The Second Wave of Hedge Fund Activism: The Importance of Reputation, Clout, and Expertise

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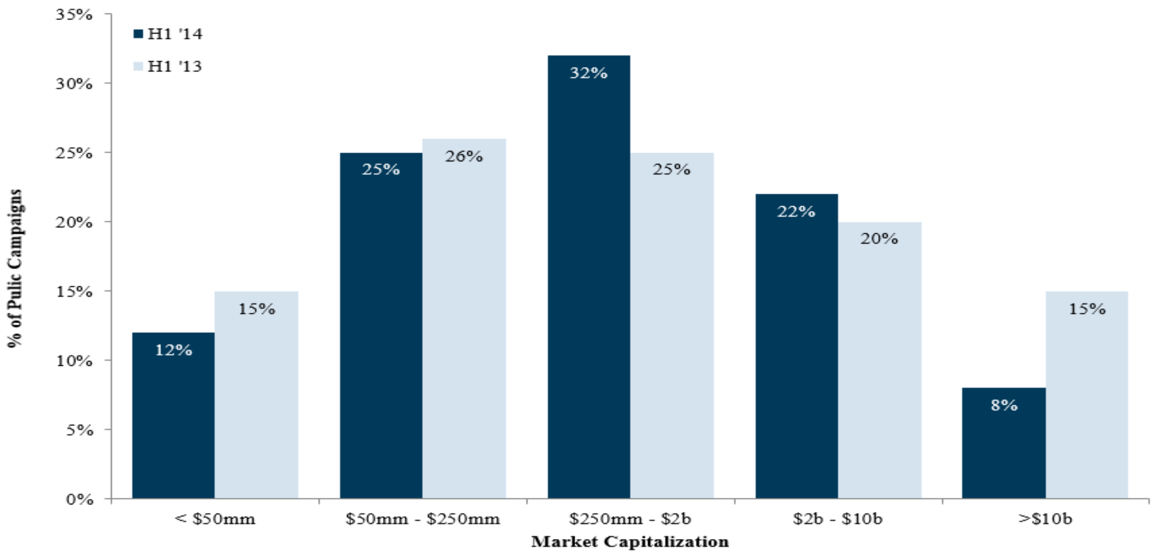
What are Hedge Funds? Why Are They Different From Institutional Investors?

