

The
Economist

Activist funds

An investor calls

Sometimes ill mannered, speculative and wrong, activists are rampant. They will change American capitalism for the better

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IMAGINE that you are an American CEO. You have just spent your week dealing with the damned regulators, the latest BS on social media, the lawyers and their ever more brain-aching rules about what you can say and to whom, a president in Washington who urges you take a patriotic rather than merely law-abiding stance to paying taxes and

campaigners who think it is your corporation's obligation to reduce social inequality. You finally get a moment to do the job you are remarkably well paid for—running a global firm in the pursuit of long-term profit—when the phone rings. It's a banker on the line.

“Hello? We're hearing rumours that an activist hedge fund has bought 4.9% of your shares.” Activists are not, in this instance, tree-huggers who dislike what your company is doing to the atmosphere. They are hedge funds that seek to shake up your company's management. It is like a ruler hearing rumours of a coup. It is the call that every CEO in America dreads getting—or has already received.

In the 1980s activists were called corporate raiders and were the jackals of capitalism, outcasts that attacked and dismembered weak companies to widespread opprobrium but consoling profit. They were immortalised in the film *Wall Street*, whose charismatic criminal, Gordon Gekko, showed his mettle by treating greed as good and lunch as for wimps. They faded from prominence after a series of scandals and the collapse of the junk-bond market in the late 1980s.

Today activism is mainstream and arguably the biggest preoccupation of America's boardrooms. The current activist crop are not the red-in-tooth-and-braces raiders of the



1980s; but they are determined to shake up the companies in which they invest, shaking that very often leads to change in the corner office. Since 2011 activists have helped depose the CEOs of Procter & Gamble and Microsoft, and fought for the break up of Motorola, eBay and Yahoo—which on January 27th said it would spin off its stake in Alibaba, a Chinese internet firm, after pressure from Starboard Value, an activist. They have won board seats at PepsiCo, orchestrated a huge round of consolidation across the pharmaceutical industry, and taken on Dow Chemicals and DuPont.

Neither age, status nor systemic importance offers any protection. Activists have removed the management of the oldest firm on the New York Stock Exchange, Sotheby's. They have won a board seat on Bank of New York Mellon, a too-big-to-fail bank at the heart of the global financial system. And they have attacked the world's most valuable company, Apple. The chairman of one of Silicon Valley's biggest firms admits, "We think about an attack all the time." A CEO with a superb record of running a giant industrial firm says that a slip up would make him vulnerable. Inside activists' offices you can have breezy chats about dismantling pillars of the establishment like Ford and Citigroup.

Since the end of 2009, 15% of the members of the S&P 500 index of America's biggest firms have faced an activist campaign, according to FactSet, a research firm, and estimates by *The Economist*—a "campaign", here, being an effort to change a firm's strategy, acquire board seats or remove managers. As activists often buy stakes in firms without going on to launch such campaigns that underestimates the number of scary phone calls the CEOs must take. *The Economist* estimates that about 50% of S&P 500 firms have had an activist on their share register over the same period. The only proven defence that a firm can offer is to not be American in the first place; 80% of activist interventions are in America, where the culture and legal system are better suited to shareholder revolts than those in Europe or Asia.

For some all this is the doctrine of shareholder value taken to an absurd extreme—"they are having a serious impact on the economy and are an aggressive deterrent to investment, research and development and employee training," says Martin Lipton, a lawyer who advises many firms that come under attack. For others activism is a breath of fresh air in the stuffy, complacent world of the big American corporation.

Money never sleeps

Back in the office of the CEO under attack a well oiled defence machine is slipping into action. Many big firms practise "emergency drills" for this moment. The CEO will summon a war cabinet and the room will fill with lawyers, bankers, experts in investor relations and

spin-doctors to deal with the media. The first casualty of an activist conflict is the CEO who underestimates his opponents.

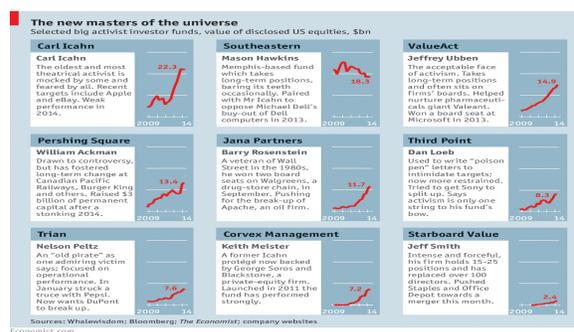


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Activists are a small sliver of the hedge-fund world. Hedge Fund Research (HFR), a research firm, says that of about 8,000 hedge funds activists number just 71—less than 1%. But they are larger than most; at \$120 billion under management the activists account for about 4% of the hedge-fund total (see chart 1). Their clients now include many of the world's big endowments, family offices and sovereign-wealth funds. And their assets have risen by a factor of five over the past decade. In 2014 they raised \$14 billion of new money, a fifth of all flows into hedge funds.

