Hedge Fund Activism

Professor Alon Brav
Fuqua School of Business
Duke University

European Financial Management Association
2014 Annual Meetings

June 25 2014
Gillian 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


- Becht et al. (2008), Bellini (2009), Mietzner and Schweizer (2011), Stokman (2007), Uchida and Xu (2008), Hamao et al. (2010), Becht et al. (2010)

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

Panel A: Number of Schedule 13D filings per year

Panel B: Number of hedge fund activists per year
Summary of Events by Hedge Funds’ Stated Goals and Tactics

Panel A: Summary of Hedge Funds’ Stated Objectives

<table>
<thead>
<tr>
<th>Tactic categories</th>
<th>Full Sample Statistics</th>
<th>Subsample Statistics</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number of Events</td>
<td>% of Sample</td>
</tr>
<tr>
<td>General undervaluation</td>
<td>1562</td>
<td>59.5</td>
</tr>
<tr>
<td>Capital structure</td>
<td>332</td>
<td>12.7</td>
</tr>
<tr>
<td>Business strategy</td>
<td>468</td>
<td>17.8</td>
</tr>
<tr>
<td>Sale of target company</td>
<td>398</td>
<td>15.2</td>
</tr>
<tr>
<td>Governance</td>
<td>813</td>
<td>31.0</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th></th>
<th>Full Sample</th>
<th>Hostile Subsample</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Initial</td>
<td>Max.</td>
</tr>
<tr>
<td>Percent Ownership</td>
<td>Invested Cap’ (in $1M)</td>
<td>Percent Ownership</td>
</tr>
<tr>
<td>5th</td>
<td>5</td>
<td>0.9</td>
</tr>
<tr>
<td>25th</td>
<td>5.4</td>
<td>4.4</td>
</tr>
<tr>
<td>Median</td>
<td>6.4</td>
<td>13.5</td>
</tr>
<tr>
<td>75th</td>
<td>9.4</td>
<td>41.3</td>
</tr>
<tr>
<td>95th</td>
<td>21.8</td>
<td>185.1</td>
</tr>
<tr>
<td>Average</td>
<td>9</td>
<td>55.4</td>
</tr>
</tbody>
</table>

– 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)

<table>
<thead>
<tr>
<th></th>
<th>Full Sample</th>
<th>Hostile Subsample</th>
</tr>
</thead>
<tbody>
<tr>
<td>5th</td>
<td>34</td>
<td>13</td>
</tr>
<tr>
<td>25th</td>
<td>148</td>
<td>65</td>
</tr>
<tr>
<td>50th</td>
<td>348</td>
<td>179</td>
</tr>
<tr>
<td>75th</td>
<td>728</td>
<td>405</td>
</tr>
<tr>
<td>95th</td>
<td>1954</td>
<td>1143</td>
</tr>
<tr>
<td>Average</td>
<td>581</td>
<td>325</td>
</tr>
</tbody>
</table>

– 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

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**

<table>
<thead>
<tr>
<th>Holding period (in months)</th>
<th>[-36,-25]</th>
<th>[-24,-13]</th>
<th>[-12,-1]</th>
<th>[+1,+12]</th>
<th>[+13,+24]</th>
<th>[+25,+36]</th>
</tr>
</thead>
<tbody>
<tr>
<td>$\alpha$</td>
<td>-0.68</td>
<td>-1.19</td>
<td>-1.40</td>
<td>0.04</td>
<td>0.04</td>
<td>0.40</td>
</tr>
<tr>
<td>$\beta_{p,RMRF}$</td>
<td>1.00</td>
<td>0.97</td>
<td>1.00</td>
<td>0.94</td>
<td>1.06</td>
<td>0.87</td>
</tr>
<tr>
<td>$\beta_{p,SMB}$</td>
<td>17.42</td>
<td>17.33</td>
<td>16.77</td>
<td>17.09</td>
<td>23.62</td>
<td>14.91</td>
</tr>
<tr>
<td>$\beta_{p,HML}$</td>
<td>0.62</td>
<td>0.46</td>
<td>0.36</td>
<td>0.49</td>
<td>0.44</td>
<td>0.67</td>
</tr>
<tr>
<td>$\beta_{p,MOM}$</td>
<td>9.00</td>
<td>6.57</td>
<td>4.81</td>
<td>6.94</td>
<td>7.61</td>
<td>8.98</td>
</tr>
<tr>
<td>$\beta_{p,RMRF}$</td>
<td>-0.06</td>
<td>0.16</td>
<td>0.41</td>
<td>0.45</td>
<td>0.29</td>
<td>0.08</td>
</tr>
<tr>
<td>$\beta_{p,SMB}$</td>
<td>-0.79</td>
<td>2.17</td>
<td>5.06</td>
<td>5.96</td>
<td>4.77</td>
<td>0.99</td>
</tr>
<tr>
<td>$\beta_{p,HML}$</td>
<td>-0.11</td>
<td>-0.17</td>
<td>-0.12</td>
<td>-0.11</td>
<td>0.02</td>
<td>0.00</td>
</tr>
<tr>
<td>$\beta_{p,MOM}$</td>
<td>-2.49</td>
<td>-3.76</td>
<td>-2.46</td>
<td>-2.38</td>
<td>0.64</td>
<td>0.05</td>
</tr>
<tr>
<td>$R^2$</td>
<td>0.74</td>
<td>0.7</td>
<td>0.66</td>
<td>0.69</td>
<td>0.8</td>
<td>0.7</td>
</tr>
<tr>
<td>N</td>
<td>211</td>
<td>211</td>
<td>211</td>
<td>211</td>
<td>200</td>
<td>188</td>
</tr>
</tbody>
</table>

