Do Activist Hedge Funds Create Value?

Stockholm (HedgeNordic) – Shareholder activism can be viewed as a valuable tool for driving efficiency at public companies and creating shareholder value. In contrast to many research papers, however, a recent study does not find evidence that hedge fund activist interventions drive improvements in either shareholder wealth or firm operating performance.

As part of their approach to investing, activist investors usually acquire stakes in struggling companies and put forward proposals including spin-offs of non-core assets, a return of excess cash, improvements in corporate governance, among others. The methods of activism can vary, but the common purpose of most activists is to generate returns on their investments by fixing, improving, or separating the business operations of targeted public companies.

Using equal-weighted abnormal stock returns, past studies find that activist interventions create value for companies long term. In a recent working paper titled "Long-Term Economic Consequences of Hedge Fund Activist Interventions," three researchers find that activist interventions create no long-term value when stock returns are calculated on a value-weighted basis. Activist campaigns at smaller firms (the smallest 20 percent of firms with an average market value of $22 million) are found to generate most of the abnormal returns, whereas the remaining and larger activist targets produce a negative equal-weighted return of 1.6 percent on average two years after an activist investor shows up on the scene.

The researchers find that activist targets exhibit an average equal-weighted return of 6.8 percent one year after being targeted by activist investors, and a return of 5.9 percent two years following the start of the activist campaign. Less than half of all activist targets experience long-term positive returns. As implied above, the average net impact of shareholder activism in terms of shareholder dollars, or total change in shareholder wealth, is insignificant mainly because most activist campaigns at larger targets do not create above-average returns.

In addition to investment returns, the study examined the impact of activist interventions on firm operations. The researchers find evidence which confirms prior findings that the operating performance of target firms appears to improve compared to similar firms in terms of size and industry. The improved operating performance, however, is mostly a manifestation of pre-activist performance trends, the researchers find. Using an appropriately matched sample to evaluate the operating performance of activist targets, the researchers "find no evidence of improvements in multiple measures of operating efficiency following activist interventions, nor do we find that analysts expect earnings improvements."

The study uses a sample of 1,964 activist interventions between 1994 and 2011. "Our findings do not strongly support arguments that activist interventions drive long-term wealth for the average investor," the authors conclude. "At the same time, we find no evidence that activist interventions destroy value." The study appears to have a minor drawback. Since activists have become more operational and longer-term-oriented investors, the study period of two years following the start of an activist campaign can be regarded as too short for evaluating a campaign's success. Longer-term examination periods of five years or more may be more suitable.

The complete study can be viewed here.

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