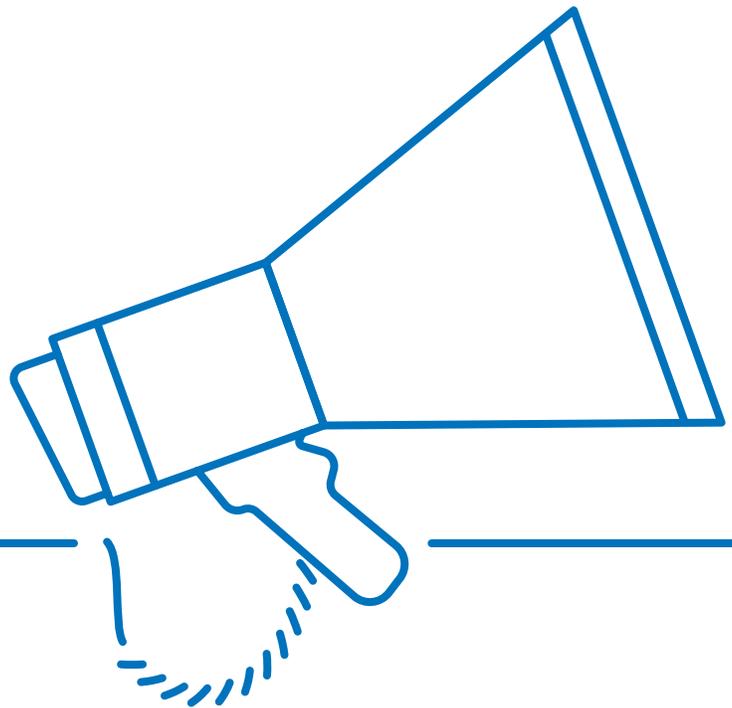




FCLTGLOBAL
FOCUSING CAPITAL
ON THE LONG TERM



REPORT

Making the Call

THE ROLE OF LONG-TERM
INSTITUTIONAL INVESTORS
IN ACTIVISM

FCLTGlobal is dedicated to rebalancing investment and business decision-making towards the long-term objectives of funding economic growth and creating future savings.

FCLTGlobal is a not-for-profit dedicated to developing practical tools and approaches that encourage long-term behaviors in business and investment decision-making. It takes an active and market-based approach to achieve its goals. By conducting research and convening business leaders, FCLTGlobal develops tools and generates awareness of ways in which a longer-term focus

can increase innovation, and create value. FCLTGlobal was founded in 2016 by BlackRock, CPP Investments, Dow, McKinsey & Company, and Tata Sons out of the Focusing Capital on the Long Term initiative. Its membership encompasses asset owners, asset managers and corporations from around the world.

MEMBERS



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Executive Summary

The prevailing wisdom is that activist investors can drive corporate short-term behavior themselves. The prevailing wisdom is wrong. At just 0.3% of total global equity assets under management (AUM) in 2018,¹ activists depend on the support of long-term investors for their influence.

Without clarity on long-term shareholders' views, companies perceive short-term pressure coming from their investors, and assume the activists speak for the entirety of the shareholder register. Having a strong investor/corporate dialogue well before an activist campaign arises is the way to encourage companies to proactively improve the drivers of long-term value creation—such as bolstering their governance, honing strategies for growth, and engaging with long-term investors. Strong long-term performance is the best way to limit opportunity for an activist campaign. Indeed, rather than being a spectator, long-term investors have a significant role to play alongside companies to counteract short-term activist behaviors. It is well within the power of these long-term investors to either amplify or dampen the short-term impact of activism, serving as essential players of the activism 'game.'

- **Despite their relatively small AUM, activists are an important and growing influence on companies' short- or long-term behavior globally.** Activists have different goals, time horizons, risk profiles, and levels of engagement than most long-term shareholders. These differences can unduly compress corporate time horizons, at times to the detriment of long-term value creation.
- **Many activists choose to emphasize the short term at the expense of the long term, perhaps as a result of their event-driven orientation and comparatively higher discount rates.** Activists run the gamut from long-term-oriented to short-term-oriented and employ a range of tactics. Research on whether activists create long-term

value is mixed, and comparisons are unreliable, given the widespread prevalence of activism in the US market. It is clearer that activist hedge funds discount future cash flows more than other shareholders, favoring corporate strategies that generate near-term results. Given that short-term and long-term shareholders can have very different objectives, it is critical that long-term investors carefully consider their support of activist investors.

