funds, both for shareholders in the target companies and for investors in the hedge funds. The evidence generally supports the view that hedge fund activism creates value for shareholders by effectively influencing the governance, capital structure decisions, and operating performance of target firms.

Keywords: Hedge fund; shareholder activism; corporate governance.

Contents

1

Introduction

During the past decade, hedge fund activism has emerged as a new form of corporate governance mechanism that brings about operational, financial, and governance reforms in the corporation. Shareholder activism (Gillan and Starks, 2007; Karpoff, 2001) and more broadly, large investors' monitoring of corporate managers (Shleifer and Vishny, 1986; Grossman and Hart, 1980) are not new phenomena in capital markets around the world. In the United States, institutional investors such as pension funds and mutual funds have been actively engaging in the management of the invested firms since the 1980s with the goal of improving shareholder value. However, the early institutional shareholder activism has been plagued by many regulatory and structural barriers such as free-rider problems and conflict of interest (Black, 1990). As a result, the evidence on the effect of their activist efforts has largely been mixed (Gillan and Starks, 2007).[1]

Hedge fund activism distinguishes itself from other institutional activism in a number of aspects. First, hedge fund managers have stronger financial incentives to make profits. Hedge funds generally

[1] One exception is Bethel et al. (1998), who provide evidence for successful activist blockholders in the 1980s.

receive a significant proportion (e.g., 20%) of excess returns as performance fees on top of fixed management fees. Moreover, the managers of hedge funds invest a substantial amount from their personal wealth into their own funds. This strong incentive for high investment returns in the compensation structure contrasts with that of mutual fund or pension fund managers, which usually does not allow managers to capture a significant portion of (excess) returns. Second, hedge funds are lightly regulated since they are not widely available to the public but only to institutional clients and a limited number of wealthy individuals. Therefore, hedge funds are not subject to strict fiduciary standards (such as those embodied in ERISA), and this in turn allows them to have much more flexibility to intervene in the invested companies. For example, since the law does not require hedge funds to maintain diversified portfolios as required for some other institutional investors, they can take large and concentrated stakes in target firms more easily. Further, they can use derivative securities or trade on margin to hedge or leverage their stakes with a given capital. These are important advantages for activist shareholders to have influence over the target firms' management.

Third, hedge funds face fewer conflicts of interest than some other institutional investors, such as mutual funds and pension funds, who often have other business relations with the invested companies or have non-financial agendas and goals. Hedge fund managers rarely face this sort of conflicts. Lastly, hedge funds usually have lock-up provisions that restrict the investors from withdrawing their principal. Given that hedge fund activists invest in target firms for more than a year on average to pursue their strategies, this feature affords the managers an extended flexibility to focus on intermediate- and long-term activist objectives.

To summarize, hedge fund activists are a new breed of shareholder activists that are equipped with more suitable financial incentives and organizational structures for pursuing activism agendas than earlier generations of institutional activists. Not surprisingly, they turn out to be successful in facilitating significant changes in corporate governance and operations of target firms, and in turn achieving the goal of improving value for both the firms' shareholders and their own investors.

In this monograph, we survey the academic literature on hedge fund activism focusing on two main questions: (i) What is the nature of activist hedge funds' intervention in target firms? and (ii) Does hedge fund activism create value for shareholders in the target firms and investors in the hedge funds? Our main analyses are based on the updated empirical evidence from an extended sample from that of Brav et al. (2008a). The sample covers hedge fund activism events in U.S. firms during 2001–2007. We also review work by other researchers on both U.S. and international hedge fund activism. We refer readers interested in general shareholder activism to the survey by Gillan and Starks (2007).

Evidence on the two questions can be summarized as follows. Hedge fund activists tend to target "value" firms that have low valuations compared to "fundamentals." In addition, activist hedge funds are more likely to target firms that have sound operating cash flows, but low (sales) growth rates, leverage, and dividend payout ratios. Therefore, one can characterize the targets as "cash-cows" with low growth potentials that may suffer from the agency problem of free cash flow (Jensen, 1986). This characterization of target firms differentiates hedge fund activism from earlier shareholder activism, which tended to target companies that had poor operating performance. The target firms are generally smaller than comparable firms. Hedge funds target small firms partly because they can accumulate a significant ownership more easily with a given amount of capital. Related to this point, the targets of hedge fund activism exhibit relatively high trading liquidity, institutional ownership, and analyst coverage. Essentially, these characteristics allow the activist investors to accumulate significant stakes in the target firms quickly without adverse price impact, and to get more support for their agendas from fellow sophisticated investors. Lastly, target companies tend to have weaker shareholder rights than comparable firms, consistent with the argument that hedge fund activists target poorly governed firms where the potential for value improvement is higher.

By and large, the evidence in the literature indicates that hedge fund activism is successful in achieving the goals of creating value for shareholders of the target companies. The short-term average abnormal returns around the announcement of the intervention of hedge funds are significantly positive across studies, on the order of 5–10%. Moreover, the perceived increase in firm value through hedge fund activism shows considerable cross-sectional differences. The categories that achieve the highest abnormal short-term returns are the sale of the target firm and changes in business strategy. In contrast, activism targeting purely capital structure or corporate governance-related agendas earns relatively low returns. In sum, investors perceive activism that facilitates efficient re-allocation of capital in the target firms has the highest potential for shareholder value improvement.

Importantly, post-event long-run returns, up to multiple years, show no reversion, indicating that the market's initial perception about value creation is justified. Furthermore, the targets experience improvements in operating performance (measured by return on assets or equity) after the activism; they also exhibit increases in CEO turnover, leverage, and payouts, but a decrease in CEO compensation. These results are consistent with the view that hedge fund activism adds value through operational, financial, and governance remedies in the target firms.

The rest of the review is organized as follows. Section 2 begins with a brief outline of the major work reviewed in this monograph. Section 3 describes data sets on hedge fund activism. Section 4 then examines the goals and tactics employed by hedge fund activists. Section 5 analyzes the characteristics of firms that activist hedge funds target. In Section 6, we address the fundamental question of whether hedge fund activism creates value for shareholders by examining short- and long-run stock returns, and changes in operating performance of target firms. Section 7 examines returns to investors in activist hedge funds. The final section concludes with remarks for future research.

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