C14 CHAPTER 14

HEDGE FUND ACTIVISM AND FINANCIAL PERFORMANCE

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C14.S1 14.1 INTRODUCTION

C14.P1 WHETHER outside shareholders can influence corporate managers to increase shareholder value has long been a question of interest in corporate finance and corporate law. The question raises two sub-questions. First, can outside shareholders identify actions that managers are not taking, but could take, that would increase shareholder value? Second, how, if at all, can outside shareholders influence corporate managers to take such actions? If shareholder activism is to increase shareholder value, shareholder activists must be able both to identify shareholder-value-increasing actions that managers are not taking, but could, and then influence corporate managers to undertake those actions. If shareholder activism does not increase shareholder value, it could be either because shareholder activists cannot identify such improvements, or because the shareholder activist can identify such improvements but cannot influence the corporate managers to undertake the necessary actions.

C14.P2 Up to the late 1990s, there was little evidence that shareholder activism generated any economically meaningful improvements in share prices or the operating performance of corporations (see, e.g., Smith, 1996; Gillan and Starks, 2007; Denes et al., 2017). In an insightful review of the evidence through the first half of the 1990s, Black (1998) judges that "[t]he evidence to date suggests that activism … has had little effect on firm performance." Commentators pinned the failure of shareholder activism in this period on the poor incentives of the shareholder activists of the time, notably public pension funds (Romano, 1993; Wang and Mao, 2015). By the early 2000s, however, a new form of shareholder activism began to emerge: shareholder activism by hedge funds.

C14.P3 So-called "hedge fund activism" promised to be different and more effective than past efforts. Professors Kahan and Rock would write in 2007 that "hedge funds hold great promise as active shareholders." Other legal scholars agreed. Professors Cheffins and

Armour (2011) observed that "hedge funds were well-placed financially to step forward as dominant players in the market for corporate influence in the 2000s." Their optimism was based on solid reasoning. Hedge fund managers have powerful financial incentives. They not only collect a healthy management fee on the assets they manage, but they can earn 10–20% or more of the profits the fund makes. It was sensible to believe that these powerful economic incentives would lead hedge fund activists to focus on changes that would benefit shareholder value, unburdened by the political agendas of past shareholder activists like labor unions or public pension funds.

C14.P4 As it turned out, however, the promise of hedge fund activism has been largely, though not entirely, unfulfilled. Hedge fund activists have influenced corporate managers to increase shareholder value, and in that sense they have succeeded where prior activists failed, doing more to compensate for a bridled market for corporate control than previous activism (Cox and Thomas, 2016). But the success of hedge fund activists has been narrow. They seem to succeed only when they facilitate the sale of the target firm. There is no strong evidence that hedge fund activists can identify other types of actions that managers are not taking, but could take, to increase shareholder value.

C14.P5 The limited nature of hedge fund successes shows up in their lackluster returns. Activist investors as a group, as measured by industry indices, have dramatically underperformed the S&P 500 index in the last several years. Many hedge fund activists suffer from a "physician, heal thyself" problem of the first order. Even clinical studies of the most successful activists show only modest success in activism campaigns (Becht et al., 2009).

C14.P6 Despite its narrow impact, hedge fund activism has been highly controversial. Hedge fund activism is just the latest incarnation of organized scrutiny of corporate management's decisions by outside shareholders. This scrutiny may arise because of an unavoidable conflict between what outside shareholders want and what other corporate stakeholders (including directors and officers) want. Outside shareholders want management to maximize shareholder returns. Others, including management itself, have an interest in seeing the corporation serve the interests of non-shareholders, including employees and their communities, suppliers and customers, and corporate management running the enterprise. Shareholder value maximization advocates, on the one hand, and stakeholder advocates on the other, both resist this characterization, asserting that capitalism presents a false dilemma: a need to choose between shareholder interests and the interests of others. Shareholder value maximization advocates claim instead that their policy keeps the economy operating efficiently and frees capital from losing companies for the next potential winners that can provide jobs in the future (Singer, 2017). Stakeholder advocates claim that shareholder interests are always aligned with the interests of others in society when shareholders think and act for the "long term," reinvesting in research and development instead of myopically trying only to maximize the current share price (Strine, 2010, 2017).