- **Investors and companies can mitigate the short-term impact of activism by preparing for and responding to activist campaigns in ways that emphasize long-term value.** Asset owners could evaluate whether to invest in activist funds and, if so, only under terms that encourage longer-term behavior. Asset managers and asset owners have the opportunity to decide whether and under what conditions to vote with activists, lend their shares to activists, engage with activists, and engage with companies that activists target. Companies can gauge whether improvements in the key drivers of long-term value, such as bolstering their governance, honing strategies for growth, and engaging with long-term investors, would preempt an activist campaign.

In the activist game, long-term investors often determine the final score.

Making the Call: The Role of Long-term Institutional Investors in Activism

Activists are a commonly cited driver of corporate short-term behavior, yet they generally don't own enough shares to effect change alone. At 0.3% of managed equities,² activists need the support of long-term asset owners and asset managers for their campaigns to succeed. For companies, bolstering their governance, honing strategies for growth, and engaging with long-term investors can lay the groundwork to withstand activist attacks. With the right approach, it is well within the power of long-term investors to mitigate the short-term impact of activism.

Driving Short-term Behavior?

Activism—when an individual or group purchases a meaningful portion of a public company's shares and/or tries to obtain seats on the company's board to effect significant change within the company—is a key influence on corporate behavior. Activists are typically driven by perceived weak corporate governance or management or by a strategic

difference of opinion. In rare instances, they are even invited in by significant investors frustrated with a company's performance via a "request for activism" (RFA). Activists can take a variety of approaches—negotiations with management, shareholder resolutions, and proxy battles—and exercise them alone or in combination and with varying degrees of aggression and success. **According to McKinsey & Co. research, just 24.9% of activist proxy battles that went to a vote resulted in an activist win⁶—defined as a campaign where management (independently or through shareholder vote) met all activist demands. For companies earning >\$1 billion in annual revenue this number was 26.2%.⁷**

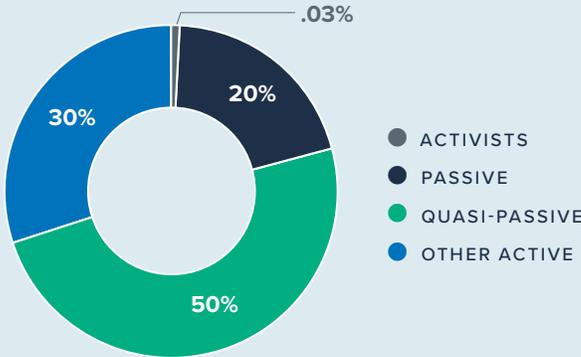
Activists differ from most long-term shareholders in a number of meaningful ways.

Goals: Activists often seek to change both governance and strategy at target companies, rather than focusing on analyzing companies and determining whether to buy or sell shares based on the strategy management has already set out. This leads to different levels and types of engagement.

Defining Activism

Activist hedge funds ("activists") typically use an equity stake in a company to put pressure on its management team to effect a significant change. Activists are commonly driven by a perceived opportunity to improve corporate governance or management or by a strategic difference of opinion; today they are occasionally also driven by environmental and social issues. While the terms "activist" and "activism" can be more broadly applied, for the purposes of this research we use these terms in reference only to engagements or campaigns that are primarily event-driven and financially motivated.³

Figure 1. Total Managed Equity AUM, 2018^{4,5}



Portfolio concentration: Activists have more concentrated portfolios than most investors, creating different risk profiles and driving different behaviors as a result.

Orientation: Activists tend to be deal-driven, often looking to create near-term catalysts for a change in control.

Fee structures: Activists have a higher share of incentive pay and similarly higher discount rates than

other asset managers. This structure incentivizes greater risk-taking and a shorter-term mindset among activist hedge funds.⁸ That short-term mindset inspires activists to pressure management teams to deliver results more quickly—arguably compressing corporate time horizons and making optimal long-term returns more elusive.