**Panel B: “Small” target firms**

<table>
<thead>
<tr>
<th>Holding period (in months)</th>
<th>[+1,+12]</th>
<th>[+13,+24]</th>
<th>[+25,+36]</th>
</tr>
</thead>
<tbody>
<tr>
<td>$\alpha$</td>
<td>0.45</td>
<td>-0.04</td>
<td>0.40</td>
</tr>
<tr>
<td>$\beta_{p,RMRF}$</td>
<td>1.58</td>
<td>-0.13</td>
<td>1.07</td>
</tr>
<tr>
<td>$\beta_{p,SMB}$</td>
<td>0.73</td>
<td>0.77</td>
<td>1.01</td>
</tr>
<tr>
<td>$\beta_{p,HML}$</td>
<td>11.27</td>
<td>11.53</td>
<td>11.59</td>
</tr>
<tr>
<td>$\beta_{p,MOM}$</td>
<td>0.95</td>
<td>1.06</td>
<td>1.14</td>
</tr>
<tr>
<td>$R^2$</td>
<td>0.64</td>
<td>0.68</td>
<td>0.65</td>
</tr>
<tr>
<td>N</td>
<td>205</td>
<td>193</td>
<td>181</td>
</tr>
</tbody>
</table>

**Panel C: “Large” target firms**

<table>
<thead>
<tr>
<th>Holding period (in months)</th>
<th>[+1,+12]</th>
<th>[+13,+24]</th>
<th>[+25,+36]</th>
</tr>
</thead>
<tbody>
<tr>
<td>$\alpha$</td>
<td>0.06</td>
<td>0.08</td>
<td>0.40</td>
</tr>
<tr>
<td>$\beta_{p,RMRF}$</td>
<td>0.23</td>
<td>0.36</td>
<td>1.50</td>
</tr>
<tr>
<td>$\beta_{p,SMB}$</td>
<td>0.97</td>
<td>1.09</td>
<td>0.81</td>
</tr>
<tr>
<td>$\beta_{p,HML}$</td>
<td>16.93</td>
<td>22.06</td>
<td>13.13</td>
</tr>
<tr>
<td>$\beta_{p,MOM}$</td>
<td>0.43</td>
<td>0.37</td>
<td>0.71</td>
</tr>
<tr>
<td>$R^2$</td>
<td>0.68</td>
<td>0.77</td>
<td>0.68</td>
</tr>
<tr>
<td>N</td>
<td>206</td>
<td>194</td>
<td>180</td>
</tr>
</tbody>
</table>
Target Firm Performance in Years Before and After Targeting

\[ y_{i,t} = \sum_{j=-3}^{3} \gamma_j D_{i,j} + \beta_1 \ln(MV_{i,t}) + \beta_2 \ln(Age_{i,t}) + \beta_3 B/M_{i,t} + \alpha SIC + \alpha_t + \epsilon_{i,t} \]
Target Firm ROA before and after Activists Intervention

![Graph showing ROA changes over time with 95% confidence intervals.](image)
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

\[ y_{i,t} = \sum_{k=-3}^{3} \gamma_k d_{i,t} + \gamma \text{Control}_{i,t} + \alpha_j + \alpha_t + \epsilon_{i,t} \]
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?

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

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 it’s a terrible thing for corporate America. I think what we’re seeing is a replay of the attempt to drive American business to short-term results instead of long-term values”
References I


References II


References III


