# DOES HEDGE FUND «ACTIVISM» CREATE LONG TERM SHAREHOLDER VALUE?

PRESENTATION AT THE ANNUAL MEETING OF
THE CENTER FOR CORPORATE GOVERNANCE
CONFERENCE BOARD OF NEW YORK

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# …..AND IS THAT THE RIGHT QUESTION? SHOULD WE ASK WHETHER THESE PLAYERS ARE MAKING CORPORATIONS BETTER FOR ALL STAKEHOLDERS?

# WHAT'S LONG TERM?
# WHAT'S SHORT-TERM?

- Not a set, fixed, time frame: three years may be long-term in some industries and very short-term in other;
- Corporate short-termism is the conscious decision (under external pressures or not) by management/boards to take actions that will bring benefits in the immediate future, knowing full well that these actions may prove eventually detrimental to the welfare of the company.

# EVIDENCE OF CORPORATE SHORT-TERMISM

- Survey of Graham, Harvey & Rajgopal in "The Economic Implications of Corporate Financial Reporting", *Journal of Accounting and Economics*, 2005
- Brian J Bushee, "The influence of institutional investors on myopic R&D investment behavior" *The Accounting Review*; Jul 1998.
- Natalie Mizik, "The Theory and Practice of Myopic Management", *Journal of Marketing Research*, Volume 47, Number 4, August 2010
- Dominic Barton and Mark Wiseman "Focusing Capital on the Long Term", *Harvard Business Review*, January-February 2014.

«A *McKinsey Quarterly* survey of more than 1,000 board members and C-suite executives around the world to assess their progress in taking a longer-term approach to running their companies

The results are stark:

- 63% of respondents said the pressure to generate strong short-term results had increased over the previous five years.
- 79% felt especially pressured to demonstrate strong financial performance over a period of just two years or less.
- 44% said they use a time horizon of less than three years in setting strategy.
- 73% said they *should* use a time horizon of more than three years.
- 86% declared that using a longer time horizon to make business decisions would positively affect corporate performance in a number of ways, including strengthening financial returns and increasing innovation.»

Source: Dominic Barton and Mark Wiseman in ***Harvard Business Review***, January 2014

# GOVERNANCE "IMPERFECTION": A CRITICAL ISSUE

In widely held public corporations

- Board members are generally responsible, dedicated people operating in a framework of fastidious, punctilious governance;
- But boards, under current governance imperatives, cannot resolve the dilemma of "asymmetric information" that makes them vulnerable, that generates a "governance imperfection".
- Over the years, various players have tapped into this governance imperfection; first private equity (known then as LBO) funds and more recently hedge funds;
- Institutional investors have also been active in demanding better *fiduciary* governance.

# CORPORATE SHORT-TERMISM: WHAT ARE THE CAUSES?

- Shifting beliefs about the purposes and responsibilities of the modern corporation; *from "stakeholder model"* to *"shareholder value maximization";*
- Ownership structure of corporations: the dominance of widely-held, listed corporations; the gradual elimination of the board as buffer;
- Perverse incentives throughout the economic system, from corporate executives to management of institutional investors;
- The tyranny (or collusion) of quarterly guidance and analyst meetings;
- The pressures on corporate directors from "investors" and governance enforcers (ISS et al.);
- Tax policies favouring short-termism (stock options, capital gains, carried interest).

Source: Allaire and Firsirotu, ***Black Markets and Business Blues***, 2009.

# A TYPICAL EXAMPLE OF GOVERNANCE FAILURE: THE LEHMAN BANKRUPTCY

«Although Lehman's management did not provide the Board with all available information concerning the risks faced by the firm in 2007 and early 2008, that fact is not surprising given the Board's limited role in overseeing the firm's risk management, and the extraordinarily detailed information available to management…

And in monitoring risk issues, the Board justifiably relied entirely on information provided by management.

… Under Delaware law, the directors are thereby immunized from personal liability.»

( **REPORT OF ANTON R. VALUKAS, EXAMINER , Lehman Bankruptcy , March 11, 2010,** Page 185)

# THE QUINTESSENCE OF GOVERNANCE "IMPERFECTION"

The board of Lehman did what it could; board members (several former CEOs of large corporations) exercised their business judgment, a judgment shaped by an experience totally foreign to the investment banking/trader business in the years 2000-2008.

They made decisions on the basis of their limited knowledge of the trading business and ***the information provided to them by management.***

# ELIMINATING (REDUCING?) GOVERNANCE "IMPERFECTIONS"

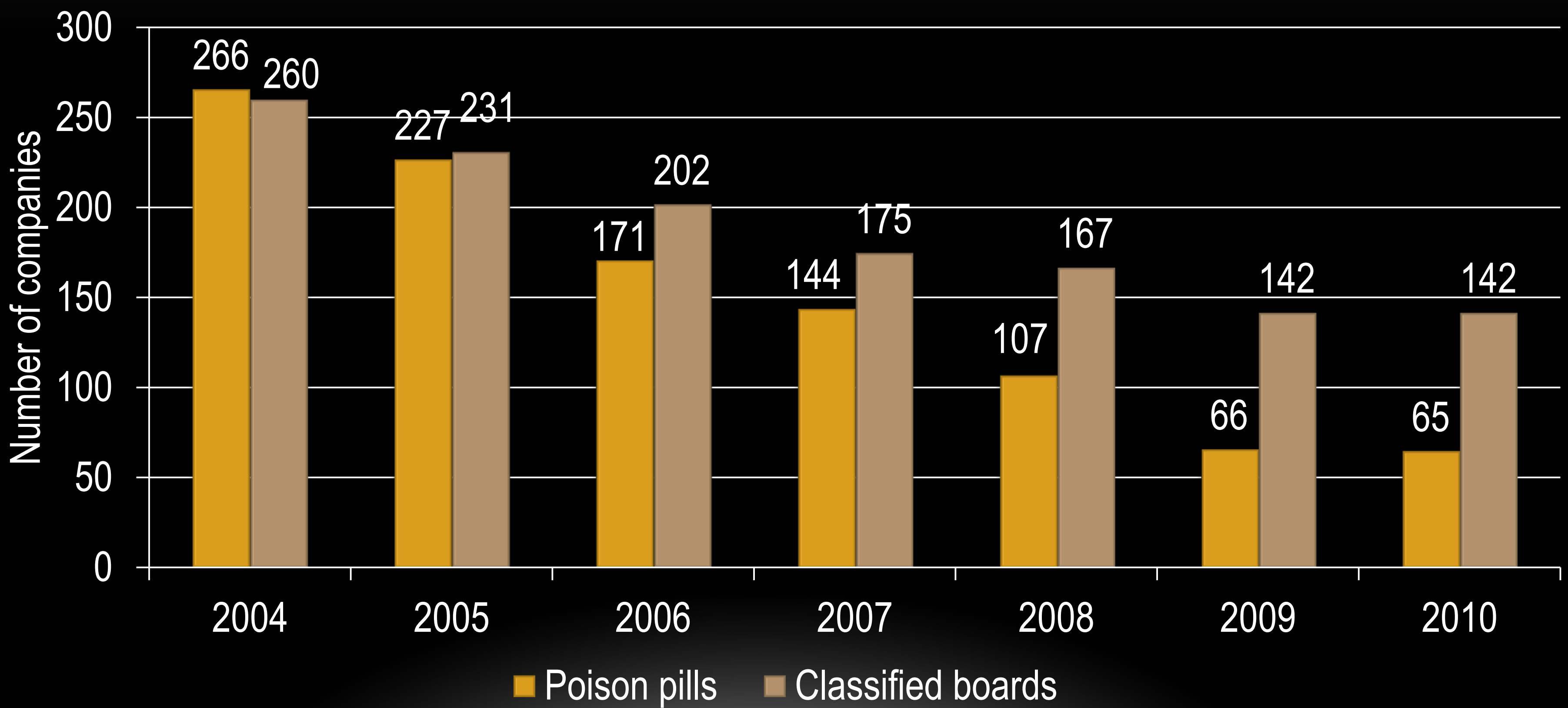
In a corporate environment still characterized by many governance failures (or imperfections), three paths to reform:

- The soft way of Institutional Investors; may soon reach its limit
- The hard way of Activist Hedge Funds; lucrative business but for whose ultimate benefit?
- Transformed governance with boards made up of "activist" members; less independence, more credibility on boards

# TWO FORMS OF ACTIVISM:
# Soft (Institutional) and Hard (Hedge Funds)

| INSTITUTIONAL INVESTORS | |
|---|---|
| • Stringent fiduciary duties<br>• Highly diversified portfolio<br>• Small stakes in target companies<br>• No economic justification for an activist campaign<br>• Activism targeted at corporate governance guidelines<br>• “Exit” simpler than “voice”<br>• *Fairly short holding period*<br>• **Driven by governance and socio-political issues** | |

