Institute for governance
of private and public organizations

"Activist" hedge funds: creators of lasting wealth?
What do the empirical studies really say?

Yvan Allaire, Ph.D. (MIT), FRSC
Executive Chair, IGOPP
Emeritus Professor

François Dauphin, MBA, CPA, CMA
Project Director, IGOPP

(Opinions expressed herein are the sole responsibility of the authors)

Executive Summary

Hedge funds have found, in some academic circles, supporters and champions of their enduring contribution to shareholder wealth. Some recent empirical research has triggered an important debate in the American corporate/financial world about the role of board of directors, the rights of shareholders, and the very concept of the business corporation. The terms of the debate run as follows: Are boards of directors responsible for the long-term interest of the company? Or, are there lasting benefits from "activist funds" pushing and prodding reticent boards of directors to take actions these activists consider likely to create significant wealth for shareholders? What are the consequences of this "activism" for other stakeholders and for the very nature of board governance?

A wide range of observers with considerable financial experience and corporate expertise take a dim view of "activist hedge funds", lambasting them for their greed-fuelled short-term stratagems and their prejudicial influence on the long-term health of companies. Professor Lucian Bebchuk of the Harvard Law School, argue that these wise people, with loads of practical experience, have no "scientific" basis for their collective judgment that activist interventions are detrimental to the long-term interests of shareholders and companies. Having assembled reams of data and statistics, Bebchuk and his colleagues claim they have "scientifically" demonstrated that hedge funds are not "myopic activists", but on the contrary bring to corporations they target performance improvements which last long after they have exited the target company.

We carefully reviewed Bebchuk *et al.*'s paper and reached the following conclusions:

First, the authors have not demonstrated that activist hedge funds, per se, create lasting, long-term value and bring a long-term perspective to their "activism". They have merely shown some statistical relationships to provide (weak) support to their thesis. The weight of experience still trumps the results presented in Bebchuk *et al.*

Secondly, the most generous conclusion one may reach from these empirical studies has to be that "activist" hedge funds create some short-term wealth for some shareholders as a result of investors who believe hedge fund propaganda (and some academic studies), jumping in the stock of targeted companies. In a minority of cases, activist hedge funds may bring some lasting value for shareholders but largely at the expense of workers and bond holders; thus, the impact of activist hedge funds seems to take the form of wealth transfer rather than wealth creation.

Thirdly, "activist" hedge funds operate in a world without any other stakeholder than shareholders. That is indeed a *myopic* concept of the corporation bound to create social and economic problems, were that to become the norm for publicly listed corporations.

Finally, the Bebchuk *et al.* paper illustrates the limits of the econometric tool kit, its weak ability to cope with complex phenomena; and when it does try to cope, it sinks quickly into opaque computations, remote from the observations on which these computations are supposedly based.

Introduction

For some time now activist hedge funds have cultivated a revamped reputation as creators of lasting economic value for shareholders. Hedge funds have now found in some academic circles supporters and champions of their enduring contribution to shareholder wealth.

Some recent empirical research has indeed triggered an important debate in the American corporate/financial world, about the role of board of directors, the rights of shareholders, and the very concept of the business corporation.

The terms of the debate run as follows: Are boards of directors responsible for the long-term interest of the company? Or, are there lasting benefits from "activist funds" pushing and prodding reticent boards of directors to take actions these activists consider likely to create significant wealth for shareholders? What are the consequences of this "activism" for other stakeholders and for the very nature of board governance?

Simply stated, would a form of "direct democracy" whereby shareholders have a say in all important decisions of the company lead to better long-term corporate performance? That is the implicit claim of "activist hedge funds".

But, a wide range of observers with considerable financial experience and expertise take a dim view of "activist hedge funds", lambasting them for their greed-fuelled short-term stratagems and their prejudicial influence on the long-term health of companies.

Among those sharing this view, one finds top corporate lawyers, public officials, at least one SEC chairman, judges of the Delaware Chancery Court, senior corporate executives, legal academics, influential economists and business school professors, prominent business columnists, business organizations, and so on.