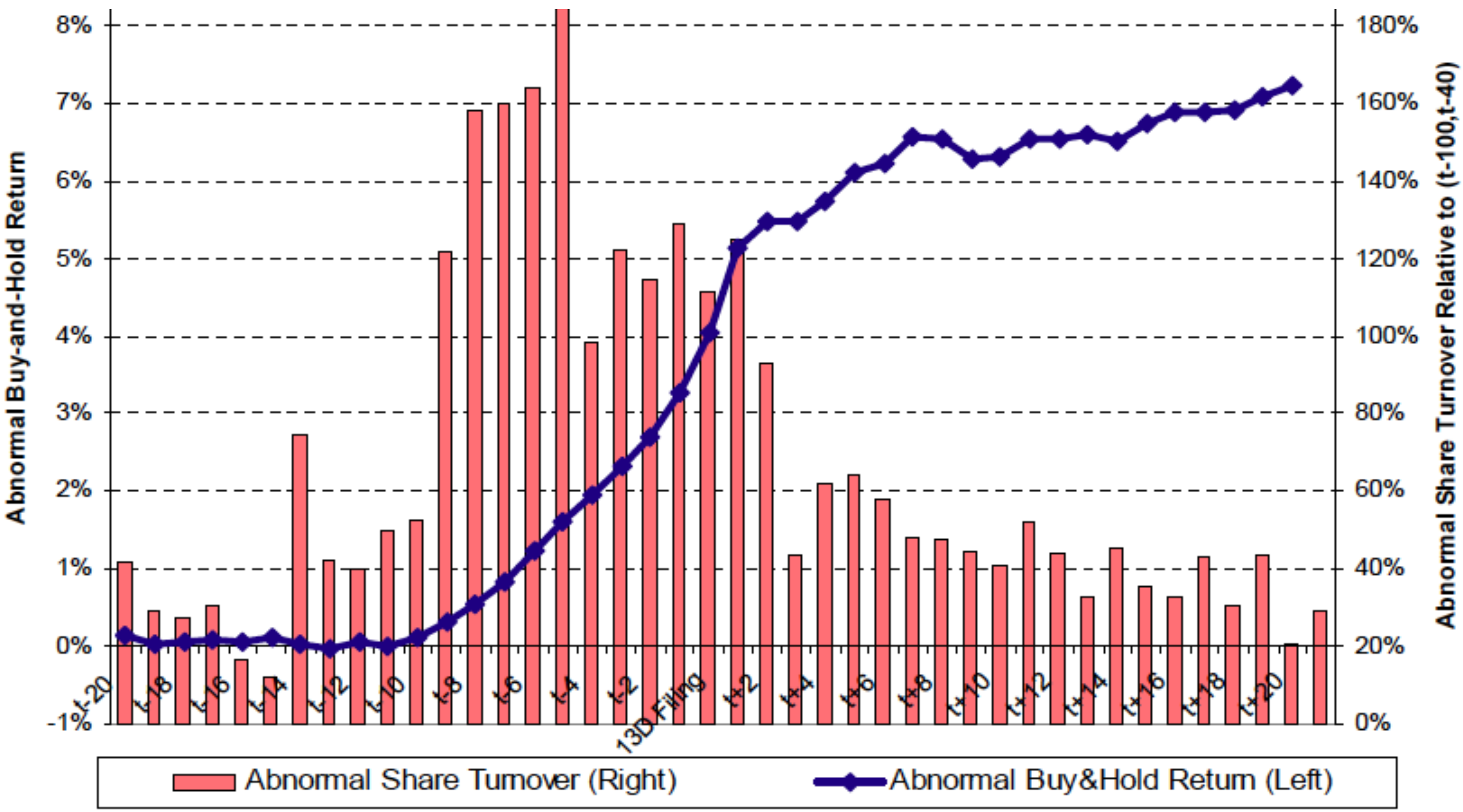
- Hedge funds are lightly regulated pools of investment capital that engage in a wide variety of investment strategies, one of which involves shareholder activism.
- Why are Hedge Funds different from traditional institutional investors?
  - Large HF manager financial incentives – 20% of profits plus 2% management fees create strong profit motives.
  - Fewer conflicts of interest than many institutional investors– e.g. mutual funds are selling product to companies, but HF's are not.
  - Flexibility, unregulated – HFs face minimal legal barriers vs. many traditional institutional investors are constrained in their investment strategies, such as, prudent investor rules and mandatory diversification requirements.

Activist Targeted Companies by Market Cap

- A significant majority of activist campaigns involve companies with a market capitalization below $2 billion