# SOFT ACTIVISM AT WORK:
# Poison pills and classified boards of S&P 500 companies, 2004-2010




Based on takeover defense trend analysis year end snapshot from 2004-2010

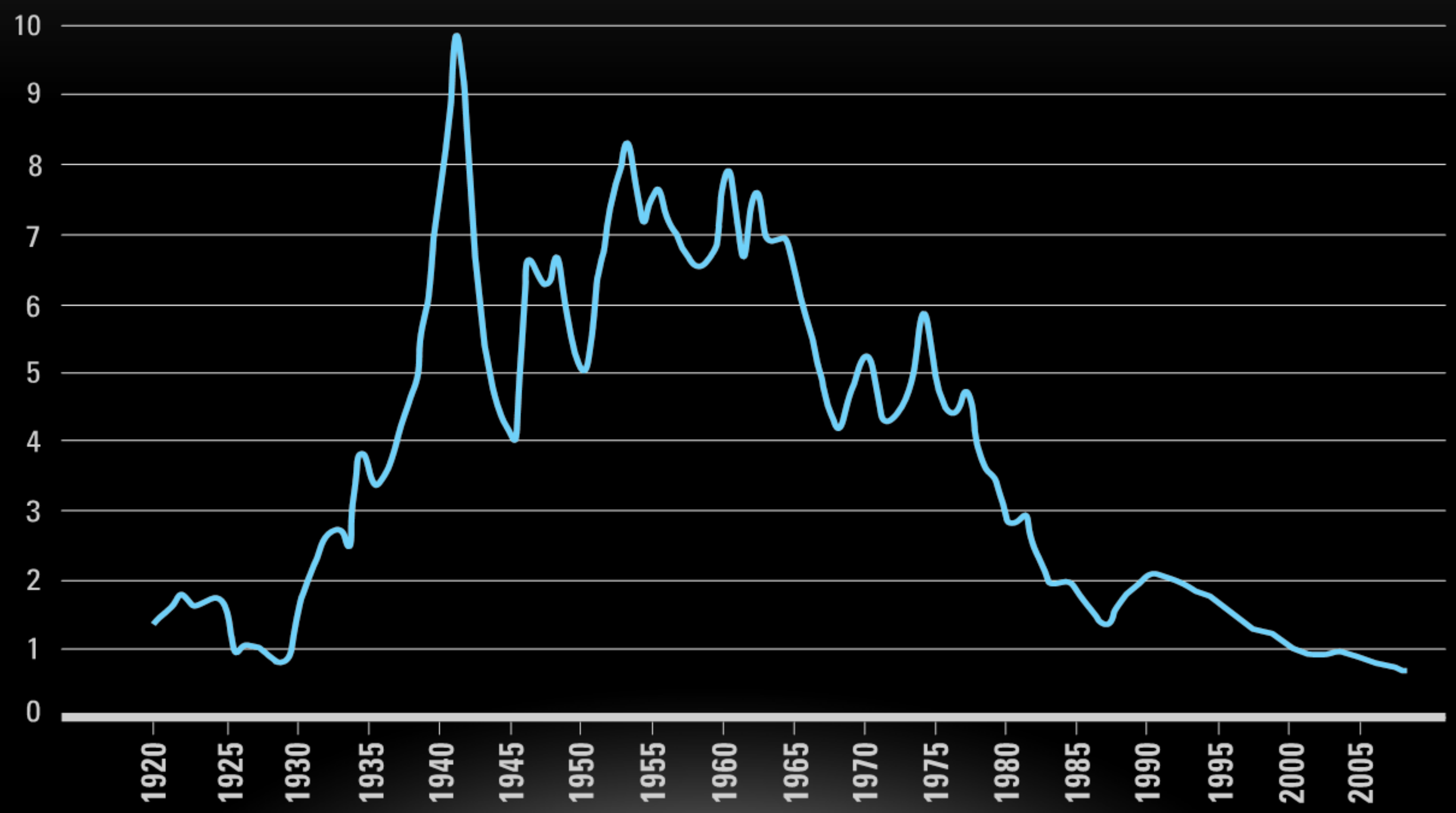




Source : www.SharkReppellent.net

# SOME EVIDENCE
# OF INVESTOR SHORT-TERMISM
# …BUT NOT A VERY RECENT PHENOMENON

# AVERAGE STOCK HOLDING PERIOD – NYSE 1920-2008



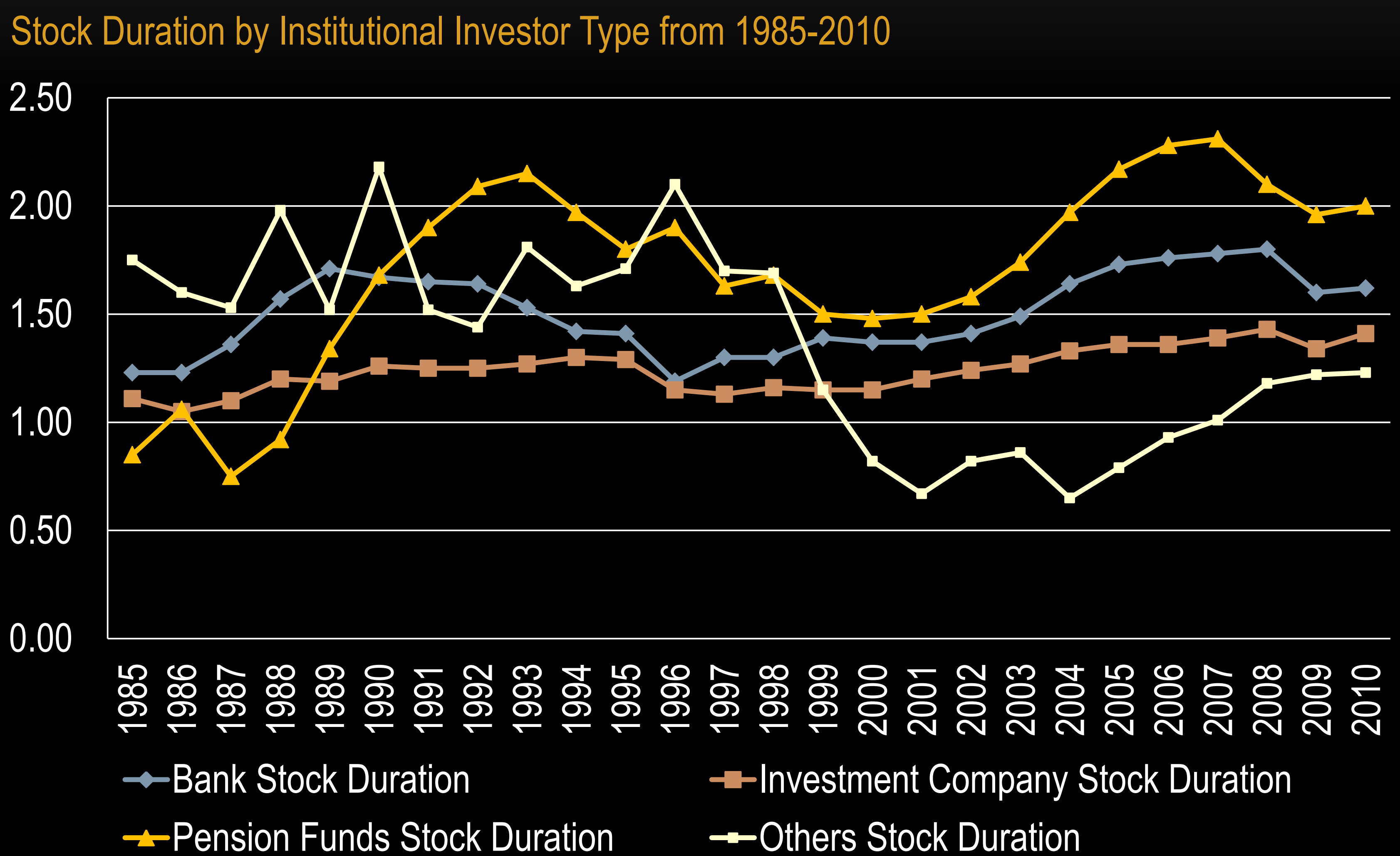

Source: SG Global Strategy Research

# MEDIAN STOCK HOLDING PERIOD FOR DIFFERENT CATEGORIES OF INVESTMENT FUNDS (IN YEARS)

| Year | Banks: Stock Duration | Investment Companies: Stock Duration | Pension Funds: Stock Duration | Others: Stock Duration |
|---|---|---|---|---|
| 1985 | 1.23 | 1.11 | 0.85 | 1.75 |
| 1990 | 1.67 | 1.26 | 1.68 | 2.18 |
| 1995 | 1.41 | 1.29 | 1.80 | 1.71 |
| 2000 | 1.37 | 1.15 | 1.48 | 0.82 |
| 2005 | 1.73 | 1.36 | 2.17 | 0.79 |
| 2010 | 1.62 | 1.41 | 2,00 | 1.23 |
| Total | 1.50 | 1.23 | 1.72 | 1.00 |

Source: Cremers, Pareek, and Sautner "Stock Duration and Misvaluation", SSRN No.2190437, December 2012

# STOCK DURATION BY INSTITUTIONAL INVESTOR TYPE




Source : Cremers, Pareek, Sautner (2012)

# ROUND-TRIP TRADES BY HOLDING PERIOD FIFO ROUND-TRIP TRADES

| | | Fund-level Cumulative Percentages (%) | |
|---|---|---|---|
| Holding Period | | Money Manager | Pension Funds |
| **At least** | **Less than** | **Median** | **Median** |
| | 1 day | 0.13 | 0 |
| 1 day | 1 week | 1.17 | 0.31 |
| 1 week | 1 month | 6.11 | 3.54 |
| 1 month | 2 months | 14.46 | 9.55 |
| 2 months | 3 months | 23.21 | 16.15 |
| 3 months | 4 months | 29.96 | 23.38 |
| 4 months | 5 months | 36.91 | 30.25 |
| 5 months | 6 months | 42.85 | 36.34 |
| *6 months* | *9 months* | *58.44* | *52.36* |
| **9 months** | **1 year** | **70.23** | **64.52** |
| 1 year | 2 years | 90.62 | 89.04 |
| 2 years | 3 years | 97.03 | 96.61 |
| 3 years | 4 years | 99.18 | 99.24 |
| 4 years | | 100 | 100 |

Source : Chakrabarty, Moulton, Trzcinka (2012)

# TWO FORMS OF ACTIVISM: Soft (Institutional) and Hard (Hedge Funds)

| INSTITUTIONAL INVESTORS | ACTIVIST HEDGE FUNDS |
| --- | --- |
| • Stringent fiduciary duties<br>• Highly diversified portfolio<br>• Small stakes in target companies<br>• No economic justification for an activist campaign<br>• Activism targeted at corporate governance guidelines<br>• “Exit” simpler than “voice”<br>• *Fairly short holding period*<br>• **Driven by governance and socio-political issues** | • Do the dirty work for institutional investors!<br>• Fewer regulatory constraints<br>• Better incentives to seek new strategies and generate higher returns<br>• Can depart from classic portfolio management principles<br>• Larger interests in fewer corporations<br>• Engage management and corporate boards and prepared to become hostile<br>• Encourage traditional investors to tag along<br>• **Driven strictly by financial returns** |

# THE **HARD ACTIVISM** OF HEDGE FUNDS: WHAT DO ACTIVIST HEDGE FUNDS WANT?

| | |
|---|---|
| • Selling the company, going private | 23% to 30% of cases |
| • Unbundling – sale or spin-off of divisions, assets, etc. | 18% to 32% of cases |
| • Disgorging cash - special dividends, share buy-back, debt restructuring | 20% to 36% of cases |
| • Changing governance, strategy and/or management | 30% to 40% of cases |
| • Pursue growth strategies | 1% to 2% of cases |

Source : Adapted from Bratton, 2006 / Brav et al., 2007

# TYPE OF ACTIVIST ENGAGEMENT OUTCOME

## Year of initial regulatory filing/press disclosure 2000-2010

| | Board (replacement of CEO, Chairman, etc.) | Payout (share buybacks or increased/special dividends) | Restructuring (divestitures and spin-offs of non-core assets) | Takeover (target firm is acquired by a strategic buyer or PEF) | Total outcomes |
|---|---|---|---|---|---|
| Number of cases | 486 | 293 | 271 | 308 | 1,358 |
| % by type | **35.8%** | **21.5%** | **20.0%** | **22.7%** | **100%** |

Source: Becht, M., J. Franks, J. Grant and H. Wagner. (2014) "The Returns to Hedge Fund Activism: An International Study". *European Corporate Governance Institute Working Paper Series in Finance*, No 402/2014.