For instance, famed lawyer Martin Lipton, founding partner of Wachtell, Lipton, Rosen & Katz, describes what he sees as the consequence of this new variant of "shareholder activism":

"U.S. companies, including well-run, high-performing companies, increasingly face:

- *pressure to deliver short-term results at the expense of long-term value, whether through excessive risk-taking, avoiding investments that require long-term horizons or taking on substantial leverage to fund special payouts to shareholders;*

- *challenges in trying to balance competing interests due to excessively empowered special interest and activist shareholders; and*

- *significant strain from the misallocation of corporate resources and energy into mandated activist or governance initiatives that provide no meaningful benefit to investors or other critical stakeholders.*

These challenges are exacerbated by the ease with which activist hedge funds can, without consequence, advance their own goals and agendas by exploiting the current regulatory and institutional environment and credibly threatening to disrupt corporate functioning if their demands are not met." (Lipton, 2013a)

However, a group of academic researchers, most prominently, Professor Lucian Bebchuk of the Harvard Law School, argue that these wise people, with loads of practical experience, have no "scientific" basis for their collective judgment that activist interventions are detrimental to the long-term interests of shareholders and companies….Having assembled reams of data and statistics, Bebchuk and his colleagues claim they have "scientifically" demonstrated that hedge funds are not "myopic activists", but on the contrary bring to corporations they target performance improvements which last long after they have exited the target company.

He and his fellow researchers have recently published the results of a large empirical study on the topic. Bebchuk even wrote an op-ed in the Wall Street Journal (August 8th 2013) to herald their findings[1]. Here's how he summarizes their study's findings:

"The Myth of Hedge Funds as 'Myopic Activists' "

Our comprehensive analysis examines a universe of about 2,000 hedge fund interventions during the period of 1994-2007 and tracks companies for five years following an activist's arrival. We find that:

- *During the five-year period following activist interventions, operating performance relative to peers improves consistently through the end of the period;*

- *The initial stock price spike following the arrival of activists is not reversed in the long term, as opponents assert, and does not fail to reflect the long-term consequences of activism;*

- *The long-term effects of hedge fund activism are positive even when one focuses on the types of activism that are most resisted and criticized – first, those that lower or constrain long-term investments by enhancing leverage, beefing up shareholder payouts, or reducing capital expenditures; and second, adversarial interventions employing hostile tactics;*

1 Before their paper was reviewed by any professional journal, a rather unusual move. The paper is slated to appear in the December 2014 issue of the ***Columbia Law Review***.

- *The "pump-and-dump" claim that activists bail out before negative stock returns arrive is not supported by the data; and*

- *Contrary to opponents' beliefs, companies targeted by activists in the years preceding the financial crisis were not made more vulnerable to the subsequent downturn."*

(***Wall Street Journal***, August 8th, 2013)

The authors conclude their paper with the following recommendation:

"Our findings that the considered claims and concerns are not supported by the data have significant implications for ongoing policy debates. Policymakers and institutional investors should not accept the validity of the frequent assertions that activist interventions are costly to firms and their long-term shareholders in the long term. They should reject the use of such claims as a basis for limiting the rights and involvement of shareholders." (p.37)

The paper of Bebchuk, Brav and Jiang (2013) is quoted *urbi et orbi* as providing compelling evidence in favour of hedge fund activism; but does it really?

The Bebchuk *et al.* paper is heavily laden with statistics and econometric jargon. Those "wise" people who disagree with Bebchuk *et al.* are usually not versed in the arcane of statistical analysis and thus avoid a direct challenge of this "empirical evidence". Then, as the statistical analysis carried out by Bebchuk, Brav and Jiang abides by the conventional norms and typical methods of econometric studies, no criticism will likely come from specialists of the trade.

Thus, the paper's data, analysis, empirical claims and conclusions have not been thoroughly vetted.

EXPERIENCE VERSUS ECONOMETRICS?

Is econometric analysis a better lens through which to understand complex social or economic phenomena than the collective judgment of people expertly engaged with these phenomena?

For instance, anyone with a modicum of experience with the operations of real-life business organizations would list as factors influencing their performance: quality of management and leadership, talented workforce, quality of the products, effective marketing, excellence of the distribution channels, differentiation, lean operations, savvy and timely investments, customer service, etc.

Yet, the common practice in econometrics is to attempt to capture the influence of these complex factors through proxy or dummy variables. The various factors influencing the economic performance of a company are supposedly captured by *firm size* and its *age*[2] and a multitude of *dummy variables to approximate the dynamics of time, and the subtlety of industrial differences*, etc.

At best, these proxy variables assembled together in a generalized linear model can "explain" a small part of the variations in observed performance but in no circumstances should one claim that these variables have "caused" the observed performance.

Econometrics provides a crude tool kit, a weak lens through which the researcher can, at best, view the blurred contours of complex phenomena.

Imagine that a researcher had collected a thousand judicial decisions in criminal cases and wanted to build a regression model to "explain" the decisions of several hundred judges. It would be edifying to have a professor of law, Professor Bebchuk for instance, build such a model; what variables would have to be included to capture the nuances of every situation; would "dummy" variables suffice for that purpose? What conclusions of a policy nature could one draw from such a study?

That is perhaps the reason why the Harvard law school (and its business school) tends to teach law (or business) through cases with their manifold complexity and nuances.