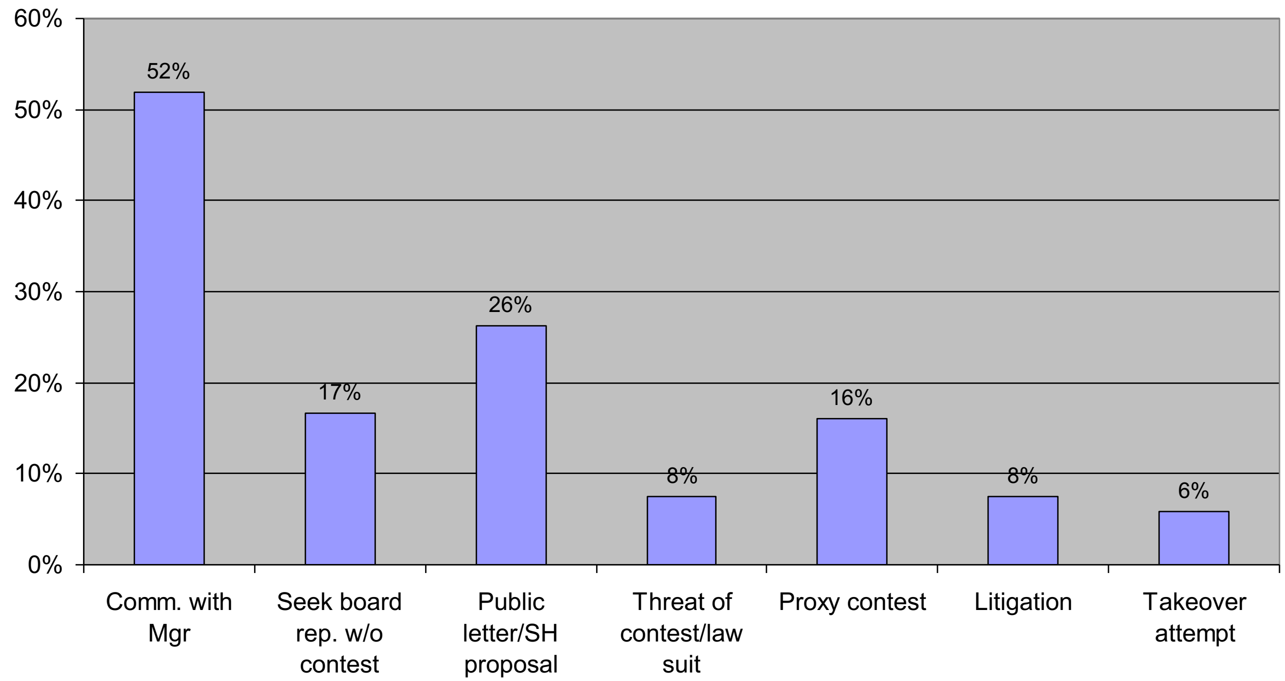


Source: Activist Insight



8%
7%
6%
5%
4%
3%
2%
1%
0%
-1%
180%
160%
140%
120%
100%
80%
60%
40%
20%
0%
Abnormal Buy-and-Hold Return
Abnormal Share Turnover Relative to (t-100,t-40)
t-20
t-18
t-16
t-14
t-12
t-10
t-8
t-6
t-4
t-2
13D Filing
t+2
t+4
t+6
t+8
t+10
t+12
t+14
t+16
t+18
t+20
Abnormal Share Turnover (Right)
Abnormal Buy&Hold Return (Left)

What Tactics Do Hedge Funds Use? (2001-2006)



How Big Are Activist Assets and Flows?

Year	Assets Under Management ($MM)	Net Asset Flows ($MM)
2003	$11,821	$921
2004	$19,465	$3,686
2005	$29,180	$3,432
2006	$47,548	$6,468
2007	$54,830	$3,507
2008	$32,268	($4,315)
2009	$36,214	($12,252)
2010	$46,802	$1,660
2011	$50,860	$3,776
2012	$65,509	$2,913
2013	$93,113	$5,276
YTD Q2 2014	$111,166	$9,425

Source: HedgeFund Research

Is Activism Desirable? It May Depend on Where You Sit

- Activists claim that increased share buybacks, dividends and higher debt prevent mgt. inefficient use of free cash flow
- Activists claim need to focus on the core business by selling/spinning off assets and get stock price up
- Activists claim need to replace poor management and improve mgt. incentives
- Activists often claim need to sell the firm

- Target claims that all of these actions reduce long run value by forcing them to reduce R&D, cut down on future capital investment, and increase bankruptcy risk
- Target claims that these actions result in diversion of wealth from other stakeholders to shareholders
- Target claims existing management is strong and pay reasonable
- Target wants to pursue long term business strategy

Data summary

- For each event, Schedule 13D/G filings
- 1,003 13D events
- 578 funds (2008-2014 is double 2001-2006)
- Larger targets ($1bn vs. $727MM market cap)
- Targets are unprofitable on average
- +7% CAR (-10,+10)
- Average ownership of 8.3%

“League Tables” of hedge funds

“Most Active” (learning?)

1 if at least 5 interventions total during 2008-10, 0 otherwise

“Top Return” (skill?)

1 if at least 10% and 3 interventions total during 2008-10, 0 otherwise

“Top Investor” (clout?)

1 if top 10 aggregate dollar investments during 2008-10, 0 otherwise

These 3 are relatively pairwise uncorrelated (Active/Top Return -8%, Active/Top Investor 37%, Top Return Top Investor 25%)

“Top Investor”

- Target larger, more profitable firms
- Are older, greater assets under management, more portfolio companies, more board seats
- Significantly higher CARs (12.4% vs. 6.6%)
- Conclusion: on average these funds have more credible reputations based on the difficulty of their past interventions, and therefore they outperform

Changes at targets from “Top Investors”?

- Significant increase in ROA, Sales, and R&D growth for four quarters
- Targets are less likely to be liquidated for poor performance
- Targets more likely to be sold
- Top Investors” target firms with significantly higher “Aggregate Entrenchment Measure” than other HFs

Why do “Top Investors” succeed?

- Not capital structure, some dividend policy (for all 3)
- Greater “Director Replacement Intent”
- 3x more proxy fights
- 3x more proxy fight wins
- 2x more lawsuits
- 3x more board seats/success
- They are more aggressive in the media

Summary

- HF activism has increased
- But still positive returns
- “Top Investors” = financial clout and expertise