All of these differences affect corporate behavior in response to or in anticipation of an activist campaign.

ACTIVISM IS GROWING AND AFFECTING TRADITIONAL ASSET MANAGEMENT

Activism is growing, spreading internationally, and impacting traditional asset management. Worldwide, activist engagement, as well as the use of activist-style tactics by traditional asset managers, is steadily increasing. In 2019, for the first time, Japan was the most-targeted non-US jurisdiction, with 19 campaigns and \$4.5B in capital deployed (both numbers acquired from local records).^{9,10,11}

	2017	2018	2019
 Investors Engaging in Activism	109	131 +20%	147 +12%
 First-time Activist Investors	23	40 +74%	43 +8%
 Companies Targeted by Activists	188	226 +20%	187 -17%
 Board Seats Won by Activists	103	161 +56%	122 -24%

Despite their relatively small size, activists have an outsized impact on corporate executives and boards. To illustrate, from 2010 to 2015, half of the S&P 500 had an activist fund on its share register, and one in seven companies had been on the receiving end of an activist campaign.¹² In addition, 21% of the S&P 500 was approached publicly by an activist shareholder in 2016,¹³ versus a record

45%, which were targeted by activists just two years later, in 2018.¹⁴ With activist engagement numbers that high, it's not surprising that investor relations professionals most commonly identified activism as one of the top two most impactful challenges (along with environmental, social, and governance issues) facing their profession 2019.¹⁵

ACTIVIST TACTICS

Activists run the gamut from long-term-oriented to short-term-oriented and employ a range of behaviors from constructive to questionable.

CONSTRUCTIVE

Share new ideas and analysis with company management and shareholders privately

Provide institutional investors with governance options they can respond to

Encourage effective monitoring of strategy or boards

QUESTIONABLE

Public statements of alternative strategies

Resorting to resource-intensive proxy battles

Requesting reimbursement of legal expenses or other cash payments

Collecting or threatening to release information about management or the board

Personal attacks on management or board members or their families

Net short debt activism¹⁸

THOUGHTFUL REGULATORS ARE TAKING ACTION TO CURB EXCESSIVE SHORT-TERM ACTIVISM

Activists have drawn the attention of global leaders, inspiring French and Japanese authorities to take regulatory action.

In April 2020, French regulators came out strongly against short-term activist behaviors, yet also emphasized that certain types of activism can be good for the market and target companies. “Shareholder involvement in the corporate life of an issuer is necessary for its satisfactory functioning. It has accordingly been encouraged by the regulator. The challenge raised by activist practices is not how to prevent activism, but how to control its excesses.”¹⁶

Similarly, in November 2019, Japanese authorities passed a bill that requires foreign investors to notify authorities before their holdings in potentially sensitive sectors reach one percent (lowering the notification threshold from the prior ten percent level). The law brings Japanese regulation into alignment with the US Foreign Investment Risk Review Modernization Act and was partially in response to increasing activist engagement in the country.¹⁷

Adding Long-term Value or Prioritizing the Short Term?

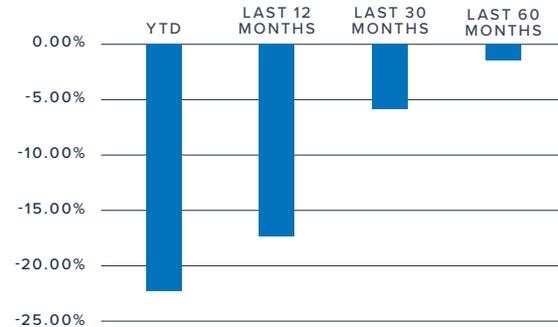
It is widely acknowledged that activists can encourage long-term value creation through detailed research and analysis, new ideas, and discipline. When activists engage with an undermanaged company, there can be an opportunity to add value for both short- and long-term shareholders. However, evidence on whether and how often activists indeed create value is thin. First, practitioner evidence is inconclusive. McKinsey finds that the median activist campaign for large companies reverses a downward trajectory in target-company performance and generates excess shareholder returns for at least three years.¹⁹ By contrast, a Lazard study found companies targeted by activists underperformed their benchmark indices in Europe.²⁰