2 Measured by the natural logarithm of the market capitalization and the natural logarithm of the firm's age.

A CRITIQUE OF THE BEBCHUK *ET AL.* PAPER

The Bebchuk paper's fundamental argument and main conclusion are derived from two tables based on 2,040 interventions[3] by activist activist hedge funds which were carried out sometime during the period from 1994 to 2007.

To assess the performance of these firms, the authors use two metrics: ROA (return on assets) and Tobin's Q (a common ratio calculated thus: the sum of the market value of equity and book value of debt, divided by the book value of equity and book value of debt).

Time "t" represents the year of the activist's "intervention", and subsequent years are identified as t+1, t+2, etc. up to the fifth year following the intervention.

The first table presents the descriptive data from the sampling of firms analyzed by the authors.

Table 1

Operating Performance Pre- and Post-Intervention

No Industry Adjustment

PANEL A: ROA

	t: Event Year	t+1	t+2	t+3	t+4	t+5
Average	0.022	0.034	0.038	0.048	0.049	0.046
Median	0.069	0.075	0.073	0.083	0.091	0.089
Observations	1,584	1,363	1,187	1,055	926	694

PANEL B: TOBIN'S Q

	t: Event Year	t+1	t+2	t+3	t+4	t+5
Average	2.039	1.975	2.003	2.052	2.095	2.160
Median	1.373	1.332	1.316	1.363	1.347	1.412
Observations	1,611	1,384	1,206	1,076	942	710

Source: Excerpt from Table 2 of Bebchuk, Brav and Jiang, 2013, p.8.

3 "Intervention" sounds almost like some psychological ministration but in fact merely means that a fund has filed a 13D report stating that it has accumulated 5% of a company's outstanding shares.

So, the average return on assets (ROA) of *1,584* firms calculated at the time of the "intervention" (that is, some in 1994, some in 1995 and so on until 2007) came out at 2.2% and at t+5, the average ROA of *694* firms is now 4.6%.

But they are not quite comparing apples with apples! Where did the 890 missing firms go? What would be their ROA? Did they disappear because of bankruptcy, acquisitions, liquidation or other discomfitures, with the healthier firms from t=event year, presumably with higher ROA, still around five years later? Or, which companies have been acquired, merged or delisted for whatever reason and what is the impact on overall statistical comparisons? The authors mention "normal" attrition rate without supplying any information about the impact of this attrition on their results.

In Panel B, results for Tobin's Q are reported, again with the sample shrinking from 1,611 observations to 710 by year 5. The median Q results indicate that the companies did not improve at all for four years and then show a small improvement in year 5 (Q=1.412), presumably (?) due to the "intervention" five years earlier of a hedge fund which has long exited the company. Whatever the case may be the authors report that none of the results in Table 1 are statistically significant.

They then proceed to compile the same statistics but in Table 2 adjusted to take into account the industrial sector. This standard procedure in econometrics serves presumably to eliminate the confounding effect of cross-industry variations. The adjusted metrics represent the average (or median) of the difference between the performance measure of a given firm and the average performance of firms in the same industrial sector (defined by 3-digits SIC code).

Table 2

Industry-Adjusted Operating Performance

Pre- and Post-Intervention

PANEL A : INDUSTRY-ADJUSTED ROA (benchmark = industry average)

	t: Event Year	t+1	t+2	t+3	t+4	t+5
Average	-0.028	-0.013	-0.010	-0.004	-0.005	-0.009
Median	-0.005	-0.002	0.001	0.000	0.005	0.002
Observations	1,584	1,363	1,187	1,055	926	694

PANEL B: : INDUSTRY-ADJUSTED Q (benchmark = industry average)

	t: Event Year	t+1	t+2	t+3	t+4	t+5
Average	-1.507	-1.369	-1.377	-1.329	-0.984	-0.935
Median	-0.748	-0.614	-0.540	-0.547	-0.470	-0.420
Observations	1,611	1,384	1,206	1,076	942	710

Source: Excerpt from Table 3 of Bebchuk, Brav and Jiang, 2013, p.9.

Apart from the same observation about the varying sample size over the years, what is most striking about these results is the large number of negative signs. The Tobin's Q improves but remains decidedly inferior to the mean Q of companies within the same industrial sector.

The median difference in the ROA of **1,584** companies at "intervention" time compared to the mean ROA of companies with the same SIC code came out as (-0.005); that is, these companies in need of the ministrations of hedge funds had a ROA performance minimally under the average performance of the companies in their industry overall. Five years later, the **694** companies remaining from the original sample now show a median ROA difference 0.002. So the positive impact of hedge funds, if that difference were really attributable to their intervention, would amount to going from a performance infinitesimally smaller than industry performance to a performance infinitesimally better than industry performance. These results are reported as "statistically significant" (which merely means that the difference is not zero) but are they significant from a managerial or investment perspective? Yet, that is the basis for the claim of Bebchuck quoted above:

During the five-year period following activist interventions, operating performance relative to peers improves consistently through the end of the period. (***Wall Street Journal***, August 8th, 2013)

The reduction in sample size between year 1 and year 5 raises significant issues; the authors of the paper should have been more transparent on what happened to the missing cases.