# *HEDGE FUND* HOLDING PERIOD (CALENDAR 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*

# INVESTMENT HORIZON OF ACTIVIST HEDGE FUNDS

**Panel A : Investment horizon of hedge fund activists (in months)**

| Percentile | 25% | 50% | 75% | 90% | Mean |
|---|---|---|---|---|---|
| Exit after initial filing | 0 | **5** | 13 | 25 | *9.42* |
| Exit after demand negotiations | 2 | **6.5** | 16 | 27 | *10.48* |
| Exit after board representation | 7 | **15** | 27 | 41 | *19.43* |
| Exit after proxy contest | 10 | **18** | 34 | 64 | *25.78* |
| Average (per campaign) | 3 | **9** | 20 | 36 | *14.66* |

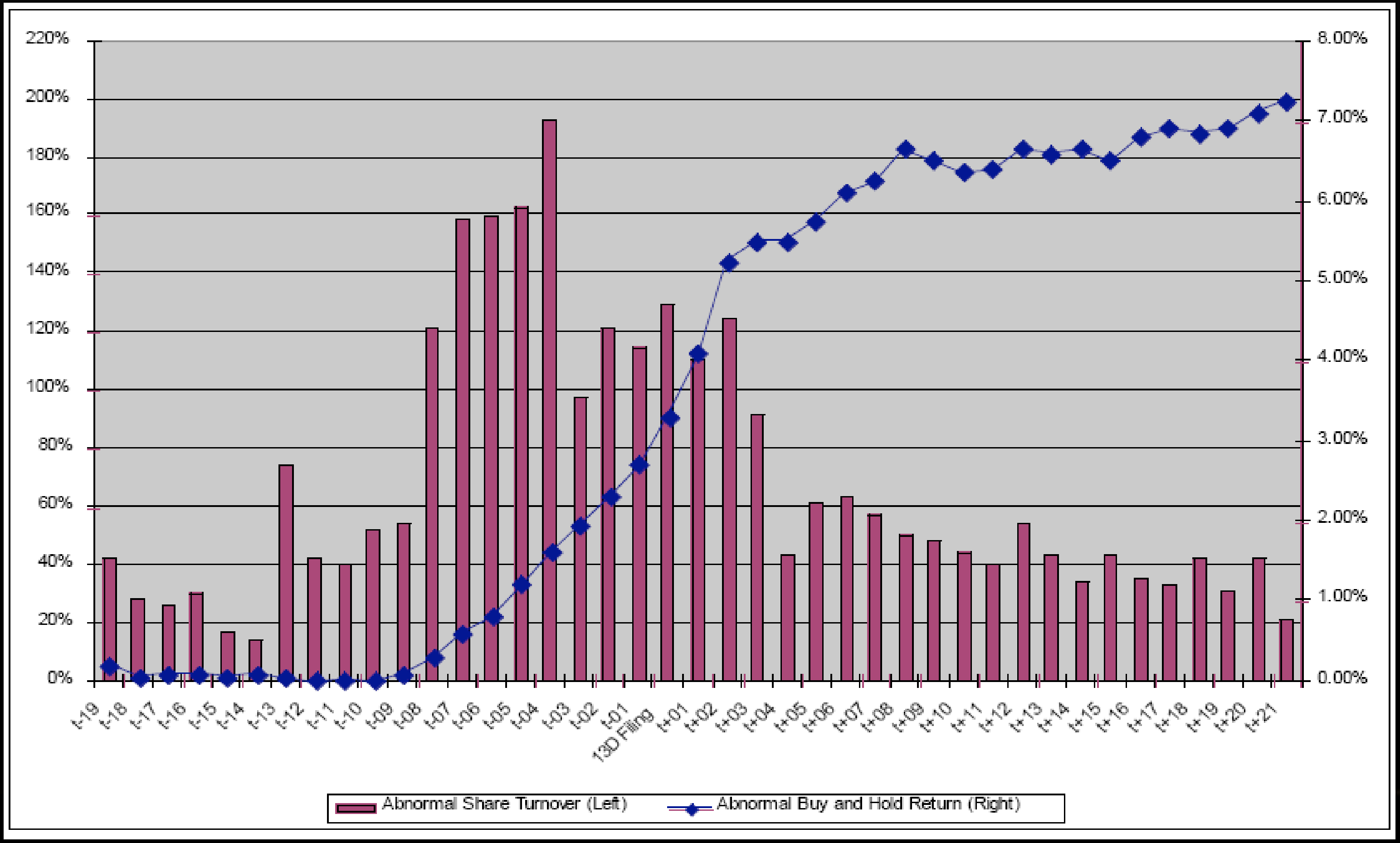
*Sample of 1,164 distinct campaigns involving 171 hedge funds and 1,023 unique targets, for the period 2000-2007*

Source: Gantchev, 2012

# ACTIVIST HEDGE FUNDS

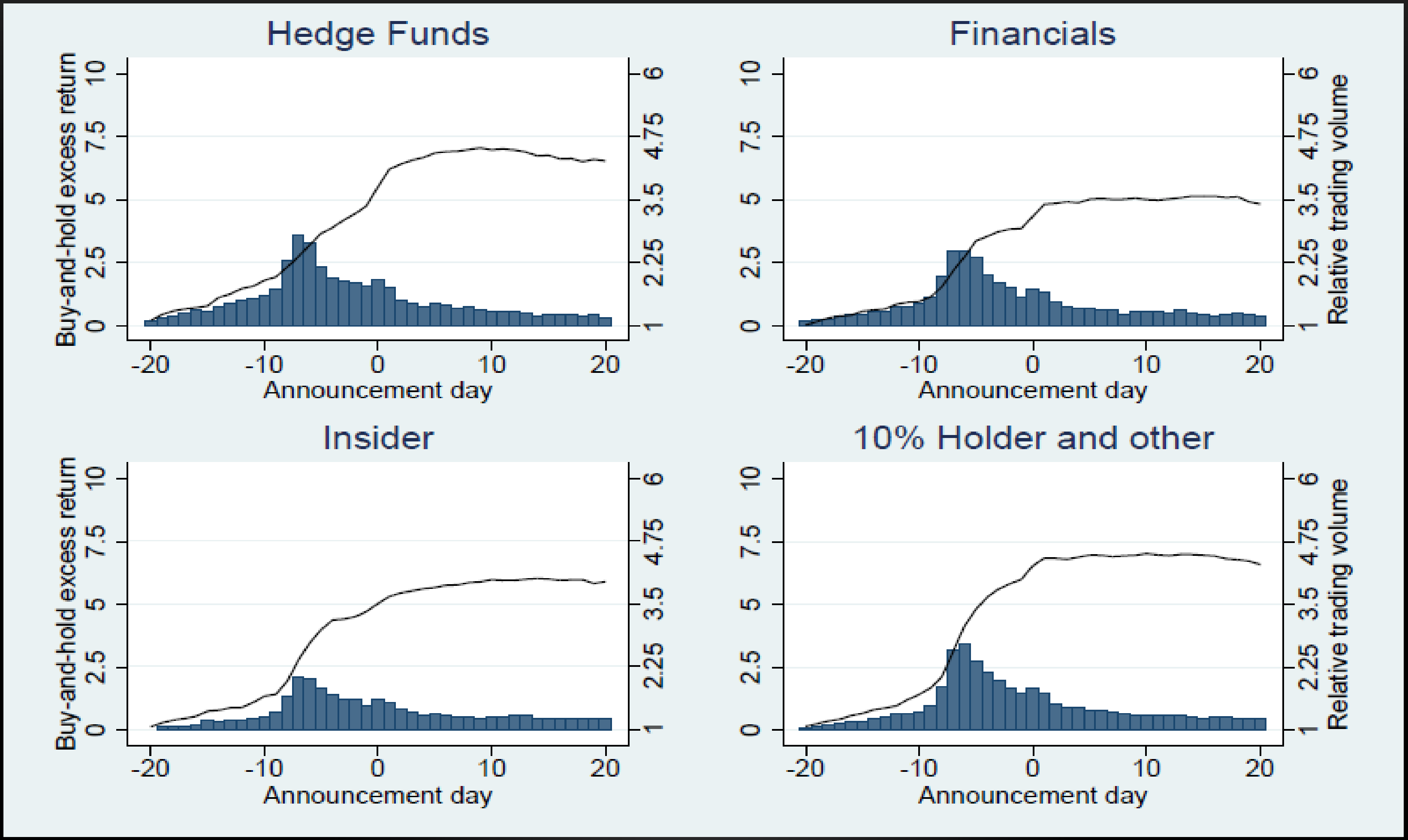
## Short-term impact

# MARKET RETURNS BEFORE AND AFTER SCHEDULE 13D FILINGS BY HEDGE FUNDS
## (+/- 20 DAYS)




*Source: Alon Brav et al., “Hedge Fund Activism, Corporate Governance and Firm Performance,” European Corporate Governance Institute (ECGI) Working Paper No. 139/2006, p. 23*

# ABNORMAL RETURNS FOR DIFFERENT 13-D FILERS




**Sample of 3,265 hedge fund events and 44,596 non-hedge fund events, period 1985-2012**

Source: Ulf von Lilienfeld-Toal and Jan Schnitzler "What is special about Hedge Fund Activism? Evidence from 13-D filings" *Available on SSRN*, June 2014.

# ACTIVIST HEDGE FUNDS

Long-term impact

- Several studies on the topic
- The best known and most quoted (op-ed in WSJ, etc.):

  *Bebchuk, Brav and Jiang, 2013*

# THE MYTH OF HEDGE FUNDS AS 'MYOPIC ACTIVISTS'

## *BEBCHUK'S OP-ED IN THE WALL STREET JOURNAL (AUGUST 7, 2013)*

- *Our study uses a data set consisting of the full universe of approximately 2,000 interventions by activist hedge funds from 1994–2007.*

- *During the five-year period following the intervention month, operating performance relative to peers improves consistently.*

- *Contrary to the belief that the market fails to appreciate the long-term consequences of activism, long-term shareholders don't suffer any negative abnormal returns during the subsequent five-year period.*