C14.P7 The cold reality is that both groups are probably wrong. Capitalism does seem to present an undeniable choice: (1) allow investors to move their capital freely into and away from businesses as shareholder value maximization dictates, but then suffer the consequences visited on others in the form of lost jobs, failed careers, and destroyed communities, or (2) restrict the ability of investors to reduce the scale of declining business entities, encourage reinvestment and research in unproductive and obsolete businesses to save jobs and preserve communities and tax bases, but then suffer the consequences of stagnated growth, competitiveness, and future prosperity. There is no easy way between the horns of this dilemma and platitudes to the contrary are only wishful thinking. Outside shareholders (that is, shareholders who are not also managers or employees) want directors and officers to maximize share prices, while almost everyone else with connections to the corporation—including employees, communities, suppliers, customers, and managers—has an interest in seeing the corporation continue to exist in a sustainable way even if that sustained existence comes at the expense of shareholder wealth.

C14.P8 Against the background of this ever-present dilemma, what makes hedge fund activism controversial is more or less the same thing that made hostile takeovers controversial in the 1980s: hedge fund activism often focuses on the benefits that accrue to shareholders when the corporation is sold. Sales put stakeholder value at risk, often leading to job cuts (including among executive teams), plant closings, and even exit from entire lines of business. This puts hedge fund activists—and the shareholders who support them—in direct conflict with those who benefit from corporate stability and longevity. Stability and longevity benefit many: careers can finish, communities can thrive for a while more, and families can stay closer for longer. The controversial nature of hedge fund activism—like much shareholder activism before it—has little to do with any dichotomy between the short-term and long-term interests of shareholders—those interests are always the same: make as much money as possible—and much to do with the irreconcilable conflict between those who own shares and those whose benefits from the corporation come in other ways. What makes hedge fund activism especially controversial—not just for stakeholders but for the shareholders who must decide whether to support them is the ferocity—the word is not too strong—with which hedge fund activists single-mindedly pursue a goal of maximizing shareholder value, not at some hypothetical "long-term" date in the future sanctioned by public opinion and corporate commentators, but right now.

C14.P9 Yet despite all the controversy, a decade's worth of research now shows hedge fund activism to be a mostly ankle-biting affair. The gains from hedge fund activism—where they exist—come from the facilitation of sales and divestitures. Section 14.2 reviews some of that evidence. But the main focus of this chapter is to explore *why* hedge fund activism has been so limited in its successes. I conclude that there likely is no form of shareholder activism that will add real value for shareholders beyond facilitating the sale of the firm. The problem, in other words, is not with the nature of the activist. The problem is with the nature of corporations themselves and the limits of "outsideness."

C14.P10 Section 14.3 argues that hedge fund activism—and shareholder activism generally—is based on the generally false assumption that corporate managers shirk their responsibilities because of so-called agency costs. If true, we might expect shareholder activists to identify a number of ways that managers could increase the performance of the corporation. But while the agency-cost paradigm remains popular in corporate finance and corporate law, there is little good reason to believe agency costs are real or large. Most of the evidence "explained" by agency theories is better explained by the assumption that managers are excessively optimistic. If managers are too optimistic, they may pursue some strategies—especially growth and reinvestment—that are not in the best interest of shareholders, but it is unlikely that optimistic managers shirk other promising action in the way agency theory suggests.

C14.P11 Section 14.4 argues that even if corporate managers miss opportunities to maximize value, hedge fund activists probably have no comparative advantage in identifying those missed opportunities beyond advocating the sale of the firm. Of course, selling the firm—especially for more than it is worth—is good for target shareholders. But other price catalysts and improvements that hedge fund activists advocate—including changes in corporate governance mechanisms—tend to generate no meaningful returns for hedge fund activists or target shareholders. That hedge fund activists lack comparative advantage is unsurprising, since virtually none are experts in the businesses of the firms they target and the former executives they sometimes rely on for expertise are likely to have less insight into the business than executives actively competing in the field.

C14.P12 Section 14.5 argues that hedge fund activism also likely rests on a faulty assumption: that it is possible to improve the performance of almost any corporation. While this is related to the problem that outside shareholders have no comparative advantage (over insiders) in identifying course-correcting corporate improvements, it is also a recognition that the problem is in fact more daunting. Much corporate decline is irreversible. Most corporations die, even the ones that were once the most successful. They decline and merge into other companies or, though less frequently, declare bankruptcy. Long-run good performance is rare, requiring an almost-Goldilocks combination of just the right growth rate (not too high and not too low), just the amount of organizational change through time (not too much and not too little), just the right balance of charismatic leadership and shared power, and just the right amount of focus on individual incentives versus collective good. Such combinations are hard to come by. As two economists once put it in a colorfully-titled article, *Survivorship and the Economic Grim Reaper*, "firm death is not an unusual or aberrant phenomenon, but a common feature of a capitalist economy" (Baker and Kennedy, 2002). Hedge fund activists often target such declining firms, the equity in which is often unsalvageable by the time the activist has taken notice, so the efforts of activists at these corporations are often unsuccessful.