Part of the reason for the discrepancy may be found in another paper by two of the authors writing with Bebchuk. Using the same dataset[4], but for the period between 2001 and 2007, Brav, Jiang and Kim (2010) listed the breakdown of various forms of hedge fund exit. Their table reproduced below shows that, on average, close to 13% of the targeted firms disappeared from the sample because they were sold, merged or liquidated.

Table 3

Breakdown of exit

Categories	Hostile	Non-Hostile	All Events
1. Sold shares on the open market	20.8%	32.9%	29.5%
2. Target company sold	11.9%	4.9%	6.8%
3. Target company merged into another	8.2%	4.1%	5.2%
4. Liquidated	1.6%	0.7%	0.9%
5. Shares sold back to the target company	0.6%	0.4%	0.4%
6. Still holding/no Information	56.9%	57.0%	57.1%

Source: Brav, Jiang & Kim (2010), in *Hedge Fund Activism: A Review*

4 Curiously, the number of events varies between the two papers for the same period. There were, for the same time period, 1,172 events in the Brav, Jiang & Kim (2010) paper, compared to 1,283 in Table 2 of the Bebchuk, Brav & Jiang (2013) paper.

But there have to be other reasons as the sample in Bebchuk *et al.* shrinks by more than 50%!

Another reason might be linked to the rate of failed attempts at intervention by hedge funds. There is some evidence that failure rate hovers between 17% and 34% (See Brav, Jiang, Partnoy & Thomas, 2008; Klein & Zur, 2009). How these failed interventions were handled in the Bebchuk *et al.* paper is unclear. Of course, only "successful" interventions should be included in a study purporting to capture the impact of hedge fund intervention on company performance. Is it the case in the Bebchuk *et al.* paper? Not clear.

A close examination of their results raises additional questions:

- A higher Tobin's Q is not a demonstration of a firm's improved performance (Dybvig and Warachka, 2012). Write-downs of assets, of goodwill, reductions in capital investments and R&D that have no near-term impact on stock price also boost Tobin's Q. So will selling assets/divisions with low ROA but perhaps high expected growth in profit. For instance, the following figure (Figure 1) shows how an activist hedge fund could pressure management to sell assets D and E, call on them to pay a special dividend or buy back shares with the proceeds. The result would be a large increase in ROA and given a probable increase in stock price as a result, also a large increase in Tobin's Q. But even if stock price did not increase, Tobin's Q would still increase substantially. In the longer run though, having been shorn of its growth assets, the company would stagnate.

Figure 1

A company with five assets/divisions

- The adjustment for "industry peers", a common practice in econometric studies, brings up a host of problems rarely, if ever, mentioned in these econometric studies: in many instances, the "peers" are not really comparable companies; companies often operate in several 3-digit SIC classification; newer types of companies are difficult to classify in this old classification (e.g. Google, Facebook, etc.). Indeed, since 1997, a new system, the North American industrial classification system (NAICS), has been developed to replace SIC codes; "*NAICS codes provide a greater level of detail about a firm's activity than SIC codes… There are 358 new industries recognized in NAICS, 250 of which are services producing industries. Additionally, NAICS codes are based on a consistent, economic concept, while SIC codes are not*". Canada has shifted totally to the NAICS while the U.S. is doing so gradually.

- Bebchuck *et al.*'s research spans the period 1994 to 2012 during which economic conditions fluctuated wildly, the industrial make-up of the American economy shifted dramatically; yet, as is the standard practice in econometric research, all these influences are deemed captured by "dummy variables". That may be good enough to publish papers in professional journals but not good enough to get at causality and capture complex relationships; that statistical device is a crude, approximate attempt at taking into account subtle, interactive, non-linear phenomena. The introduction of "firm fixed effect" is particularly questionable; the authors write: *In regression (2) we include **a dummy for each firm**, running a firm fixed effect regression, to account for time-invariant factors unique to each firm. Under such a specification, the coefficients on the key variables, t, t+1,…, t+5, should be interpreted as the excess performance of a target firm, during years t to t+5, over its **own all-time average** and adjusted for market-wide conditions (due to the year fixed effects). Firm fixed effects automatically subsume industry fixed effects.* (Emphasis added). In "*Hedge Fund Activism, Corporate Governance, and Firm Performance*", Brav, Jiang, Partnoy & Thomas mention that "for the period 2001 to 2006 […], the target companies span 183 three-digit SIC code industries." That means there are at least 182 dummy variables in the regressions for industry fixed effects. The authors never explain how the original sample of 2,040 interventions observed for 8 years (thus leading to some 16,320 observations) turns into some **120,000** observations (!) for the purpose of regression analysis. The paper utterly lacks transparency about the many unobserved decisions made by the authors in the course of their analysis.