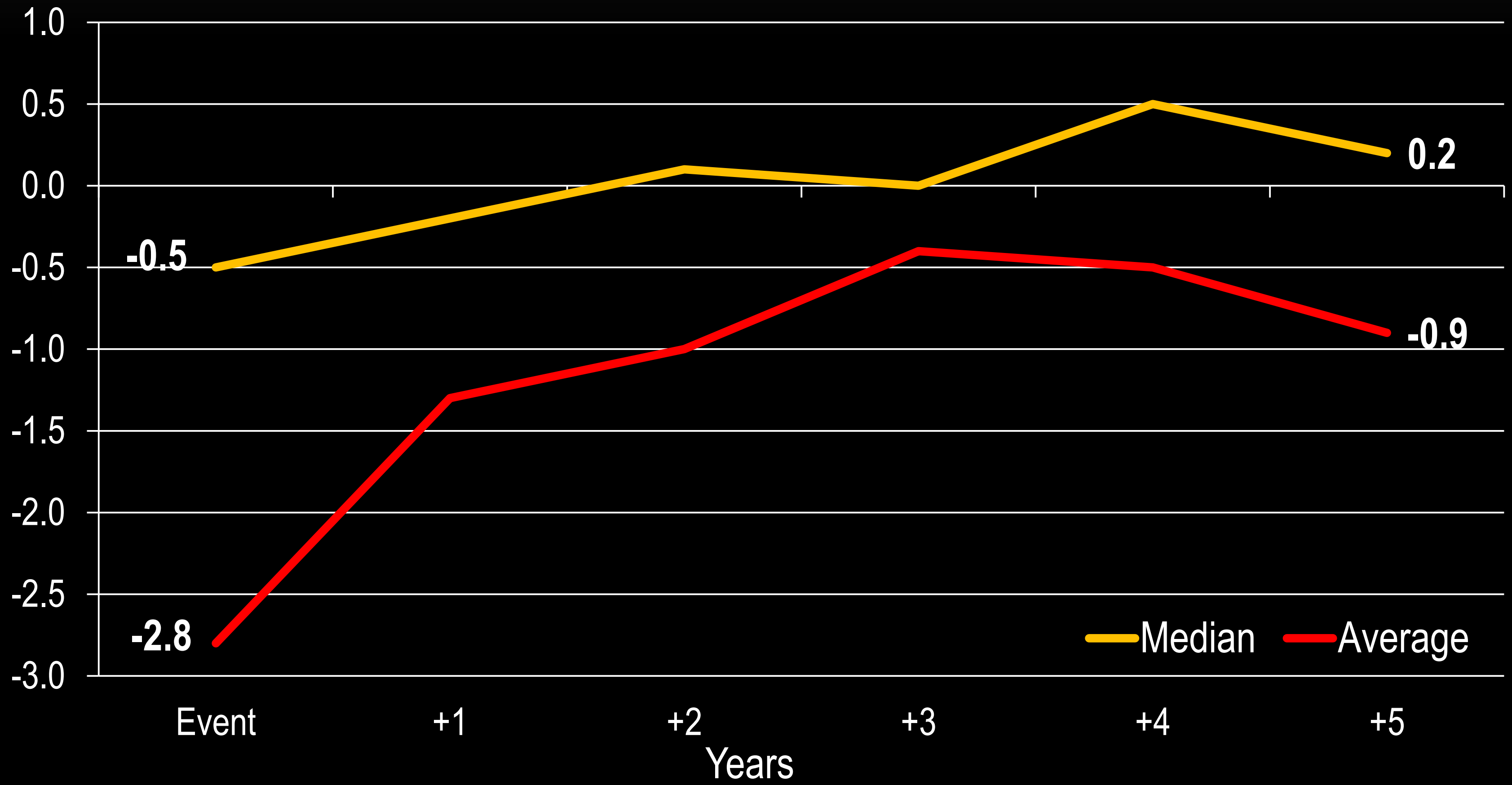
# INDUSTRY-ADJUSTED OPERATING PERFORMANCE: PRE- AND POST-INTERVENTION

| 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 Tobin's 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.

# BEBCHUK, BRAV & JIANG (2013)
## *"THE LONG-TERM EFFECTS OF HEDGE FUND ACTIVISM"*
## INDUSTRY-ADJUSTED **ROA**

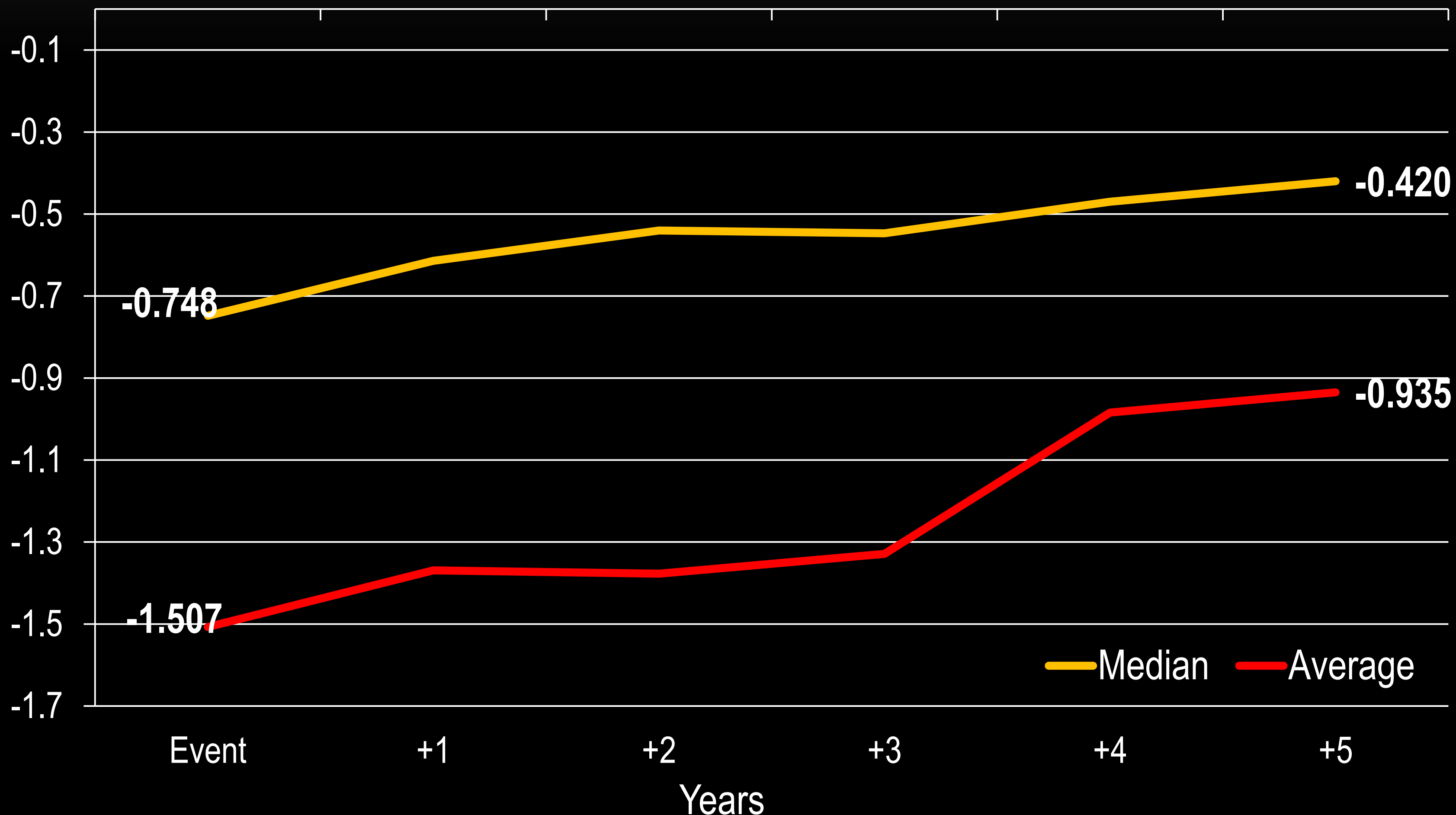



Source: Adapted from Bebchuk, L., A. Brav and W. Jiang. "The Long-Term Effects of Hedge Fund Activism", forthcoming, *Columbia Law Review,* 2013.

# BEBCHUK, BRAV & JIANG (2013)

## *"THE LONG-TERM EFFECTS OF HEDGE FUND ACTIVISM"*

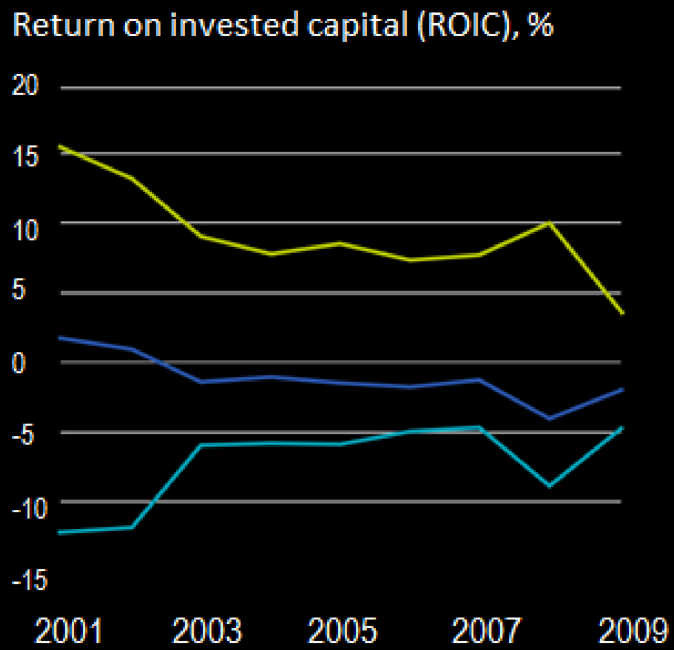
## INDUSTRY-ADJUSTED **TOBIN'S Q**

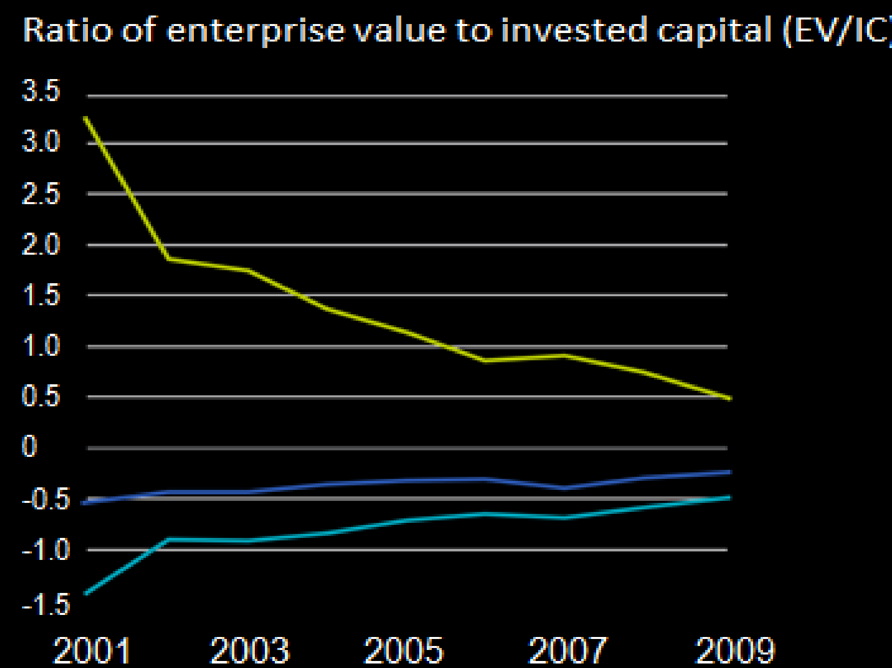



Source: Adapted from Bebchuk, L., A. Brav and W. Jiang. "The Long-Term Effects of Hedge Fund Activism", forthcoming, *Columbia Law Review,* 2013.