Second, academic evidence on whether activism creates long-term value is inconclusive, due to the prevalence of activism, especially in the US market.²¹ The studies that find a positive long-term impact of activism for the typical shareholder are equally weighted, and the positive impact of activism is based on the smallest 20% of firms by market value—so small, in fact, that this cohort had an average market value of just \$22 million.²² The larger 80% of firms experience insignificant negative long-term returns.²³ One notable exception took activist target company size into account and found that activist hedge funds do not destroy long-term value, defined as a five-year return on assets following the activist attack.²⁴ Comparisons are also problematic. Since activism has been prevalent in the US markets—the focus of the majority of activist studies—for decades, and activist campaigns on peers also shape company behavior²⁵, it is difficult to compile a control group of firms that are not affected by activism.

Finally, taken as a group, the performance of activist hedge funds themselves has been poor. As demonstrated by the HFRI® Event-Driven Activist

Index, activist funds have underperformed on a one-, three-, and five-year basis in terms of annualized performance.²⁶

Figure 2. HFRI: Event-driven Activist Index Annualized Performance (as of April 2020)



Notably, we could not find academic evidence of long-term value creation by activists. By contrast, academic research more clearly demonstrates that activist hedge funds almost exclusively prefer shorter-term returns. Activist hedge funds represent an extreme among shareholders in discounting future cash flows more heavily than other shareholders, due to the greater uncertainty of valuing long-term outcomes within their shorter time horizons.²⁷ This, in turn, may shorten corporate time horizons, thereby triggering corporate executives and boards to prioritize actions that yield more immediate financial returns at the expense of greater long-term value creation. Indeed, activists could increase long-term value in some situations, but often opt to “bring earnings forward” instead.

Figure 3. Increasing Long-term Value

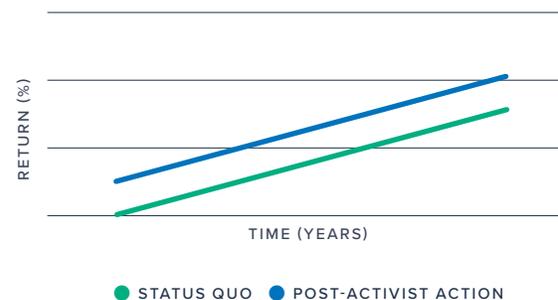
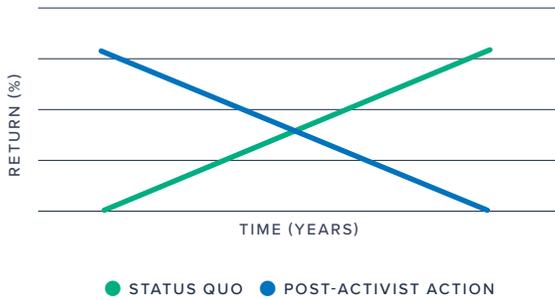


Figure 4. Bringing Earnings Forward



These findings emphasize the roles that different shareholders play in balancing a firm’s short- and long-term financial and non-financial priorities.²⁸ In fact, it is difficult, if not impossible, for a corporate management team to please both short-term and long-term shareholders in its strategic decision-making, making it even more critical for long-term investors to make their own interests clear and carefully consider under what conditions to engage with, invest with, and support activists.

Tools to Mitigate the Short-term Impact of Activism

Asset owners determine whether to invest in activist funds and, if so, under what terms. Asset owners and asset managers must decide whether and under what conditions to vote with activists, lend their shares to activists, engage with activists, and engage with companies that activists target. Shareholder support for activist campaigns is often based on the relative reputations for long-term value creation of the activist and the company engaging with the activist. Activists have built their reputations for building long-term value through prior deals and actions. Long-term investors who vote with activists, and asset owners who invest with activists, legitimize the behaviors of those activists and expose themselves to potential reputational risk by such association.

CONSIDERATIONS FOR CORPORATIONS

The proliferation of activist engagement over the past two decades has inspired many companies to anticipate activist attacks and plan for such contingencies. Companies considering such preparation can gauge whether improvements in the key drivers of long-term value, such as bolstering their governance, honing strategies for growth, and engaging with long-term investors, would improve their long-term performance and forestall an activist campaign.