- In their regression analysis, the authors use the natural logarithm of the age of the firm as control variable. In the literature, this variable is frequently used; the well-known relationship is that as firms grow older, the ROA tends to decrease. What is interesting to observe is that the coefficient of Ln(Age) is **positive** and statistically significant on all the regressions using ROA as dependent variable, a result completely at the opposite of what previous studies have established. The authors give no explanation for this surprising result, which may be an indication of a common, but serious, econometric problem called "multicollinearity", making the interpretation of all coefficients subject to great caution.

- The methodology used by Bebchuk *et al.* does not provide proof or causal relationships of the benefits of hedge fund "intervention". [Actually, no econometric study ever does.] For instance, the pattern of changes in ROA and Tobin's Q reproduced here as Tables 1 and 2 is consistent with typical historical or cyclical patterns of company performance.

  The graphs in Figure 2 illustrate this point. By mapping the return on invested capital (ROIC, a close equivalent of ROA) and enterprise value over invested capital (EV/IC, a close equivalent to Tobin's Q) for 743 firms from 2001 to 2009, McKinsey and Co. found a clear pattern of convergence towards the mean. Firms which showed performances better than average at the beginning of the period tended to do less well eight years later. Firms at the bottom in terms of performance moved closer to the average performance.

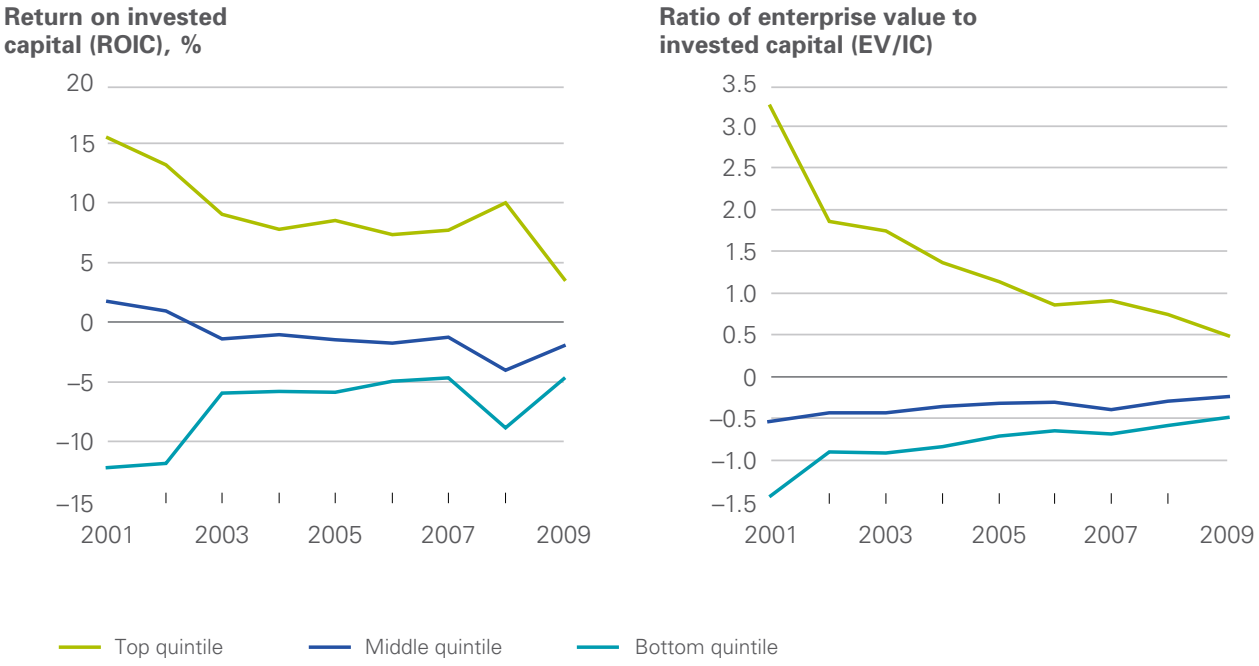
  The bottom line in these two graphs is virtually identical to the results presented above as Tables 1 and 2 drawn from Bebchuck *et al.* Yet, there were no generalized hedge fund "intervention" in the data collected by McKinsey; only the dynamic interplay of competition as the advantage of the best-performing firms is eroded by imitation by other firms and best industry practices gradually become the norm and standard for all players (Bradley, Hurt and Smit, 2011).