# 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*



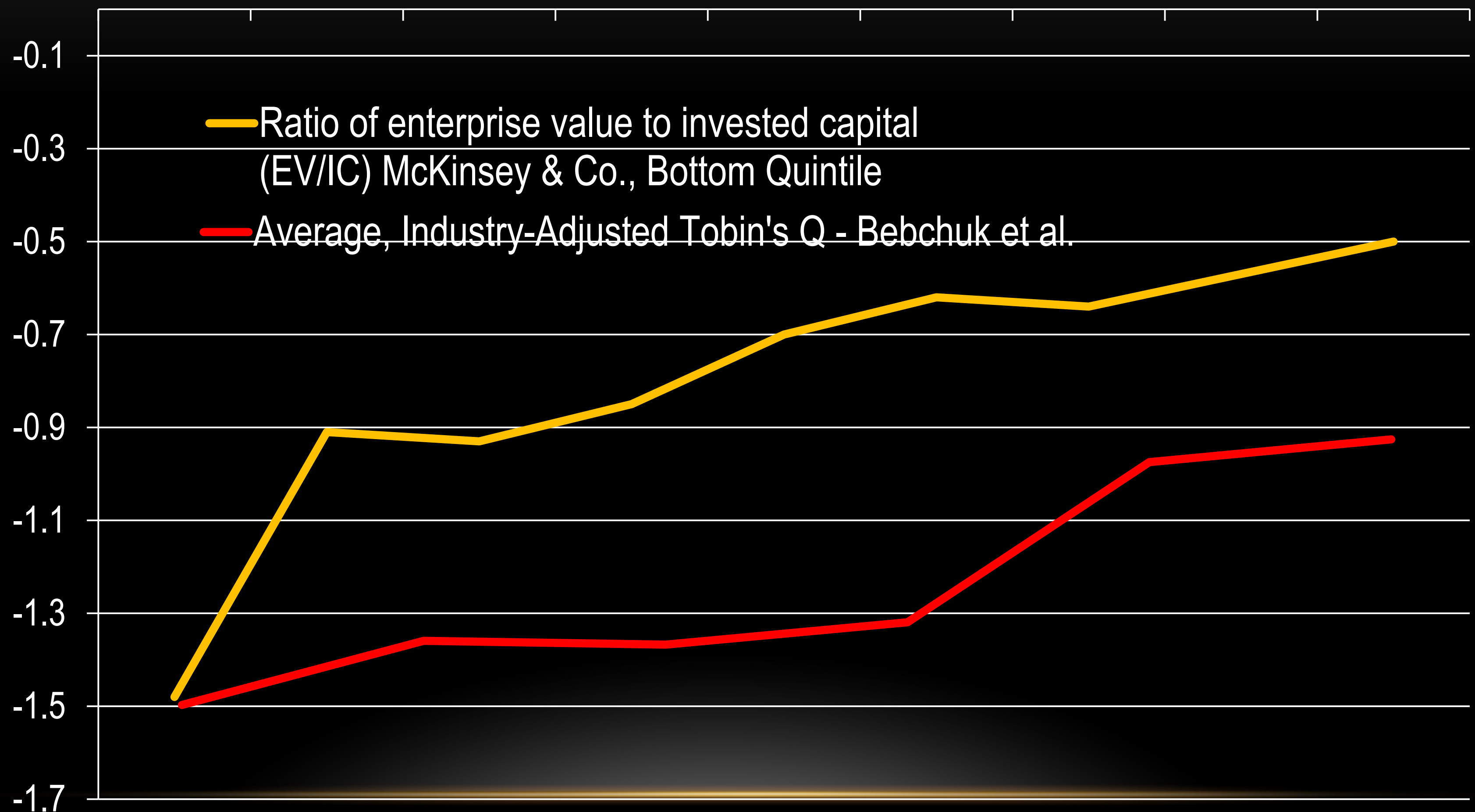




Top quintile   Middle quintile   Bottom quintile

*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

# CONVERGENCE OF PERFORMANCE TOWARDS THE MEAN – SUPERPOSITION OF MCKINSEY'S EV/IC BOTTOM QUINTILE AND BEBCHUK *ET AL.* INDUSTRY-ADJUSTED TOBIN'S Q



# DIFFERENT STUDIES, DIFFERENT NUMBER OF CASES

| | Bebchuk, Brav, Jiang (2013) | Brav, Jiang and Kim (2012)[a] | Brav, Jiang and Kim (2013)[b] | Boyson and Mooradian (2007) | Clifford (2008)[d] | Klein and Zur (2011)[e] | Greenwood and Schor (2009)[f] |
|---|---|---|---|---|---|---|---|
| 1994 | 10 | | 8 | 13[c] | | 5 | 10 |
| 1995 | 37 | | 29 | 20 | | 21 | 10 |
| 1996 | 99 | | 83 | 34 | | 28 | 30 |
| 1997 | 212 | | 178 | 91 | | 38 | 66 |
| 1998 | 161 | | 137 | 42 | 82 | 41 | 74 |
| 1999 | 118 | | 98 | 34 | 62 | 42 | 90 |
| 2000 | 120 | | 98 | 24 | 63 | 44 | 84 |
| 2001 | 96 | 92 | 83 | 21 | 71 | 36 | 83 |
| 2002 | 134 | 120 | 118 | 33 | 94 | 50 | 89 |
| 2003 | 127 | 122 | 112 | 43 | 106 | 61 | 67 |
| 2004 | 148 | 144 | 133 | 42 | 118 | 70 | 87 |
| 2005 | 237 | 234 | 210 | 21 | 192 | 98 | 153 |
| 2006 | 269 | 252 | 259 | | | 101 | 137 |
| 2007 | 272 | 208 | 297 | | | | |

Allaire, Y. and F. Dauphin (2014). "Hedge Fund Activism and their Long-Term Consequences: Unanswered Questions to Bebchuk, Brav and Jiang" *Institute for Governance of Private and Public Organizations*, available on SSRN, 11p.

# DIFFERENT STUDIES, DIFFERENT NUMBER OF CASES

"*There are a considerable number of cases in Brav et al* [the data base used for the Bebchuk, Brav and Jiang study] *that are not in our database and vice versa. We examine the first 80 cases alphabetically from a combination of Brav et al and our sample and find that in 27 cases there is overlap in the two data bases;* ***19 cases are in our sample but not in Brav et al, 34 cases are in Brav et al but not in our sample. Reasons for non-overlapping samples appear to be differences in exclusion criteria and search techniques****.*" (Emphasis added)

Becht, M., J. Franks, J. Grant and H. Wagner. (2014) "The Returns to Hedge Fund Activism: An International Study". *European Corporate Governance Institute Working Paper Series in Finance*, No 402/2014.

# Market Capitalization of Target Companies in the Brav, Jiang and Kim Database

| *Sample of 2,624 fund-target firm pairs, period 1994-2011* | **Market capitalization, in millions of dollars** |
|---|---|
| Mean | 835.3 |
| Median | ***134.6*** |
| Average Difference with Matched Firms | -1,906.1 |

Source: Brav, A. W. Jiang and H. Kim. "Hedge Fund Activism: Updated Tables and Figures". September 2, 2013

# SOME OBSERVATIONS ON THE BEBCHUK ET AL. STUDY

- The authors have not demonstrated that activist hedge funds, per se, create lasting, long term value. Their sample data, with all its limitations, show no longer-term reversal of performance.

- They show that “activist” hedge funds produce short-term «abnormal» return; but the same result is observed for most 13D filers.

- When activist hedge funds bring some lasting value for shareholders, it often takes the form of wealth transfer from employees and debt holders rather than wealth creation.

# HEDGE FUNDS:
# VALUE CREATION OR VALUE TRANSFER?

"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, Jiang et al, 2013, p.22, emphasis added)

# HEDGE FUNDS AND VALUE TRANSFER FROM BOND HOLDERS

- *…we find that hedge fund activism significantly reduces bondholders' wealth… Confrontational campaigns and the acquisition of at least one seat on the target's board elicit more negative bond returns. We also find an expropriation of wealth from the bondholder to the shareholder.*

Source: "The Impact of Hedge Fund Activism on the Target Firm's Existing Bondholders", Klein and Zur (2010)

# MOODY'S ABOUT SHAREHOLDER ACTIVISM

"Our finding that its [shareholder activism] effects on the creditworthiness of Moody's-rated issuers is ***almost universally negative***, even if only moderately."

"***As short-term shareholder activists have become more influential, we have observed numerous examples of concessions to activists that have eroded credit quality contributing to downgrades***."

Source: Byrd, F., D. Hambly & M. Watson. *Short-Term Shareholder Activists Degrade Creditworthiness of Rated Companies*, Moody's Investors Services Special Comment, June 2007.

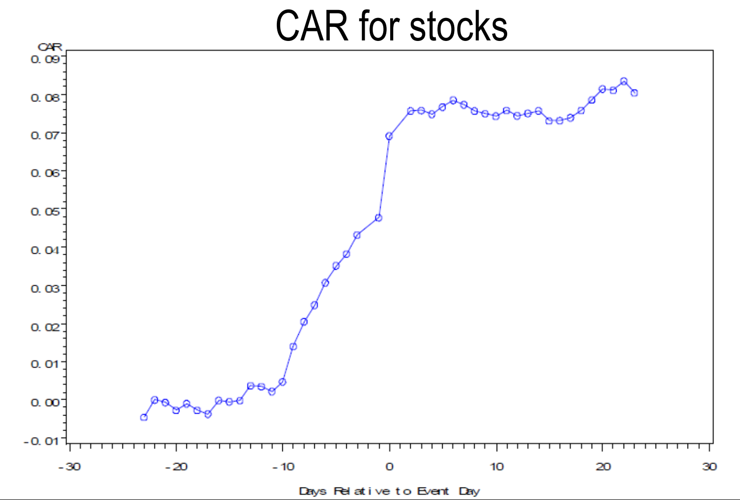
# STANDARD & POOR'S – SPIN-OFFS OFTEN COME AT A PRICE TO CREDITORS

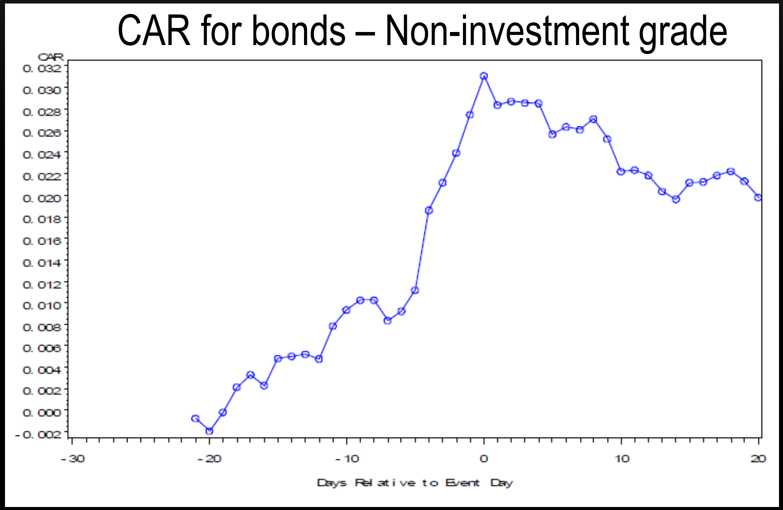
"Since Aug. 1, 2013, Standard & Poor's has lowered or placed on CreditWatch with negative implications ***one-third*** of its ratings on companies that initiated spin-off transactions."