C14.S2 14.2 THE NARROW SUCCESS OF HEDGE FUND ACTIVISM

C14.P13 In the first large study of hedge fund activism, Alon Brav of Duke University and three coauthors compiled a database of hedge fund activist campaigns from 2001 to 2006

(Brav et al., 2008). The only form of hedge fund activism they found to generate statistically-significant positive returns was activism that helped generate the sale of the company or substantial asset spinoffs from the company (see also Clifford, 2008). In a leading follow-up study, Robin Greenwood of Harvard Business School and Michael Schor, then of Morgan Stanley, determined that returns for other types of activism were indistinguishable from zero (Greenwood and Schor, 2009; see also Boyson et al., 2017). Aside from encouraging takeovers, however, hedge fund activists seem to have little impact on the companies they target. Targeted firms do reduce research and development expenditures (Brav et al., 2018). Return on assets—a measure of how much the corporation earns on its assets in place—improves a little at target firms (Brav et al., 2015), but this effect is only a reversal of minor declines in prior years (Bebchuk et al., 2015). In a comprehensive recent study, deHaan et al., (2018) find no evidence that hedge fund activism has been either helpful or harmful to long-run shareholders.

C14.P14 That hedge fund activists play a role in facilitating takeovers is not evidence of socially valuable behavior, of course, since considerable evidence suggests that acquirers systematically overpay for target firms they buy (Roll, 1986; Varaiya, 1988; Black, 1989; Gu and Lev, 2011). This evidence shows, however, that this part of hedge fund activism is valuable for shareholders of the target firm, less any loss from the shareholders' ownership of the acquiring (that is, overpaying) firm. Other than facilitating sales, however, hedge fund activists often focus on actions known *not* to generate meaningful returns, most notably, corporate governance initiatives. For example, Brav et al. (2008) found a number of campaigns seeking a change in the chief executive officer or chairman position (5.6% of the sample), seeking various corporate governance changes regarding the board of directors (15.0% of the sample), and changes in pay practices for senior officers (4.7% of the sample), none of which tended to have, on average, a statistically significant effect on corporate valuation.

C14.S3

14.3 AGENCY COSTS ARE SMALL

C14.P15 Much hedge fund activism is based on the proposition that the relationship between corporate managers and outside shareholders generates significant agency costs. Among these agency costs are actions corporate managers take (or inaction by them) that decrease shareholder value. That agency costs exist is an assertion many corporate finance and corporate law scholars accept even without good evidence of their existence. If it is true that managers undertake actions or are inactive in ways that harm shareholders, then the scope for shareholder activism is larger. At a minimum, this would make it more likely that outside shareholders could identify actions that managers are not taking, but could take, that would increase shareholder value. But what evidence do we have that all these asserted agency costs are real? Why might someone disbelieve it? Because if agency costs are nonexistent or fully controlled by other means, the scope for shareholder activism is likely to be highly limited.

C14.P16 Agency cost theory evolved from early objections to the profit-maximization assumption of neoclassical economics. Several economists, most notably Oliver Williamson (1963), asserted (without any real empirical evidence) that managers maximizing their own utility would intentionally divert value to themselves and shirk the job of maximizing profits. Until the mid-to-late 1970s, however, finance scholars mostly rejected this idea, remaining committed to the assumption that managers maximized current market values. For example, Fama and Miller (1972: 75) stated that "despite many years of controversy, [it has not] yet been demonstrated that the market value rule leads to predictions that are so widely at variance with observed management behavior as to rule it out, even as a first approximation."

C14.P17 The first step toward agency theory in finance was taken almost as an afterthought by Stephen Ross (1973), who advanced a general economic analysis of agency theory along with a suggestion that it might apply to managers and shareholders. Michael C. Jensen and William H. Meckling pursued Ross's suggestion at full speed in a landmark paper four years later. They claimed that "the relationship between the stockholders and manager of a corporation fit the definition of a pure agency relationship" (Jensen and Meckling, 1976: 309). This is incorrect as a legal matter. Shareholders are not principals, and directors, officers, and managers are not shareholders' agents. Corporations own assets; shareholders own shares. As lawyers have understood for hundreds of years, incorporation is special precisely because it allows for separateness: a partitioning of a set of assets, locked in by shareholders who then cannot pull them out, where those assets are shielded from the claims of shareholders' creditors who otherwise might rip the corporation apart to satisfy their claims.