Figure 2

Market and economic forces drive convergence of performance towards the mean

Markets drive a reversion to mean performance

Performance cohorts based on position in 2001 relative to mean, n = 743*



*Sample of largest 1,200 nonfinancial US-listed companies in 2009 was narrowed to 743 that were also listed in 2001.

Source: Standard & Poor's Compustat; McKinsey analysis

STOCK PRICE IN THE SHORT AND LONG TERM?

The authors of the paper claim that, not only does the stock price of targeted companies increases in the short term, but that this price increase persists for 36 months or 60 months after the "intervention".

They never show actual stock prices but proceed by statistical estimations of "alpha" in the well-known capital asset pricing models (CAPM) and the Fama-French four-factor model. This "alpha" is supposed to capture the value added over and above the market risk and other factors that may influence stock price.

Again, the number of treatments[5], estimations and assumptions going into producing their results are mind-numbing. Here's an example:

Specifically, for each event, we compute the buy-and-hold return over a predetermined holding period after the intervention net of a benchmark return that is meant to capture the event firm's expected return. In particular, for each event firm, we use information on its pre-event market capitalization and book-to-market to match it *to one of the Fama and French 25 size and book-to-market value-weight portfolios.* **[Question: why is a company's future stock performance supposed to behave in the same way as companies that have similar market capitalization and book-to-market valuation, but may come from different industries?]**

Since the target firm's market capitalization and book to market ratio change over the subsequent holding period we allow the benchmark portfolio to change by using the new firm attributes in every subsequent year. **[So, every year the stock market performance of the target firm is compared to that of a new set of companies!]** *In those cases in which a target firm is missing a book to market ratio in a given year we impute the value from the previous year and if, missing, two years earlier.* **[What is the impact of this treatment?]** *Finally, if a target firm delists prior to the chosen investment horizon we reinvest the proceeds in the market portfolio (the Fama and French value weight portfolio, "RM") and similarly reinvest the benchmark return to that point in the market as well.* **[How many target firms were delisted? What is the "proceeds"? How many were delisted because of acquisitions? How does the study take into consideration the fact that these acquired companies would have benefited from a control premium? What were the consequences of this treatment on results?]** (Bebchuk *et al.*, 2013)

After an examination of these statistical treatments, assumptions and approximations, the "scientific" character of these empirical studies appears dubious. Perhaps, Bebchuk should not be so dismissive of actual real-world experience.

5 It is curious that for their estimation of stock price performance, the authors manage to retain some 1397 firms after five years but for the ROA/Q computations reported in Tables 1 and 2, the number of cases dropped to 694 and 710 after five years. Can it be that more than 600 companies were "delisted" and the authors "reinvest the proceeds in the market portfolio and similarly reinvest the benchmark return to that point in the market as well"? The net effect of these treatments cannot be assessed without more information. Some explanation and detailed divulgation would have been welcome here.

ACTIVIST HEDGE FUND: LONG-TERM OR SHORT-TERM INVESTOR?

The Bebchuk *et al.* paper is discreet about the length of time that hedge funds remain engaged with target companies. But, in another study based on the same data set, the authors, Brav, Jiang and Kim (2010) provide this useful information: the duration (in days) of hedge fund activists' investment in target companies.

The results reproduced in the Table 4 below show that half of the interventions, from the first Schedule 13D filing to divestment, had duration of 266 days or less (not even 9 months). Claiming that these are long-term "investors" seems a bit of a stretch. It is even more of a stretch to credit these activist funds for a favourable, enduring effect on the performance of a firm 3 to 4 years after their departure.

Table 4

Length of Holding Period (Days) for Completed Spells

Percentile	Hostile (Initial)	Non-hostile (Initial)	All Events
5%	11	23	22
25%	96	141	126
50%	229	285	266
75%	439	504	487
95%	840	1,273	1,235

Source: Brav, Jiang & Kim (2010), in *Hedge Fund Activism: A Review*

VALUE CREATION OR VALUE TRANSFER?

Assuming for a moment that "interventions" by activist hedge funds produce positive (or "abnormal") returns at least in the short term[6] and possibly in the longer term, the question becomes: where did this added value come from? Certainly the data reported above on the ROA improvement do not explain stock price improvement.

Several studies actually show that there is no "creation" of value, but rather a "transfer" of value in favour of the shareholders from employees (Brav, Jiang and Kim, 2010, 2013) and bondholders (Klein and Zur, 2009).