A dossier prepared by an investment bank will help the CEO and his *consiglieri* understand who they are dealing with. The big funds (see table) are differentiated by their vintage, staying power and propensity to campaign, and by their belligerence once the game is afoot.

The old guard includes Carl Icahn, an outrageous and outrageously successful septuagenarian, who has been on the warpath since the 1980s. Nelson Peltz has similarly deep roots, but rather more gravitas. Over the years he has attacked Cadbury, Pepsi and Kraft.



The new establishment includes ValueAct, Third Point and Elliott Advisors, all of which earned their spurs in the 2000s. Its most prominent figure is William Ackman of Pershing Square, who says Warren Buffett is his inspiration. Mr Ackman has had some disasters, including J.C. Penny, a department store he tried to resuscitate, but also some triumphs, including Allergan, a pharmaceutical firm that was taken over last year. The industry’s young guns include Sachem Head and Corvex, set up by protégés of the old guard.

The established funds lock in their clients’ money for one to two years, more than the typical hedge-fund lock-in of a few months. Last year Mr Ackman launched a \$3 billion vehicle listed in Amsterdam with an indefinite life.

In theory this allows activists to take a medium-term view. In practice most trade in and out of firms often—the typical position is held for less than a year, according to JP Morgan Chase. But big bets are made for longer. In firms where it has board seats ValueAct holds its positions for two to four years, according to Jeffrey Ubben, its boss.

Activists’ propensity to campaign varies. Southeastern, based in Memphis, says it invests in about 20 firms at any given time but only intervenes in firm’s management occasionally. Starboard Value runs a portfolio of 20 stocks, too, but thinks that it can help each firm it owns to improve.

The last differentiating factor is belligerence. Mr Icahn is famous for public insults, and in his young-punk days Dan Loeb of Third Point wrote strikingly acerbic letters, though he says he has mellowed. ValueAct is known for its quiet diplomacy—at Microsoft it argued for change behind the scenes, helping to ease Steve Ballmer out of the top job in favour of Satya Nadella in 2014. But it does occasionally bare its teeth—on January 5th it publicly criticised MSCI, a firm which runs financial indices. By January 30th MSCI had caved in to its demands.

Whether they favour a knockout punch, a hug or torture-by-PowerPoint, activists are persistent: if they commit themselves to a full-blown campaign they usually get at least some of what they want. The CEO's first tactic is thus to try to persuade them that he is already working behind the scenes to meet their concerns in the hope they will relent. Even if they agree with the activists, most CEOs would prefer to reform their companies on their own. At this stage the odds of an all-out campaign are probably about 50%.

Impossible relationships

Within a month the activist and the CEO will meet. If the CEO is confident he may agree to a casual dinner. If he is weak he will come phalanxed by lawyers and some of the firm's directors. If it comes to war, both sides need to be able to claim they talked, so there will be a veneer of courtesy. But privately the CEO will be wondering how on earth the activist has so much clout. After all, such people typically own only 5% of the equity in firms in which they invest. In total, activists' assets amount to only 1% of the value of the S&P 500 index of top firms.

Activists wield disproportionate power because the ownership of big firms in America has polarised. On one side is the lazy money. About 20% of the typical firm is owned by index managers such BlackRock and Vanguard, which mimic the market and charge low fees. Followers of the market rather than its trendsetters, they have not in the past felt much need to worry about how the firms they invest in are run. Alongside them are the managers of mutual funds and pension funds, such as Capital Group and Fidelity. They actively pick stocks and talk to bosses but their business is running diversified portfolios and they would rather sell their shares in a struggling firm than face the hassle of fixing it.

At the other end of the spectrum is the bossy money. Berkshire Hathaway, the \$350 billion fund run by Warren Buffett, buys entire firms and runs them for ever. Private-equity funds also buy whole firms, replacing managers and setting strategy.



Activists provide a way for lazy money to outsource the messy task of fixing subpar firms. It is a task which, because they do not pay takeover premiums or rely heavily on debt, activists can do more efficiently than private equity.



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Because their fees are charged over a smaller pool of capital, the absolute sum the activists skim off is small. And their performance is pretty good, at least before fees. The typical activist position has outperformed the S&P 500 (see chart 2). After fees the picture is murkier. The HFR index of activists has risen by 89% since the end of 2008, after fees. That is worse than the S&P (159%) but better than most hedge funds (50%) and demonstrably good enough to convince many investors seeking to diversify their holdings to give activists more cash.