But it isn’t just reputation that is on the line with these decisions. As demonstrated, the evidence for activists adding long-term value is thin. For investors with particularly long time horizons, activist tactics that pull forward earnings—cannibalizing future growth opportunities or starving them of growth capital in favor of juicing near-term earnings—can have a negative impact on long-term returns. Encouraging such behavior is not aligned with the stewardship and fiduciary goals of most long-term investors.

With the right tools, long-term asset managers and asset owners can provide an important counterbalance to activist pressure to shorten corporate time horizons. Since activists rely on asset owners as their source of funds and on other significant shareholders and asset managers for support, long-term owners and managers have a significant role to play when it comes to mitigating the short-term impact of activism. In the pages that follow, we lay out a framework for use in evaluating these decisions and taking action to counterbalance questionable activist tactics.

Conclusion

Activists are an important and growing influence in capital markets worldwide. With different levels of engagement, time horizons, risk profiles, and goals than most long-term shareholders, activist investors often have motivations that are not aligned with the interests of long-term investors. Activists can add long-term value to undermanaged target companies, but many emphasize the short term at the expense of the long term. However, while activists are often described as driving corporate short-term behavior, they depend on long-term investors for their influence.

These findings emphasize the function that different shareholders have in balancing a firm's short- and long-term financial and non-financial priorities.²⁹ With the right tools, long-term asset managers and asset owners can counterbalance activist short-term pressure—and companies can proactively improve the drivers of long-term value creation to remove underperformance as the incentive for an activist campaign. More broadly, asset owners, asset managers, and corporations can mitigate the short-term impact of activism by engaging in a constructive ongoing dialogue in ways that emphasize long-term value.

Mitigating Short-term Activism: Areas for Focus

Long-term Asset Owners

Long-term asset owners can determine whether to support activists at all, choose to invest only with appropriate activists, and influence the behavior of activists in advance of any campaign.

ASSET OWNERS CAN	TO MITIGATE SHORT-TERM BEHAVIOR
<p>Determine whether to support activists at all</p>	<ul style="list-style-type: none"> • Inclusion or exclusion of allocations to activists • Stance on lending shares to activists
<p>Evaluate activists' behavior on key issues and reputation</p>	<ul style="list-style-type: none"> • Company leverage levels • Average activist holding periods • Target company CEO references from prior campaigns • Approach to settlement agreements³⁰ • Timeline between first contact and public disclosure of positions or demands • Personal attacks on management or board members
<p>Prohibit certain actions</p>	<ul style="list-style-type: none"> • Collection or release of personal information about management, the board, or their families • Net short debt activism • Request for reimbursement of legal expenses or other cash payments
<p>Incorporate long-term mandate language</p>	<ul style="list-style-type: none"> • Long-term performance fees • Ability to redeem LP units in kind to allow activists to lock up shares • Reporting requirements on tactics used • For more on the topic see Institutional Investment Mandates
<p>Proactively engage with companies</p>	<ul style="list-style-type: none"> • Understand investee core issues • Provide investees with clear and direct feedback on areas for improvement, subject to regulatory constraints • For more on this topic see Driving the Conversation: Long-Term Roadmaps for Long-Term Success • Engage with companies in adherence with long-term stewardship principles

Long-term asset owners can evaluate and influence the outcome of activist campaigns underway.

ASSET OWNERS MUST DECIDE	ISSUES FOR CONSIDERATION
Whether to vote with activists	<ul style="list-style-type: none">• Effect of campaign on long-term strategy and value creation• Effect of campaign on total exposure to the company (both debt and equity)• Alignment with community or stewardship responsibilities• Evaluation of reputations of the activist and target corporation• Assessment of proxy advisor recommendation• Evaluation of independence and incentive alignment of activist-nominated board candidates
How to engage with corporate targets	<ul style="list-style-type: none">• Perspective on settlement agreements• Aspects of the activist feedback viewed as constructive or destructive to long-term value creation• Company plans to address or refute issues raised, including timeline and milestones• Preference for direct engagement or via asset managers• Provision of advance notice of voting intention where possible
How to engage with activists	<ul style="list-style-type: none">• Analysis of company and strategic recommendations• Analysis of activist's net exposure to the company (debt, equity, and hedges)• Industry expertise of activist or proposed board candidates• Timeline and share lockup commitments• Target company CEO references from prior campaigns

Long-term Asset Managers

Long-term asset managers can anticipate how to navigate activist campaigns on their portfolio companies in advance of any particular event.

