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The Surprising Market Response to Activist Hedge Funds

Studying 1,262 interventions since 2008, we found that stock prices for the targeted companies rose soon after.

By **FRANK PARTNOY**
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Billionaire activist investor Carl Icahn in 2014 *PHOTO: BLOOMBERG NEWS*

Is hedge-fund activism good or bad? This question has dominated financial debate this year, as hedge funds besiege on average nearly one company a day seeking to shake up managements. This month's battle over the future of Vivendi follows recent activist campaigns at Dow Chemical, DuPont, PepsiCo, Sotheby's, Yahoo and many others. Martin Lipton—a prominent lawyer who has defended companies against agitating shareholders since the 1980s—labels the new efforts a "war" and warns that "activist hedge funds are winning."

The rhetoric on both sides is heated. Critics say hedge funds destroy companies by pushing them to load up with debt, lay off employees, slash research and development, and pump up short-term dividends and profits. Laurence Fink, the CEO of the investment management company BlackRock, says activists' financial strategies "can jeopardize a company's ability to generate sustainable long-term returns." Yale Prof. Jeffrey Sonnenfeld has argued recently in these pages that activist funds lag the market and that even the most successful activists, such as Carl Icahn, also have spectacular failures such as TWA and Blockbuster.

Mr. Icahn defends his role as "doing the right thing in trying to shake up some of these managements," and can point out many successes, recently at eBay and Family Dollar. Pershing Square's William Ackman has raised billions of dollars from institutional investors with long-term horizons, and he cites positive long-term returns and change at numerous companies, including Burger King and Canadian Pacific.

In a study published this month, (Vanderbilt Law and Economics Research Paper No. 15-9), C.N.V. Krishnan of Case Western Reserve University, Randall Thomas of Vanderbilt University and I examined 1,262 interventions by hedge-fund activists from 2008 through mid-2014. The findings were surprising. A previous study (Journal of Finance, 2008), in which Mr. Thomas and I were involved, showed that the stock market's reaction to the announcement of hedge-fund activism had been declining through 2007. Our new research shows that the market more recently has reacted very favorably to activism.

For example, in 2013 the stock price of the targets of activist hedge funds rose on average around 9% relative to the market during the 21-day window before and after the announcement of the activists' stakes. During the past six years, the "announcement period stock return" of targeted firms has averaged around 6%.

That might not sound like a lot. But reliably beating the market by 6% is like discovering the secret to winning the lottery. Large institutional investors have poured tens of billions of dollars into these activist funds.

Noteworthy also, hedge funds with 10 interventions or more had lower announcement-period stock returns than hedge funds with just one intervention. From this record it appears that the most active hedge funds may be spreading themselves too thin. For example, the share price of Horizon Pharma declined significantly during the period surrounding the August 2012 announcement that Discovery Group owned 6.5% of the company. Discovery Group also announced, in mid-2012, ownership stakes of greater than 5% in four other companies (Keynote Systems, U.S. Auto Parts, Globecomm, and Anaren).

In our study the best performers (including Carl Icahn and Pershing Square) made larger investments in fewer companies. These top performers are relatively small in terms of personnel, but large in terms of money under management, and they also target large firms. They tend to have a longer track record and a history of holding board seats, both of which give them credibility with corporate managers and other investors.

For example, Potomac Capital Partners, one of the top performers in our study, began purchasing common shares of PLX Technologies in November 2012, at prices in the range of $4 per share. In January 2013, Potomac announced its ownership and the stock price rose 18% in the announcement period. After more than a year of pressuring PLX's management and board, PLX was purchased by Avago Technologies for $6.50 per share.

Still, critics question whether market reactions to activists are fickle, and instead ask about the longer run. It is true that many targeted firms are sold within one to five years, in our sample (so far) about 20%. But the performance of companies that are targeted by the top activists, but are not sold, also generally improved. During the first year after a top activist intervened, return on assets grew by 9% and research and development grew by 2.6%. In contrast, both measures declined after other activists intervened.

There has been much speculation that hedge funds make money by engaging in complex financial engineering using derivatives. And many non-activist hedge funds do use derivatives extensively. However, the activist hedge funds in our study rarely do. Instead they buy stock in companies they believe are undervalued, and then pressure managers to improve.

So are activist hedge funds good or bad? For managers and board members of public companies, they are potentially bad. They challenge those individuals' wisdom, their strategies and even their positions in the company. But for most investors, many of these activist funds—though not all—are good. Since 2009, one in seven of the largest U.S. firms has faced an activist campaign. During the same time, U.S. equities have generated strong returns.

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