The essence of the evolutionary spirit

A week after meeting the CEO the activist sends a letter and 300-page presentation to the board. Once the directors have waded through the numbers and snarky asides about the corporate jet, it boils down to three demands: a buy-back, the spin-off of a non-core

subsidiary and the search for a merger partner. Just over half of the demands made by activists in 2014 fell into these categories, according to FactSet.

The typical CEO will feel defensive, and his board of directors will dither. Perhaps the activists' suggestions were examined several years ago and rejected by clever folk at McKinsey & Co, a consultancy, and by the helpful banker who made that initial warning call. An old-timer on the board may suggest playing dirty, by putting in place a poison pill—a cap on the number of votes any individual shareholder can have—or “staggering” the board so that only a few directors can be ousted each year. But such defences are more likely to provoke than to deter, and these days boards avoid them. Instead the board will often string the activist along, hinting it agrees with him while doing nothing. Big mistake, as Julia Roberts, consort of another 1980s corporate raider in *Pretty Woman*, memorably remarked.

At this point the diddled-around activist may go public, raising its stake to over 5% (which triggers a regulatory disclosure), putting its documents online with a video and campaigning for shareholders' votes like a politician in a primary. The media go wild, especially about the corporate jet.

The typical CEO launches a roadshow of his own to elicit his big shareholders' solidarity. But he may well find that up to a fifth of the firm's shares have changed hands and now lie with “event-driven” traders who make very short-term speculative bets on events like takeovers and deals. They gamble that the activist will succeed and that the shares will jump.

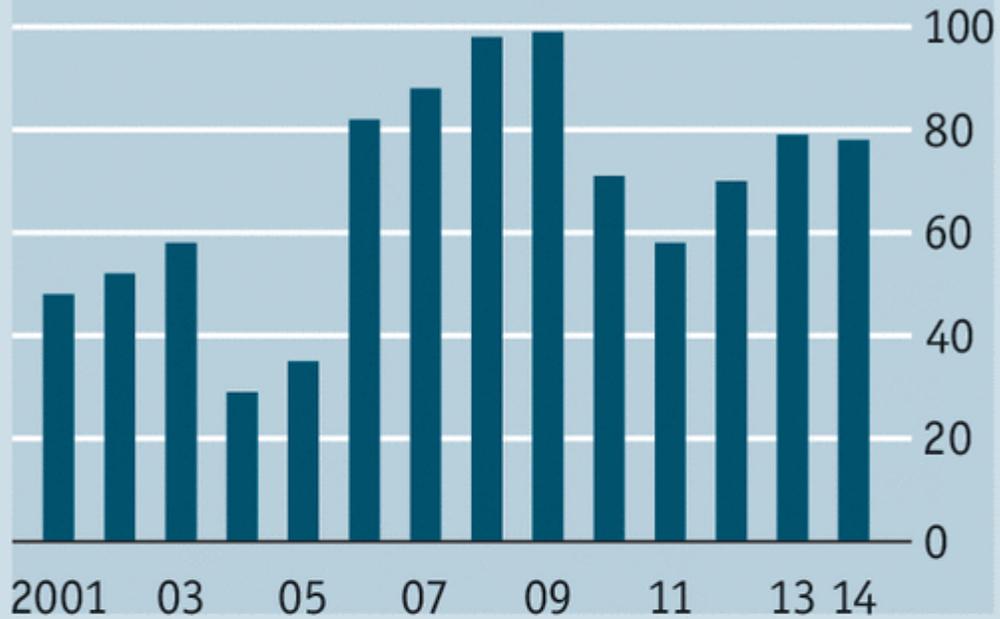
When he enters the Los Angeles offices of his biggest shareholder—call it Capital—the typical CEO discovers the people there have already met the activist and have bought in to spinning off the subsidiary. The final straw comes when the CEO visits ISS and Glass, Lewis & Co, two proxy-advisory firms. They have a duopoly on guiding passive index funds how to vote in “proxy contests”—campaigns to win shareholders' vote at companies' annual meetings. Most CEOs have never met the proxy firms before; the activist funds have spent years building up relationships and know how to present their ideas in a way that fits with these firms' thinking.

After a month's campaigning the CEO knows he faces a good chance of losing the vote. In 2014 73% of so-called proxy votes were won by dissidents, according to FactSet (see chart 3). Now it is the CEO's turn to pick up the phone and call the activist.

A proxy nation

3

Proxy fights against US companies



Success rate, %



Source: FactSet

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All these quick victories have helped activists bring about short-term outperformance. But what do they do for investors and companies in the long term? Naturally activists embellish their role. Mr Icahn claims credit for a big return to shareholders of some of Apple's \$177 billion cash pile and the break-up of eBay, but both events would have happened anyway. Big firms can have a short-term mentality without any help—IBM has spent twice as much on buy-backs as on research and development and is shrinking, perhaps as a result. Activists point out that if they were to propose changes that clearly damaged a firm's prospects the stock price would fall. "Unless you have one eye on the long term

—how customers and products are affected—you will not succeed," says Mr Loeb.