C14.P18 The incorrect assumption that shareholders are principals and managers are agents is less important, however, than the idea that shareholders and corporate managers may have different objectives. Jensen and Meckling (1976: 308) call the costs of controlling managers' actions in light of these different objectives "agency costs," defined "as the sum of: (1) the monitoring expenditures by the principal, (2) the bonding expenditures by the agent, [and] (3) the residual loss" (1976: 308). The power of agency cost theory is the theoretical flexibility this three-pronged concept allows. That may help to explain its success. An outcome that seems optimal can be explained by solutions to the asserted agency-cost problem; an outcome that seems suboptimal can be explained by residual losses from agency costs that could not be controlled. For example, managers who use cash flow to acquire companies can be characterized as empire builders wasting shareholder funds, while managers who do not expand their businesses can be characterized as being unfaithful by enjoying the quiet life.

C14.P19 But there are two serious problems with agency theory. First, neither Jensen and Meckling (1976) nor subsequent researchers in the agency-cost paradigm adequately confronted the fact that real-world managers face brutal business competition that constrains their ability to shirk and divert. Jensen and Meckling admitted the problem in a footnote, but having admitted it, dismiss it with a circular argument, claiming that "the existence of competition in product and factor markets will not eliminate the agency costs due to managerial control problems … If my competitors all incur agency costs equal to or greater than mine I will not be eliminated from the market by their competition." Assuming that agency costs will exist despite competition because agency costs exist everywhere is unpersuasive. Allen and Gale (2000) provide an in-depth analysis of the constraint that product market competition places on agency problems.

C14.P20 Second, agency problems are easily controlled by existing corporate law. Early experimental evidence suggested that investigation and sanctions eliminate most shirking of the kind asserted by Jensen and Meckling (see DeJong et al., 1985). This matters because "[m]ost of corporate law is concerned with the array of substantive rules and procedural devices that are aimed at controlling managerial slack and diversion while preserving adequate discretion to carry out business operations efficiently" (Clark, 1986: xxiii). The plain-vanilla constraints of corporate law are too powerful to leave much to do for debt, large shareholders, and takeovers in controlling intentional managerial disloyalty, certainly among large US corporations. Despite thousands of articles invoking agency theory, there is virtually no evidence that managers do not maximize current shareholder value because of managerial disloyalty.

C14.P21 This is not to say—Candide-like—that we live in a world of the best possible managers. Rather, where managers appear to make bad decisions, it appears to be due to excessive optimism and not disloyalty (Roll, 1986; Heaton, 2002; Malmendier and Tate, 2005a, 2005b, 2008, 2011, 2015). The natural way to correct for optimism where needed is likely to move the assets away from value-impairing optimistic managers. Even if this merely shifts the assets to other optimistic managers, shareholders can benefit from the sale price. This may help to explain why only sales have generated gains to hedge fund activism.

C14.S4 14.4 HEDGE FUND ACTIVISTS LACK A COMPARATIVE ADVANTAGE

C14.P22 Hedge fund activism is not rocket science. Hedge fund activists are price speculators. Price speculators try to buy assets that are worth less when they buy them than they are worth when they sell them. What distinguishes hedge fund activists from other sorts of price speculators is that hedge fund activists are, as their name says, active and not passive. One who speculates on the price of oil, for example, has no choice but to be passive. Not even a large oil-producing *nation* can have much impact on the price of oil. A price speculator in the oil market can take a view on whether the price of oil will increase or decrease but cannot do anything to move that price herself.

C14.P23 Hedge fund activism is different. A price speculator in publicly-traded common stock can take actions that may move the price of the stock, even if all that person does is publicize their analysis. This is possible because the price speculator's analysis and willingness to invest in persuasion can make other investors expect something to happen that will increase the stock price. The largest stock price increases can be divided into two groups: (1) stock price increases that occur when another company acquires the corporation at a premium to its stock price before the acquisition announcement; and (2) stock price increases from organic growth of successful corporations, like Apple or Google or Amazon. We have seen that virtually all of the gains from shareholder activism come from the first category, an area where hedge fund activist may have a comparative advantage (see Corum and Levit, 2019). Hedge fund activists have been unable to make headway in the second category.