Brav, Jiang and Kim (2013), two of them co-authors of the Bebchuk paper and thus strong supporters of the benefits of activist hedge funds, must nevertheless acknowledge that:

> *Overall, results in this section suggest that target firm workers do not share in the improvements associated with hedge fund activism. They experience a decrease in work hours and stagnation in wages, while their productivity improves significantly. Moreover,* ***the relative decrease in productivity-adjusted wages from above-par levels suggests that hedge fund activism facilitates a transfer of "labor rents" to shareholders which may account for part of the positive abnormal return at the announcement of hedge fund interventions.*** (Brav et al, 2013, p.22, emphasis added)

This "admission" provides a counterpoint to the fawning description of the whole undertaking: *create value for shareholders by taking it from workers!*

Other studies show that the value created for shareholders comes in part at the expense of bond holders.

"For our sample, on average, bondholders lose an average excess return of -3.9% around the initial 13D filing, and an additional -4.5% over the remaining year after the filing date...We also find evidence suggesting an expropriation of wealth from the bondholder to the shareholder". (Klein and Zur, 2009)

Aslan and Maraachlian (2009) also claim that existing bonds of companies that were targeted by the activist investors performed more poorly than a portfolio of comparable bonds by a difference of 5% per year on average for the two years following the announcement of the intervention, in addition to being more likely to undergo a ratings downgrade.

"Collectively, our results indicate that activism is viewed negatively by bondholders in the long-run and that part of the overall gain to stockholders is the result of a wealth transfer from bondholders". (Aslan and Maraachlian, 2009)

These empirical results reveal a more sombre reality than that painted by the new admirers of these activist "benefactors".

6 The more academic researchers claim to have proven the benefits to shareholders from "activist interventions", the more likely and the stronger will markets react to the news that a hedge fund has taken a position in a target company!

CONCLUSIONS

What conclusions can one draw from these various considerations?

First, Bebchuk *et al.* have not demonstrated that activist hedge funds, *per se*, create lasting, long-term value and bring a long-term perspective to their "activism". They have merely shown some contorted statistical relationships to provide some (weak) support to their thesis.

Their paper provides little "scientific" support for their categorical final recommendation:

"Policymakers and institutional investors should not accept the validity of the frequent assertions that activist interventions are costly to firms and their long-term shareholders in the long term. They should reject the use of such claims as a basis for limiting the rights and involvement of shareholders."

Policy makers should weigh the experience and expertise of knowledgeable people rather more than tortured statistics.

Secondly, the most generous conclusion one may reach from these empirical studies has to be that "activist" hedge funds create some short-term wealth for some shareholders (and immense riches for themselves) as a result of investors, who believe hedge fund propaganda (and some academic studies), jumping in the stock of targeted companies. In a minority of cases, activist hedge funds may bring some lasting value for shareholders but *largely at the expense of workers and bond holders*; thus, the impact of activist hedge funds seems to take the form of wealth transfer rather than wealth creation.

Thirdly, "activist" hedge funds operate in a world without any other stakeholder than shareholders. That is indeed a *myopic* concept of the corporation bound to create social and economic problems, were that to become the norm for publicly listed corporations.

Finally, the Bebchuk *et al.* paper illustrates the limits of the econometric tool kit, its weak ability to cope with complex phenomena; and when it does try to cope, it sinks quickly into opaque computations, remote from the observations on which these computations are supposedly based.

REFERENCES

- Aslan, H. & H. Maraachlian. (2009) "Wealth Effects of Hedge Fund Activism". *SSRN Working Paper Series*.
- Bebchuk, L. A., A. Brav & W. Jiang. (2013) "The long-term effects of hedge fund activism" *Columbia Business School*, July, 40p.
- Becht, M., J. Franks, J. Grant & H. Wagner. "The Returns to Hedge Fund Activism: An International Study". *European Corporate Governance Institute Working Paper Series in Finance*, No 402/2014.
- Borstadt, L. & T. Zwirlein. (1992) "The Efficient Monitoring Role of Proxy Contests: An Empirical Analysis of Post-Contest Control Changes and Firm Performance". *Financial Management*, Vol. 21, No. 3.
- Bradley, C, M. Hirt & S. Smit. (2011) "Have you tested your strategy lately?". *McKinsey Quarterly*, January.
- Bratton, William W. "Hedge Funds and Governance Targets". Georgetown Law Journal, Vol. 95, p. 1375; SSRN No 928689, August 11, 2010
- Brav, A. W. Jiang & H. Kim. (2013) "The Real Effects of Hedge Fund Activism: Productivity, Asset Allocation, and Industry Concentration". *SSRN Working Paper Series*.
- Brav, A., W. Jiang, F. Partnoy & R. Thomas (2008) "Hedge Fund Activism, Corporate Governance and Firm Performance". *The Journal of Finance*, Vol. 63, no. 4, 1729-1775.
- Brav, A., W. Jiang & H. Kim. (2010). "Hedge Fund Activism: A Review". *SSRN Working Paper Series*.
- Brav, Alon, Michael Bradley, Itay Goldstein and Wei Jiang, "Shareholder Activism and Price Dynamics: Evidence from Closed-End Funds", Duke University, University of Pennsylvania, and Columbia University, Working paper 2007
- Dos Santos, J. & C. Song. (2009). *Analysis of the Wealth Effects of Shareholder Proposals – Volume II*. U.S. Chamber of Commerce, May, 25p.
- Dybvig, P. H. & M. Warachka (2012). "Tobin's q Does Not Measure Firm Performance: Theory, Empirics, and Alternative Measures". *SSRN Working Paper Series.*
- Fleming, M. J. (1995) "New Evidence on the Effectiveness of the Proxy Mechanism" *Federal Reserve Bank of New York*, Research Paper No. 9503.

