November 24, 2015

Hedge Fund Activism and Long-Term Firm Value

A November 2015 article, *Hedge Fund Activism and Long-Term Firm Value*, by K.J. Martijn Cremers, Erasmo Giambona, Simone M. Sepe, and Ye Wang, is a very impressive econometric study showing that hedge fund activism more likely destroys long-term value, rather than creates it. It shows that prior studies of the type Harvard Law School Professor Lucian Bebchuk relies on to validate his policy arguments supporting unfettered attacks by activist hedge funds do not warrant the credibility claimed for them. Rather than summarize *Hedge Fund Activism and Long-Term Firm Value*, it can speak most definitively for itself:

"The ability of shareholders, especially activist hedge funds, to determine changes in corporate policies or firm control in the short-term complicates both managerial-decision making and the extent to which other stakeholders want to invest in their relationship with the firm. . . . In both cases, the result is a reduction in long-term firm value. By enhancing shareholders' ability to pressure directors and managers, hedge fund activism could thus exacerbate the shareholders' limited commitment problem rather than acting as a beneficial corrective to managerial moral hazard."

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"These results [which Bebchuk employs], however, need to be interpreted with caution, because the decision to target a particular firm at a particular time is an entirely discretionary choice by the activist hedge fund. Hence, firms being targeted by hedge funds could potentially be substantially different from other firms, and this heterogeneity may be related to their subsequent performance rather than to the activist hedge fund campaign directly. In order to better understand whether activist hedge funds tend to target a particular type of firms, we predict the determinants of activism through logit and Cox proportional hazard models. These models suggest that prior firm performance is the key predictor of becoming a target in an activist hedge fund campaign. Specifically, we find that firms are much more likely to become the target of hedge fund activism if they [have] been performing relatively poorly in the past one to five years – that is, hedge funds seem to primarily target relatively undervalued firms."

"This result, in turn, raises the possibility that the increase in firm value documented by prior studies might be attributable to market mechanisms other than the intervention by activist hedge funds. Indeed, in competitive markets, many different actors can intervene to turn things around at a relatively poorly performing company, including key employees, top executive management, directors, long-term shareholders, as well as other stakeholders like large customers or suppliers. In order to address the possibility that other factors may explain the increase in firm value following hedge fund activism, we create a matched sample, where for each "target" firm that is targeted by an activist hedge fund we assign a "control" firm that has similar characteristics (using those characteristics that we document matter for being targeted) as the target firm in the year before the start of the target firm's activist hedge fund campaign."

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"[W]e find that when. . . long-term stakeholder relationships matter more to a hedge fund's target, the targeted firms experience on average a more severe decline in Q in the three years after the intervention, relative to the firm value of the matched control firms. Also in this case, our results are economically large and statistically significant. For example, the group of firms in the industry with the most productive labor force that are targeted in hostile hedge fund campaigns have declined in value by 29.71% relative to the control firms in the three years after first being targeted, while the other firms targeted in hostile hedge fund campaigns declined in value by 7.75% relative to their control firms."

"Our finds have significant implications for the current corporate governance debate, as they challenge the desirability of an indiscriminate expansion of shareholder rights. While we recognize that managerial moral hazard or having entrenched managers and directors are concrete risks in corporate governance, our research suggests that facilitating the interventions of activist hedge funds might be an undesirable solution to address these risks. Indeed, once one takes into account the full range of informational problems faced by shareholders – including *both* managerial moral hazard (or entrenchment) *and* the shareholder limited commitment problem – hedge fund activism may carry costs that seem to outweigh its potential benefits. This also suggests that a desirable direction for future empirical research would be to investigate whether alternative corporate governance solutions exists that may better address the trade-offs posed by the multiple informational problems that imbue the shareholder-manager relationship."

Other 2015 studies that reach the same conclusions are:

The Conference Board, *Is Short-Term Behavior Jeopardizing the Future Prosperity of Business?*

Yvan Allaire and Francois Dauphin, *The Game of Activist Hedge Funds: Cui Bono?*

John C. Coffee, Jr. and Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance.*

Martin Lipton, *Is Activism Moving In-House?*

Martin Lipton