C14.P24 This may be because hedge fund activists lack any comparative advantage in ideas generation beyond the sale of the company. This is sometimes apparent in the almost-comical attacks some well-known hedge fund activists lob at corporate management. Name-calling is easy, but it does little to propose solutions. Many targets of hedge fund activism underperform their peers but pointing this out does not explain why or offer a solution to improve competitiveness.

C14.P25 Much hedge fund activism is a sort of appeal to authority, namely, the authority of the large shareholder. Some of these authorities (that is, hedge fund activists) are quite well known. But they are almost never an authority on the business of the target. Rarely do hedge fund activists themselves have expertise or training in the relevant business. When they bring in those who do—as proposed board members for example—their experience is often dated. Especially where activists call for business changes, it is difficult for other outside shareholders to believe that the activist has any special insight on the problem. Such campaigns have been the largest embarrassment for the hedge fund activists who have waged them.

C14.S5

14.5 IS CORPORATE DEATH (MOSTLY) INEVITABLE?

C14.P26 The zero-to-very low returns to activism not involving the sale of the activist's target suggests that activists cannot crack the second method of increasing stock prices significantly: increasing organic growth. In this section I argue that opportunities to do so are often beyond the capability of both insiders and outside shareholder activists.

C14.P27 Given their importance in our world economy, the data on corporate decline are sobering. For US firms listed on the New York Stock Exchange or the American Stock Exchange between January 1963 and December 1995, only about 6% of the firms traded for the entire 33-year period; over 55% of the firms delisted. A 2014 study from J.P. Morgan found that between 1980 and 2014, 320 companies were taken out of the S&P 500—the most widely-watched index of large, successful US public companies—because of business distress. This disappearance of firms coincides with poor returns. In a pathbreaking 2018 article, Hendrik Bessembinder of Arizona State University found that the majority of US listed common stocks since 1926 returned less than the risk-free rate (that is, the one-month Treasury bill) over their lives as listed company. Just 4%

of listed US companies account for all of the gains of the US stock market from 1926 to 2016. The median time a company remains listed on a US exchange? Only 7.5 years. These results are consistent with large-scale studies of operating performance. A 2012 study of the operating performance of US public companies found that only 0.5%—half of one percent—of the firms showed even "moderately strong evidence of sustained superior performance over 5 years or more" during the period 1966–2008 (Polson and Scott, 2012).

C14.P28 That corporations decline should hardly come as a surprise. After all, every major corporation traces its existence to some early effort to seize a promising profit opportunity. Those opportunities never last forever. Competitors emerge. Times change. New technologies replace old ones. Rare is the company that can innovate and compete over and again for decades. Poor, eventually, are most companies that try. Consider Polaroid Corporation. In a famous Delaware Court of Chancery opinion upholding a defensive measure, the Court wrote (*Shamrock Holdings, Inc. v Polaroid Corp*., 559 A.2d 257, 260 (Del. Ch. 1989)):

> C14.P29 Because of the nature of its business, Polaroid has always devoted a significant portion of its resources to research and development. Although the technological advances generated by this work sometimes lead to successful commercial products, that is not always the case. In addition, it may take years of research and development before a new product is introduced and begins generating income. In short, research and development cuts into Polaroid's short-term profits but provides the basis for anticipated long term growth.

C14.P30 Polaroid went bankrupt twelve years later in 2001.

C14.P31 Individual firms can decline whether or not the industry itself is declining, since attractive industries tend to attract competitors who then compete vigorously to a "shake out" of firms that cannot survive. A decline in an entire industry—sometimes measured by both a decline in the number of firms and the decline in the real value of industry sales over a long period of time—takes most firms down with it. Overall, research suggests that firm decline is both a function of firm-specific and industry-specific factors.

C14.P32 These facts present a severe challenge to hedge fund activists. On the one hand, the fact of corporate decline might present opportunities for activists to help turn things around. On the other hand, the fact of corporate decline may be too powerful a force for activists to overcome. To shed some light on this question, I obtained a comprehensive list of US hedge fund activism campaigns for the period 1996 to 2015 from Alon Brav of Duke University. I then obtained a list of US public-company bankruptcy filing dates since June 1, 2001 from Bloomberg. I matched companies that have a bankruptcy-filing date on or after June 1, 2001 through January 29, 2018 with hedge fund activism campaigns that were followed by a bankruptcy filing from six months to five years later. More than 100 hedge fund activism campaigns met this criterion, suggesting that many hedge fund activists show up to unsalvageable firms.