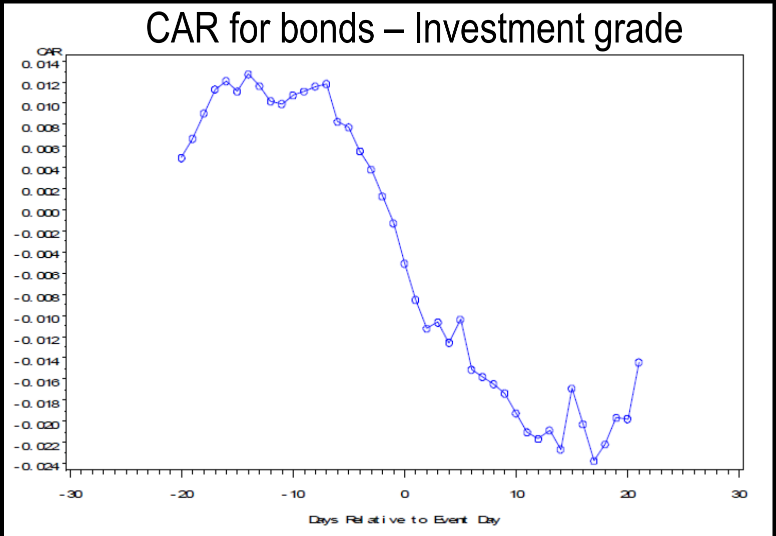
"Longer-term credit quality for companies that execute a spin-off has deteriorated as well, ***since about 40% of these issuers now have lower ratings."***

Source: Standard & Poor's press release of the report titled "Spin-Offs, On The Rise Again In The U.S., Can Signal Weaker Credit Quality For Parent Companies", October 10, 2014

# CUMULATIVE ABNORMAL RETURNS OF TARGET BONDS AND STOCKS SUBJECT TO HEDGE FUND ACTIVISM




**Activism sample of 1,332 target firms, for the period 1996-2008**

**From trading days -22 to trading day +22, where day 0 is the event day**

Source: Aslan, H. and H. Maraachlian. (2009) “Wealth Effects of Hedge Fund Activism”. Paper submitted to the *European Finance Association*, 36th annual conference, 59p.

# SOME FURTHER OBSERVATIONS ON BEBCHUK *ET AL*.

- "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.

- 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.

# TWO OTHER RECENT STUDIES PURPORTING TO SHOW POSITIVE LONG-TERM EFFECTS OF HEDGE FUND ACTIVISM

- Gow, I. D., S-P. S. Shin and S. Srinivasan. "*Activist Directors: Determinants and Consequences*". *Harvard Business School Working Papers*, #14-120, June 2014.

- Goodwin, S. "*Myopic Investor Myth Debunked: The Long-Term Efficacy of Shareholder Advocacy in the Boardroom*". Available at SSRN, October 2014.

# GOW, I. D., S-P. S. SHIN AND S. SRINIVASAN STUDY (2014)

"Activist directors appear to be associated with significant strategic and operational changes in target firms…

We find evidence of *increased divestiture, decreased acquisition activity, higher probability of being acquired, lower cash balances, higher payout, greater leverage, higher CEO turnover, lower CEO compensation, and reduced investment*."

- These authors view all of these as positive long-term results from hedge fund activism!!! Yet, what about return to shareholders?

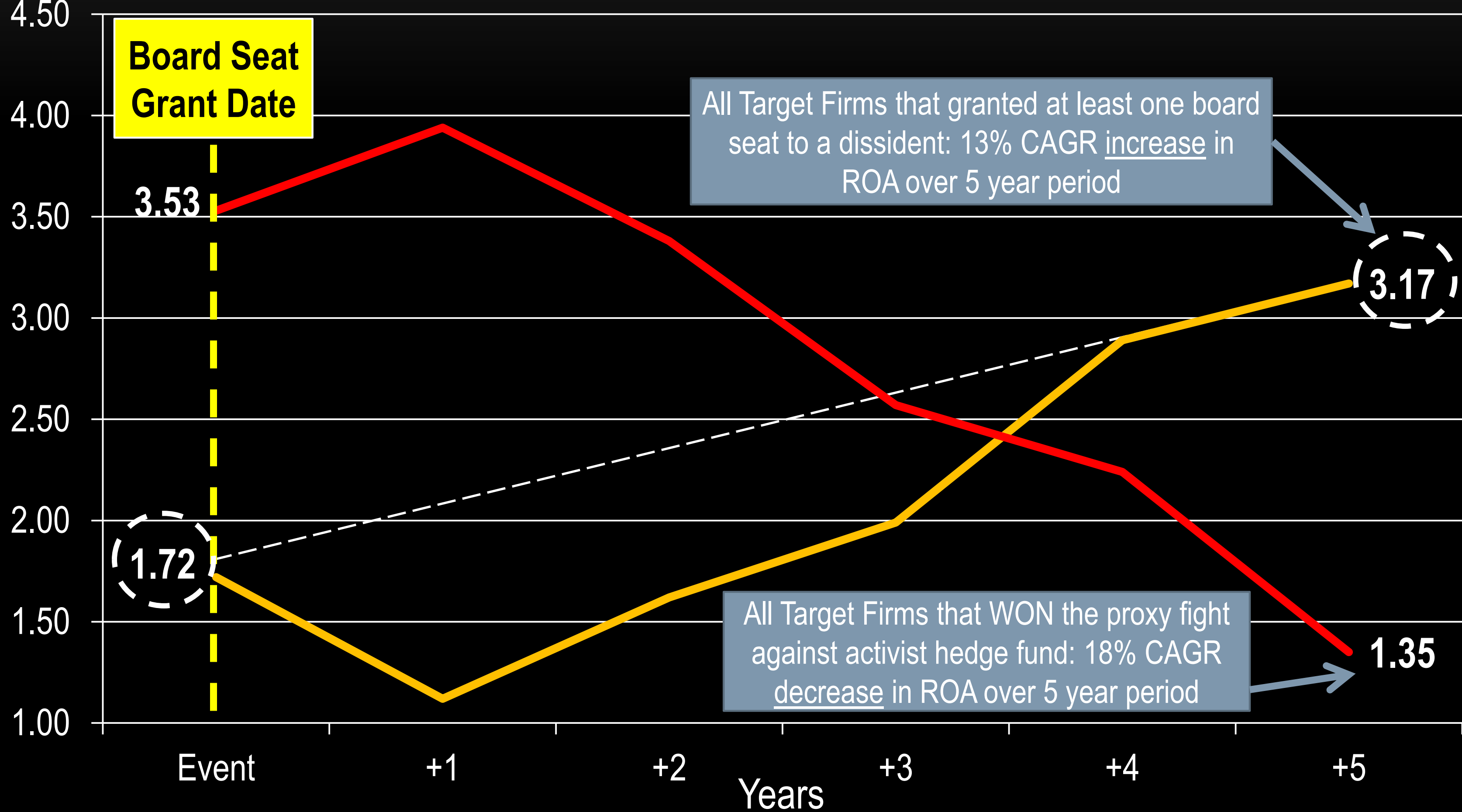
Source: Gow et al., sample of 1,969 activism events, for the period 2004-2012

# GOW *ET AL.*-STOCK RETURNS BY CATEGORY OF ACTIVISM, FROM ACTIVISM ANNOUNCEMENT (MONTH *T* TO MONTH *T* + 36)

| Category of activism | Number of events | Raw returns | Size-adjusted returns | Fama-French three-factor adjusted returns |
|---|---|---|---|---|
| Non-board related activism events | 1,089 | 67.6% | 45.9% | -0.9% |
| Activists demanded, *but did not win,* *board seats* | 456 | 135.2% | 100.1% | 4.8% |
| Activists were granted one or more board seats | 424 | 24.1% | 0.1% | -5.1% |

Source: Gow, I. D., S-P. S. Shin and S. Srinivasan. "Activist Directors: Determinants and Consequences". *Harvard Business School Working Papers*, #14-120, June 2014.

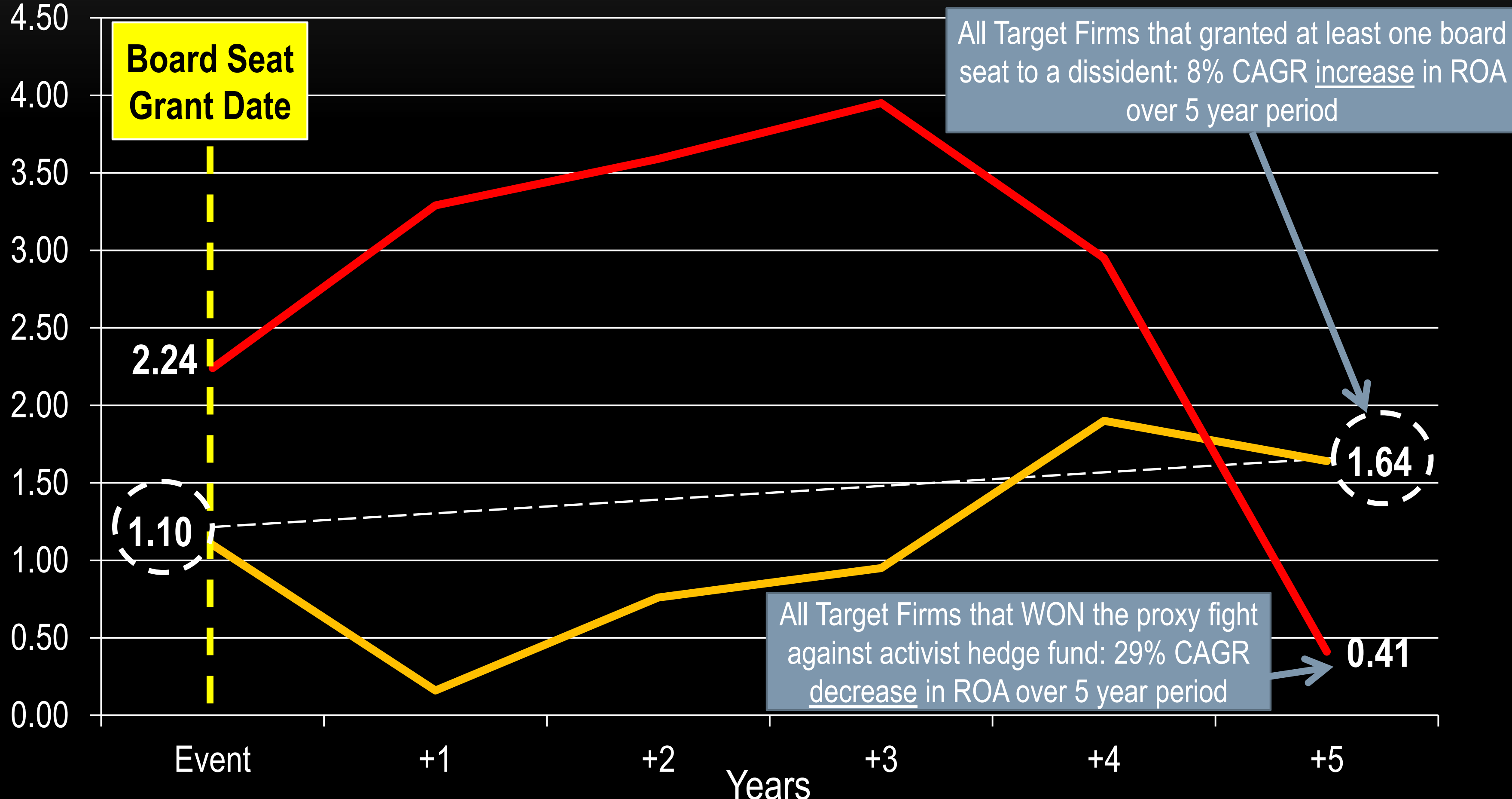
# Goodwin, S. "*Myopic Investor Myth Debunked: The Long-Term Efficacy of Shareholder Advocacy in the Boardroom, 2014* - THE ROA (MEDIAN, AS PER GRAPH 3, P.24)…