ASSET MANAGERS CAN	TO MITIGATE SHORT-TERM BEHAVIOR
<p>Determine whether to support activists at all</p>	<ul style="list-style-type: none"> • Stance on share lending policy for activists • Stance on meeting with activists • Stance on requests for activism (RFAs)
<p>Evaluate activists' behavior on key issues and reputation</p>	<ul style="list-style-type: none"> • Company leverage levels • Average activist holding periods • Target company CEO references from prior campaigns • Approach to settlement agreements • Timeline between first contact and public disclosure of positions or demands • Personal attacks on management or board members—collection or release of personal information about management, the board, or their families • Net short debt activism • Request for reimbursement of legal expenses or other cash payments
<p>Strategically plan for activist campaigns on portfolio companies</p>	<ul style="list-style-type: none"> • Prepare a list of questions to ask activists during campaigns • Consider the implications—both legal and client—of voting with activists in particular jurisdictions
<p>Proactively engage with investee companies</p>	<ul style="list-style-type: none"> • Understand investee core issues • Provide investees with clear and direct feedback on areas for improvement, subject to regulatory constraints • For more on this topic see Driving the Conversation: Long-Term Roadmaps for Long-Term Success • Engage with companies in adherence with long-term stewardship principles

Long-term asset managers can evaluate and influence the outcome of activist campaigns underway.

ASSET MANAGERS MUST DECIDE	ISSUES FOR CONSIDERATION
Whether to vote with activists	<ul style="list-style-type: none">• Effect of campaign on long-term strategy and value creation• Effect of campaign on total exposure to the company (both debt and equity)• Alignment with investment or stewardship responsibilities• Evaluation of reputations of the activist and target corporation• Assessment of proxy advisor recommendation• Evaluation of independence and incentive alignment of activist-nominated board candidates
How to engage with corporate targets	<ul style="list-style-type: none">• Perspective on settlement agreements• Aspects of the activist feedback viewed as constructive or destructive to long-term value creation• Company plans to address or refute issues raised, including timeline and milestones• Provision in advance notice of voting intention where possible
How to engage with activists	<ul style="list-style-type: none">• Analysis of company and strategic recommendations• Analysis of activist's net exposure to the company (debt, equity, and hedges)• Industry expertise of activist or proposed board candidates• Timeline and share of lockup commitments• Target company CEO references from prior campaigns

Long-term Companies

Long-term corporations can focus on long-term performance and prepare for activist campaigns in advance.³¹

CORPORATIONS CAN	TO MITIGATE SHORT-TERM BEHAVIOR
Bolster governance	<ul style="list-style-type: none">• Recruit a cognitively and demographically diverse board• Ensure that the board spends sufficient time on strategy, capital allocation, risk management, sustainability, and succession planning• Stay apprised of and, if appropriate, implement new governance best practices• Periodically conduct activist tabletop exercises to identify and address emerging areas of risk, forge relationships with the media and board, and build a core team (IR, legal, PR) to address any future activist campaigns• For more on long-term boards see The Long-Term Habits of a Highly Effective Corporate Board
Hone strategies for future growth	<ul style="list-style-type: none">• Communicate three-to-five-year strategic and capital allocation plans, including milestones, key performance indicators, core growth drivers, risks, competitive advantages, multi-stakeholder commitments, and any strategic realignments or turnarounds with shareholders• Bolster sustainability profile• Conduct competitive analyses to identify any activist triggers• Build relationships with key stakeholders: labor unions, other employees, NGOs• For more on long-term strategies for future growth see Driving the Conversation: Long-Term Roadmaps for Long-Term Success
Engage with long-term investors	<ul style="list-style-type: none">• Develop a statement of purpose that includes a commitment to long-term shareholders• Maintain a robust and open dialogue with long-term shareholders and address their concerns about long-term performance or corporate governance issues• Ensure that the lead director and committee chairs spend sufficient time with shareholders• For more on effective engagement see Tools for Strategic Engagement

Target companies can influence the outcome of activist campaigns underway through their responses.