C14.S6

14.6 CONCLUSION

C14.P33 Hedge funds, like other asset managers, are most successful in raising funds from investors when they have a good story for their investing approach (Lakonishok et al., 1992)). Hedge fund activists have a good story. The story goes like this: The smartest guys in the room—they often are guys—will pore over research on potential target firms, identify good candidates for change, then call other shareholders to arms to increase shareholder value. The strategy is firm-specific and so less correlated with market returns, which investors like. And the strategy is both easy to understand—unlike, say, a black-box quant strategy—and comes with a certain splashy quality of seeing your hedge fund manager at work in the trenches when the business news flocks to cover the activist campaign.

C14.P34 Unfortunately, the story turns out to be pretty uninteresting. Hedge fund activists are neither the threat to corporate strength that opponents decry nor the power for positive change that activists and their supporters claim. Hedge fund activists appear to do one thing that matters: encourage companies to sell themselves. That's about it. Hedge fund activists are otherwise more or less impotent to effect meaningful change at corporations. There are no great activist success stories, no one or two companies we look at in agreement that it was hedge fund activism that turned the company around or took a good company to a significantly higher level. The large-sample empirical evidence is equally unimpressive. While an academic cottage industry emerged to study hedge fund activism from every possible angle, the effect sizes this research documented—that is, the magnitude of changes in observable quantities of interest at hedge fund activism targets—are economically small and unimportant except when the company is up for sale. When it can facilitate the sale of companies, hedge fund activism is likely to benefit target shareholders, though investors must consider whether the companies acquiring the targets are also in their portfolios and merely overpaying, so that money is simply shifting from one part of their portfolio to another. But the rest of hedge fund activism finds itself sitting with past rounds of shareholder activism of which it is only the latest manifestation. Like those past forms of shareholder activism, it just doesn't seem to matter much.

C14.P35 If hedge fund activists—the best incentivized investors in the world—cannot significantly impact target-firm financial performance other than by facilitating sales and spinoffs, what does this suggest about the broader enterprise of shareholder activism? I propose that the available evidence suggests that—except for pressuring for sale or divestitures—outside shareholders simply do not add value to corporate decision making. This is primarily because outside shareholders cannot identify important actions that managers are not taking, but could take, that would increase shareholder value. As such, outside shareholders who believe they have identified such actions are seldom believed by management or other shareholders, so their activist campaigns fail.

C14.P36 In a prescient 1992 article, a then-professor at Harvard's Kennedy School of Government, John Pound (1992), pondered the likely evolution of shareholder action following the collapse of the hostile takeover and leveraged buyout waves of the 1980s. Pound wrote at a time when the high-yield (junk bond) market had dried up, institutional investors seemed incapable of effective shareholder activism, and corporate managers appeared to be well-entrenched and protected from outside interference. Looking back on corporate history, however, Pound saw no reason to believe that corporations would escape the watchful eyes of shareholders. While some time might pass after the 1980s tactics, history taught that "market participants devise new tactics that reflect changes in the legal, political, and economic environment, and a vital free market in oversight reasserts itself." Pound expected the same would occur soon. Pound expected an evolution toward tactics that would be "less overtly hostile and less often aimed at achieving quick and complete control." He saw the prospect of "critical examination of current corporate strategies, the articulation of alternative corporate plans, and the mounting of limited voting challenges," each of which forms a critical part of hedge fund activism. At the time he wrote, the "hedge fund" was little-discussed in academic circles and that term (and thus the term "hedge fund activist") does not appear in Pound's article.

C14.P37 Pound's most interesting prediction was that due to the growing importance of large institutional investors, the next wave of activist investors might find themselves less in the role of takeover artists and more in the role of information providers, persuaders, and advocates for change to larger investors who would have the real say with corporate management in the form of their votes or threatened votes. Corporate managements would then have to refute those arguments if they could. The power of persuasion does play a more important role than anything else in the phenomenon of hedge fund activism. Despite the vigorous debate in the press and academic journals, however, it now seems clear that capital market participants and corporate directors and officers need not be fearful of the challenges of hedge fund activists. Poorly formed criticisms fail, as they mostly have in prior waves of shareholder activism. We are, in the end, reminded of the famous response attributed to Edison about his failures (to that point) to discover a way of making an adequately-working light bulb. Edison is said to have responded that he had not failed, but rather discovered yet another way not to make a light bulb. With hedge fund activism, we may—in the last decade or so—simply have discovered another way that shareholder activism does not work. Whether anyone will eventually hit on something more useful, as Edison did, remains to be seen, but there are good reasons to be skeptical.

C14.S7 References

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