*Goodwin: treatment group of 448 hedge fund wins and 73 management wins, for the period 1996-2013*

Source: Goodwin, S. "Myopic Investor Myth Debunked: The Long-Term Efficacy of Shareholder Advocacy in the Boardroom". Available at SSRN, October 2014.

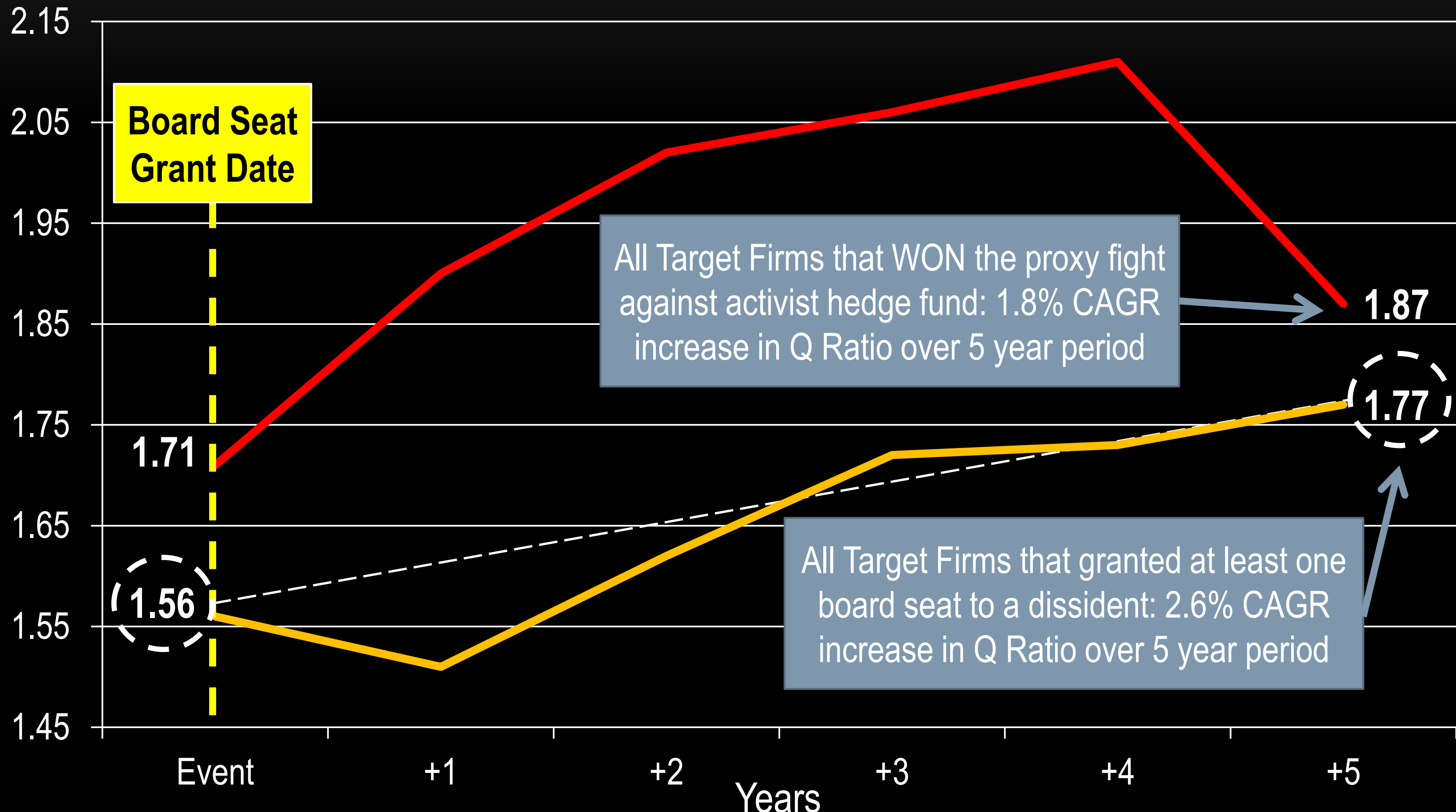
# Goodwin, S. "*Myopic Investor Myth Debunked: The Long-Term Efficacy of Shareholder Advocacy in the Boardroom, 2014* - THE ROA (MEAN, GRAPH NOT PRESENTED)…




*Goodwin: treatment group of 448 hedge fund wins and 73 management wins, for the period 1996-2013*

Source: Goodwin, S. "Myopic Investor Myth Debunked: The Long-Term Efficacy of Shareholder Advocacy in the Boardroom". Available at SSRN, October 2014.

# Goodwin, S. "*Myopic Investor Myth Debunked: The Long-Term Efficacy of Shareholder Advocacy in the Boardroom, 2014* - THE Q RATIO (MEAN, AS PER GRAPH 4, P.25)…

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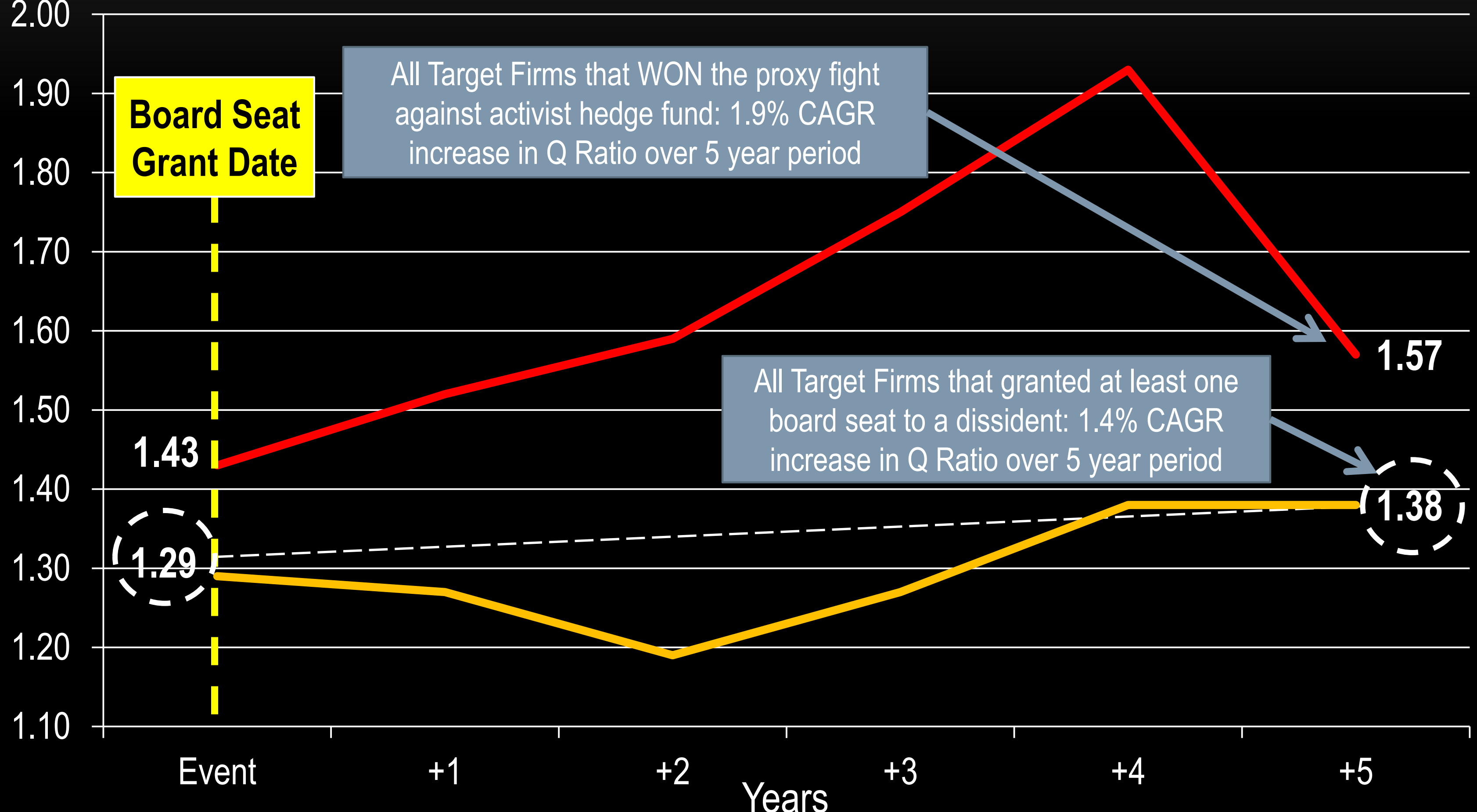


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Source: Goodwin, S. "Myopic Investor Myth Debunked: The Long-Term Efficacy of Shareholder Advocacy in the Boardroom". Available at SSRN, October 2014.

# SPILLOVER EFFECTS OF ACTIVISM

"We document strong industry persistence of activism, which is seen as a threat to yet-to-be-targeted firms in the industry.

[O]ur results demonstrate *positive* real externalities of hedge fund activism, establishing that the impact of activism reaches beyond the firms being targeted and may have been underestimated in previous studies. […] We show that managers rationally respond to the threat of activism in the way suggested by the anecdotal evidence."

Source: Gantchev, N., O. Gredil and C. Jotikasthira. "Governance under the Gun: Spillover Effects of Hedge Fund Activism", *available on* SSRN, March 2014, pp.3-4.