- Greenwood, R. & M. Schor. (2007) "Hedge fund investor activism and takeovers" *Harvard Business School*, July, 08-004.

- Ikenberry, D. & J. Lakonishok. (1993) "Corporate Governance through the Proxy Contest. Evidence and Implications." *Journal of Business*, vol 66, no 3, 405-435.

- Ingraham, A. T. & A. Koyfman. (2013) *Analysis of the Wealth Effects of Shareholder Proposals – Volume III*. U.S. Chamber of Commerce, May, 25p.

- Karpoff, J. M., P. H. Malatesta & R. A. Walkling. (1996) "Corporate Governance and Shareholder Initiatives: Empirical Evidence". *Journal of Financial Economics*, Vol. 42, 365-395.

- Klein, A. & E. Zur (2009). *The Impact of Hedge Fund Activism on the Target Firm's Existing Bondholders*. *SSRN Working Paper Series.*

- Lipton, M. (2007) "Shareholder Activism And The 'Eclipse of The Public Corporation'" *The Corporate Board*, May/June.

- Lipton, M. (2013a). "Empiricism and Experience; Activism and Short-Termism; the Real World of Business". *The Harvard Law School Forum on Corporate Governance and Financial Regulation*, October 28.

- Lipton, M. (2013b). "The Bebchuk Syllogism". *The Harvard Law School Forum on Corporate Governance and Financial Regulation*, August 26.

- Macey, J. & E. Buckberg (2009). *Report on Effects of Proposed SEC Rule 14a-11 on Efficiency, Competitiveness and Capital Formation*. NERA Economic Consulting, August 17, 29p.

- Prevost, A. K. & R. P Rao. (2000). "Of What Value Are Shareholder Proposals Sponsored by Public Pension Funds". *The Journal of Business*, Vol. 73, No. 2.

- Romano, R. (2001). "Less is More: Making Institutional Shareholder Activism a Valuable Mechanism of Corporate Governance". *Yale Law School, Faculty Scholarship Series*. Paper 1916.

- Strine, Jr., L. E. (2010). "One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?" 66 Business Lawyer 1, November, 32p.

- Strine, Jr., L. E. (2014). "Can we do better by ordinary investors? A pragmatic reaction to the dueling ideological mythologists of corporate law". *Columbia Law Review*, Vol. 114, 449-502.

- Wahal, S. (1996). "Pension Fund Activism and Firm Performance". *Journal of Financial Quantitative Analysis*, Vol. 31, No. 1, 1-23.

About IGOPP

THE REFERENCE IN GOVERNANCE MATTERS

Created in 2005 by two academic institutions (HEC Montréal and Concordia University – The John Molson School of Business) and the Stephen Jarislowsky Foundation, the Institute for governance (IGOPP) has become a centre for excellence about governance of public and private organizations. Through research, training programs, policy papers and participation in public debates, IGOPP has become a key reference on all issues of governance in the private and public sectors.

OUR MISSION

- Strengthen fiduciary governance in the public and private sectors;
- Make organizations evolve from a fiduciary mode of governance to a **value-creating governance®;**
- Contribute to debates, and the solution, of governance problems by taking positions on important issues and by a wide dissemination of information and knowledge about governance.

OUR ACTIVITIES

The Institute's activities focus on the four following areas:

- **Policy papers**
- **Training**
- **Research**
- **Knowledge dissemination**

This article is available online in PDF format at www.igopp.org

Design: Karine Bellerive

1000 De la Gauchetière St. West, Suite 1410, Montréal (Québec) H3B 4W5

Telephone 514.439.9301 | **Fax** 514.439.9305 | **info@igopp.org** | **www.igopp.org**

Institute for governance
of private and public organizations