CORPORATIONS MUST DECIDE	ISSUES FOR CONSIDERATION
<p>How to address activist feedback</p>	<ul style="list-style-type: none"> • Aspects of the activist feedback viewed as constructive or destructive to long-term value creation • Company plans to address or refute issues raised, including timeline and milestones
<p>How to engage with the board</p>	<ul style="list-style-type: none"> • The activists’ reputation and historical behavior • The board’s level of support for management and requirements to maintain or increase support
<p>How to engage with long-term shareholders</p>	<ul style="list-style-type: none"> • The investors’ level of support for management and requirements to maintain or increase support • Perspectives on settlement agreements
<p>How to engage with activists</p>	<ul style="list-style-type: none"> • Outside legal, public relations, and investment banking experts to form an activist response team • Feedback from other long-term investors • Timeline and commitments to lock up shares, hold minimum unhedged positions, and limit pledging of shares in margin account • Requirements to avoid a public fight • Perspective on settlement agreements
<p>How to communicate with employees</p>	<ul style="list-style-type: none"> • Shared vision for success

FCLTGlobal anticipates that investors and companies will adapt these toolkits to their own circumstances to encourage long-term behavior. Many of these tools are already in use in various forms today, and we would appreciate feedback on your experience in implementing these and other ideas at Research@FCLTGlobal.org.

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- 19 Cyriac et. al., “Preparing for Bigger, Bolder Shareholder Activists,” McKinsey & Company, 2014. https://www.mckinsey.com/~/media/mckinsey/dotcom/client_service/Corporate%20Finance/MoF/Issue%2050/MoF50_Preparing_for_shareholder_activists.ashx.
- 20 Comparable US and global data are unavailable. Source: Rossman et. al., “2019 Review of Shareholder Activism,” Lazard Shareholder Advisory Group, January 2020. <https://www.lazard.com/media/451141/lazards-2019-review-of-shareholder-activism-vf.pdf>.
- 21 Activist tactics are now so widespread and well understood, especially in the US, that companies often engage in their own internal activist assessments, making it difficult to construct a reasonable control group to compare to activist-targeted companies. For more information see Gantchev, N. et al, “Governance under the Gun: Spillover Effects of Hedge Fund Activism”, ECGI Working Paper Series in Finance, November 2018, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2356544.
- 22 deHaan, et. al., “Long-Term Economic Consequences of Hedge Fund Activist Interventions,” Review of Accounting Studies, February 2019, <https://link.springer.com/article/10.1007/s11142-019-9480-8>.
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- 25 Gantchev, N. et al, “Governance under the Gun: Spillover Effects of Hedge Fund Activism”, ECGI Working Paper Series in Finance, November 2018, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2356544.
- 26 For the period ended April 2020, the returns of HFRI® Event Driven: Activist Index were (21.89)% year-to-date, (16.95)% for the last 12 months, (5.80)% for the last 36 months, and (1.63)% for the last 60 months. <https://www.hedgefundresearch.com/family-indices/hfri>.
- 27 DesJardine, M. and Rodolphe Durand, “Disentangling the effects of hedge fund activism on firm financial and social performance,” Strategic Management Journal, January 2020. <https://onlinelibrary.wiley.com/doi/full/10.1002/smj.3126?af=R>.
- 28 DesJardine, M. and Rodolphe Durand, “Disentangling the effects of hedge fund activism on firm financial and social performance,” Strategic Management Journal, January 2020. <https://onlinelibrary.wiley.com/doi/full/10.1002/smj.3126?af=R>.
- 29 DesJardine, M. and Rodolphe Durand, “Disentangling the effects of hedge fund activism on firm financial and social performance,” Strategic Management Journal, January 2020. <https://onlinelibrary.wiley.com/doi/full/10.1002/smj.3126?af=R>.
- 30 Note: A settlement is defined as a campaign where management or shareholders met some but not all activist demands.
- 31 Note: Shane Goodwin’s work includes “Clear Day Principles” and numerous firms have activist practices.

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