# SPILLOVER EFFECTS OF ACTIVISM

"[T]his study shows that hedge fund activism has a preventive effect. […] [I]n proactive response to an increase in the likelihood of hedge fund intervention, *firms cut CEO pay, reduce cash holdings and leverage, limit capital investment and R&D expenses, and raise shareholder distributions and CEO turnover. As a result of these policy improvements, return on assets increases significantly.*

[B]y showing that hedge fund activism is an effective and viable mechanism for corporate governance, the study allows policymakers to make more informed decisions as they face heightened pressure to increase hedge fund regulations."

Source: Zhu, H. "The Preventive Effect of Hedge Fund Activism", *available on* SSRN, November 2013, pp.36-37.

# LET'S IMAGINE THE INDUSTRIAL STRUCTURE RESULTING FROM GENERALIZED HEDGE FUND MINISTRATIONS

- …whether from actual attacks by an increasing number of hedge funds or from pro-active, preventive moves by corporations…

We would witness the following on a massive scale (if we believe the academic advocates  of hedge funds):

*increased divestiture, decreased acquisition activity, higher probability of being acquired, lower cash balances, higher payout, greater leverage, higher CEO turnover, lower CEO compensation, and reduced investment (Gow, et al., 2014)*

*Firms cut CEO pay, reduce cash holdings and leverage, limit capital investment and R&D expenses, and raise shareholder distributions and CEO turnover* (Zhu, 2013)

**That is a fairly dismal world**, shorn of long-term investments, of concern for any stakeholder other than shareholders. Corporate management, already pushed to short-termism, would be driven to implement hedge funds' favorite initiatives…

# THE ESSENTIAL FACILITATORS OF ACTIVIST HEDGE FUNDS

- Public pension funds supplying money to activists and supporting, more or less tacitly, their initiatives;
- Institutional investors and their soft activism targeting any and all defenses of boards against unwanted takeovers and pushing for a shareholder-centric form of governance;
- Proxy advisory firms as cheer-leaders of activist hedge funds...

# THERE ARE SEVERAL POTENTIAL COUNTERMEASURES TO THE HEDGE FUND BRAND OF ACTIVISM

- Institutional investors could adopt a longer term perspective for their holding, refusing to support the "hard" activism of hedge funds and recognizing the responsibility of public corporations to multiple stakeholders; they could, as per Calpers, divest of hedge funds;

# A COUPLE OF ACID TESTS COMING UP FOR INSTITUTIONAL INVESTORS

- Valeant cum Pershing Square v. Allergan
- PepsiCo v. Trian Fund

**See for an analysis of a successful case**: Allaire, Y. and F. Dauphin (2014). "Why was Pershing Square so successful at Canadian Pacific Railway?", IGOPP.

# INDRA NOOYI, CEO OF PEPSICO (2010): "COMPANIES CANNOT SIMPLY BE DRIVEN BY THE NEEDS OF SHAREHOLDERS"

"Companies have to think of themselves as serving stakeholders, they have to worry a lot about their cost to society. How do you make sure that as a company everything you do serves the next generation, serves communities, serves you employees better?"

Source: The Telegraph, *PepsiCo chief executive Nooyi brings in healthy profits in lean times*, February 1st 2010

Source: Allaire, Y. and M. Firsirotu (2011). *A Capitalism of Owners*, IGOPP, 184p.

# REACTIONS TO PEPSICO'S LOWERING OF EPS GUIDANCE IN JULY 2011

"Is she ashamed of selling carbonated sugar water?"
*(Wall Street Journal, July 28th 2011)*

"Pepsi faced criticism from analysts for neglecting its carbonated beverage business and **focusing too heavily on healthier products**." (emphasis added)
*(Financial Times, July 22nd 2011*

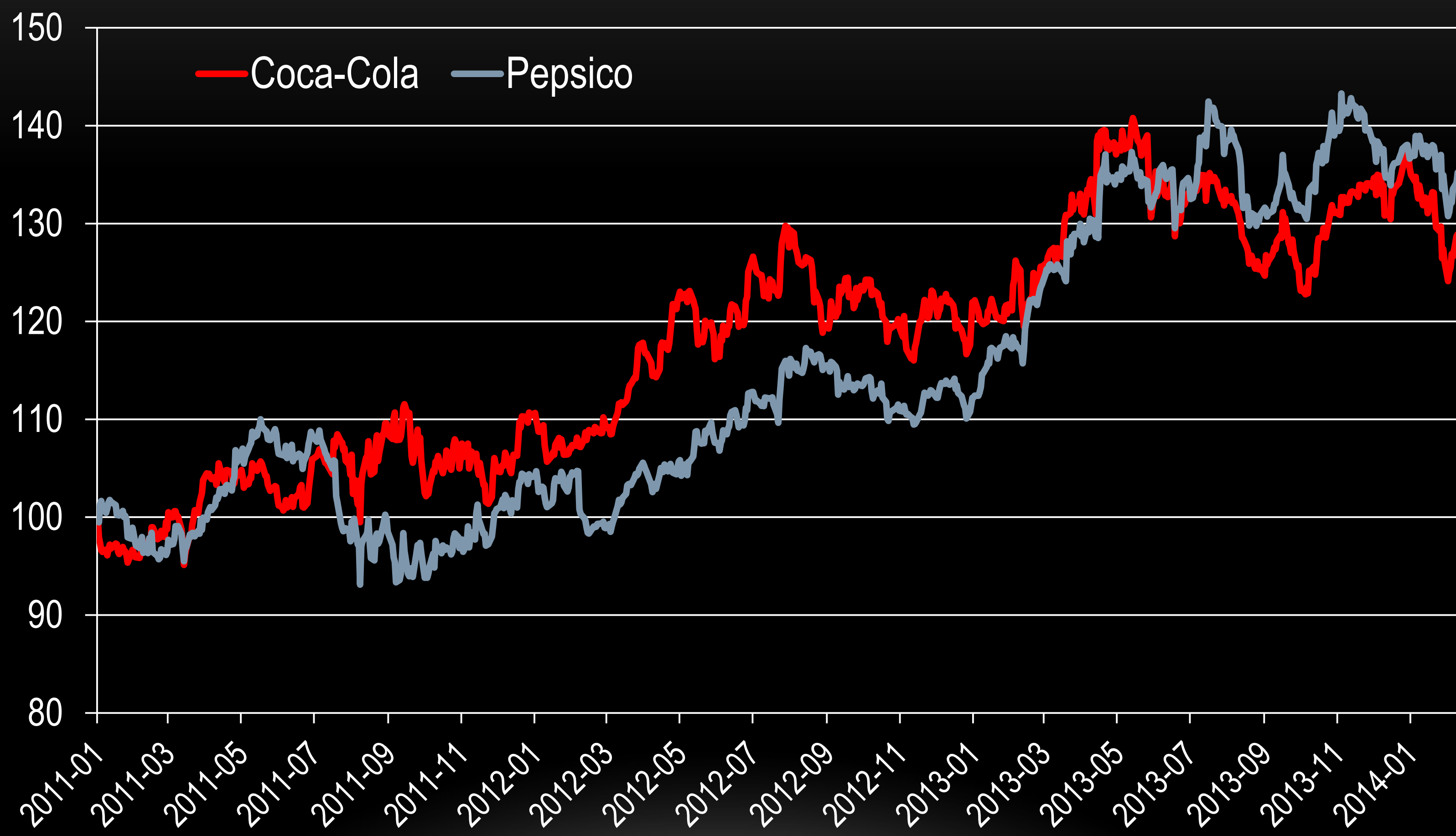
"Ms. Nooyi set the company on a healthier course… virtuous this may be, but it has not been good for the bottom line."
*(The Economist, October 15-21, 2011)*

Source: Allaire, Y. and M. Firsirotu (2011). *A Capitalism of Owners*, IGOPP, 184p.

# NELSON PELTZ AND PEPSICO

- In July 2013, Nelson Peltz, the activist hedge fund manager, announced that his Fund "Trian" beneficially owned in excess of $1.3bn of PepsiCo shares.
- Peltz then issued a 59-page white paper making the point that "*the status quo is unsustainable*".
- Peltz proposes that PepsiCo be split in two stock-traded companies: BeveragesCo and SnacksCo.
- In his estimation, such a strategic move would produce a 25% return for investors over 2.5 years.

# PEPSICO VS. COCA-COLA SINCE 2011 (BASIS 100)



# INDRA NOOYI REITERATES HER MESSAGE

Performance with Purpose is PepsiCo's recognition that the company's success is inextricably linked to society's success. In order to do well by our shareholders, we also have to take into account the needs and concerns of a wide range of stakeholders. *If our financial success comes at the expense of the environment, our consumers or our communities*, *we will not be viable in the long run.*

*Indra K. Nooyi, Letter to shareholders,*
*PepsiCo's 2013 Annual Report*

Is she right or is she the forlorn defender of a bygone epoch?

Will institutional investors support her strategy or will they side with the hedge fund?

# THERE ARE SEVERAL POTENTIAL COUNTERMEASURES TO THE HEDGE FUND BRAND OF ACTIVISM

- Institutional investors could adopt a longer term perspective for their holding, refusing to support the "hard" activism of hedge funds and recognizing the  responsibility of public corporations to multiple stakeholders;
- **Different forms of ownership and control: dual class, time-phased voting, etc.; *imitate what private equity funds and hedge funds do when they go public*!**

# DUAL CLASS OF SHARES* MAKES COMPANIES OUT OF REACH OF "ACTIVIST" HEDGE FUNDS

- Berkshire Hathaway; Alibaba; Google; Facebook; Groupon; Expedia, UPS; Tyson; Ford, Nike, etc.
- The NY Times; News Corp; CBS, Comcast, etc.
- …***and those you would not expect, given their devotion to unfettered capitalism and shareholder sovereignty***…
- Blackstone; KKR; Apollo; Pershing Square Holdings, Third Point, etc.

**But should include, as in Canada, a "coat-tail" provision so that control cannot be sold without the "minority" shareholders benefiting equally.*

# THERE ARE SEVERAL POTENTIAL COUNTERMEASURES TO THE HEDGE FUND BRAND OF ACTIVISM

- Institutional investors adopting a longer term perspective for their holding and refusing to support the "hard" activism of hedge funds
- Different forms of ownership and control: dual class, time-phased voting; imitate what private equity funds and hedge funds do when they go public!
- **Transformed governance: respond to hedge fund activism with *board activism*; less independence, more credibility on boards to do what's right for the long-term welfare of the company.**

(**See** Allaire, Y. and M. Firsirotu (2013). "On Becoming an Activist Board! Sketch of a Corporate Governance that Creates Value", Working Paper available on SSRN, 23p.

# DOES HEDGE FUND «ACTIVISM» CREATE LONG TERM SHAREHOLDER VALUE?

PRESENTATION AT THE ANNUAL MEETING OF
THE CENTER FOR CORPORATE GOVERNANCE
CONFERENCE BOARD OF NEW YORK

**Yvan Allaire**, Ph.D. (MIT), FRSC
Executive Chair,
Institute for governance of private and public organizations (IGOPP)

November 14th 2014