Every economy has rotten firms that need bitter medicine, which is why some bosses admit a grudging respect for the activists. "It keeps management on their toes," says a former chairman of one of Mr Peltz's conquests. And some activist funds lay good claim to long-term vision. ValueAct backed a turnaround plan at Adobe, a software maker, that sacrificed short-term earnings and took years to come good, says Mr Ubben.

A study of activism in 1994-2007 by Lucian Bebchuk of Harvard Law School, and his colleagues, found that activist interventions lead to a sustained, if modest, improvement in operating performance and better shareholder returns. Its period of interest precedes the recent growth in activism, but there is reason to believe that the pattern persists. *The Economist* has analysed the 50 largest activist positions taken since 2009. In most cases profits, capital investment and R&D have risen (see chart 4). There is little evidence of Gekko-style "asset stripping". Even when firms have cut back, it is worth considering that others in the same sector may have done just the same with no campaign.



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The biggest threat to activism is not a poor record, but a paucity of prey. Given the size of activist funds and their pace of intervention, they collectively need to find 100 large target companies over the next three years. Only 76 firms in the S&P 500 are currently showing persistently poor returns on equity (an average of below 7% for five years) and only 29 trade at below their liquidation value, which suggests 100 targets may be hard to find. “I think it’s saturated,” says one of the biggest activists, adding that some of his competitors may not have cottoned on to this. “You have a lot of people who don’t have experience or a track record.”

One option might be to look abroad, but most big funds think the cultural barriers are too great. European activist funds such as Cevian and Knight Vinke tread very softly. Asia is a world unto itself. An attempt by TCI, an activist fund in London, to take on Coal India, a

giant state-owned firm, was like a gnat biting at an elephant. In 2013 Mr Loeb's efforts to force Sony to restructure proved a damp squib.

Wanting the fairy tale

Instead overcrowding may lead activists to attack well-run firms in America. About a third of recent targets were outperforming the wider market when the activist campaign began, according to JP Morgan Chase. On January 8th Mr Peltz launched a proxy fight against DuPont, a chemicals group that has performed strongly and has a widely admired manager. That a firm is doing well does not mean it couldn't do better, but the case gets harder to make.

Even if activists start to attack unwisely, though, the outcome for America Inc could still be good, because the lazy money is being roused from its slumber.

Rather than face a proxy fight the typical CEO cuts a deal—awarding the activist, say, two board seats out of a total of 12 and promising to consider the spin-off idea. If the activist is one of those prone to theatre he will boast, inaccurately, of his total victory. The CEO considers resigning. But what if, after six months, the activist starts to agitate again, calling for a drastic cut in capital investment—not routine, but not unheard of? At this point, something unexpected happens. The CEO consults the index funds and traditional managers, with whom he now has a more intimate relationship. This time they support the firm not the activist.

This scenario is more likely than it may seem. Provoked by the activist wave, big passive money managers are waking up. In 2014 Larry Fink, the head of BlackRock, the world's biggest asset manager, declared "we need to work for the long-term interest". Vanguard, another big passive manager, has said it wants to intensify its contact with companies' boards. Most big companies are also making more effort to talk to index funds directly, says Abe Friedman, of Camberview, a consulting firm. Once viewed by companies as dumb bystanders, passive funds may come to be seen in a new light. Since they own stocks indefinitely they should have a longer-term perspective than almost anyone else.

Meanwhile mutual- and pension-fund managers are being forced to engage in more intense debates about strategy with managers and activists. Since their support is vital for any activist campaign, they are enablers but also potential restraints. "Activism is about floating balloons," says Mr Ackman. "If the



ideas are good, they will happen. If they are bad, they won't get support. It is hard for activism to be harmful."

Natural selection will ensure that activists who make foolish suggestions fade away over time, says the head of a big equity-fund manager of the old school. He says his firm is becoming more involved in companies than in the past. Mr Ubben of ValueAct, says he has a "symbiotic" relationship with such managers.

Over the long run activism will evolve in one of two ways—both of them positive. It could mature to become a complement to the investment-management industry—a specialist group of funds that intervene in the small number of firms that do not live up to their potential, with the co-operation of other shareholders. Alternatively it could overreach—and in so doing force index funds and money managers into taking a closer interest in the firms they own. If that is the way things go, activists could eventually become redundant.

Until, that is, stockholders return to lazy ways and managers feel they have nothing to worry about. Then it will be time once again for the phone call of fear.

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