

The Power of Different Points of View

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Activist investors are unpopular with almost everyone. Executives lament that they interfere with their long-term plans, instead pressuring them to deliver short-term returns. Policymakers and the public fear that they force a company to focus entirely on shareholders, ignoring stakeholders such as customers, employees, and the environment. A recent book captures the popular belief: “Shareholder activists ... are more like terrorists who manage through fear and strip the company of its crucial underlying assets, and then sell it back to the market with grossly diminished chances of long-term success... This greedy gang strips a company down to the leanest, meanest core, extracting cash out of everything that would otherwise generate long-term value.” Accordingly, Democratic Senators Bernie Sanders and Elizabeth Warren both backed a bill to constrain activist hedge funds.

The painting of activists as villains plundering a company, like barbarians pillaging a city, creates a compelling narrative. And there are certainly examples where this is the case. Renowned activist Bill Ackman – through his hedge fund Pershing Square – took a stake in retailer JC Penney, which then laid off workers and ended its famous customer discounts. This actually ended up harming long-term value for investors, including Pershing Square itself.

But are activist investors really as bad as people think? It’s almost always possible to find an example of anything you’d like to show. So before passing any regulation, it’s important to study the effect of activists in general.

And this is what a decade of research by professors Alon Brav (Duke), Wei Jiang (Columbia) and their coauthors has done. Their first paper found that, when an activist hedge fund takes a large stake in a company, the stock price rises by 7% - with no long-term reversal.

Still, you may be sceptical. Even if there are long-term benefits to shareholders, they might come from financial engineering rather than true improvements. So their second paper obtained confidential data on the productivity of a company’s individual plants, from the US Census. They found that hedge funds increase plant productivity, primarily through raising labour productivity. And this wasn’t by squeezing more out of workers – wages didn’t fall, and hours didn’t rise. Interestingly, productivity also rises in plants sold by hedge funds. Contrary to concerns of “asset stripping”, such sales reallocate plants to buyers who can make better use of them.

A third paper studies investment. Hedge funds cut R&D expenditure, which appears to be the smoking gun that critics are looking for. But innovation actually rises – more patents are generated, and patent quality increases. The company produces more with less.

This highlights a broader point, beyond the question of whether activists create value. Policymakers often criticise companies for selling businesses (even if they become more productive under new ownership), and argue that a company should invest as much as possible. As Senator Warren argued, “the real way to boost the value of a corporation is to invest in the future”. This view underpins the criticism of share buybacks, which I’ll address in a future column. For now, it’s critical to recognise that what matters isn’t how much a company invests, but how well it invests. It takes no skill to simply spend money. In the 2015-16 Premier League, Leicester City spent far less than Manchester City, but invested better as it won the title.

The above evidence suggests that activist hedge funds generally create long-term value for shareholders. This increased value arises not from taking slices of the pie from other stakeholders, but by growing the pie for the benefit of all.

What does the academic evidence mean for practitioners? There are important takeaways for both companies and non-activist investors. Starting with companies, rather than immediately viewing activists as the enemy, going on the defensive and arguing against their suggestions for reform, executives should start by entertaining the possibility that they might be right. Improved productivity and innovation are outcomes that every executive should desire, and an outsider's perspective – challenging the groupthink of the current management team – is useful in achieving this.

For non-activist shareholders, the evidence means that they are much more aligned with activists than commonly thought. Some argue that activists are only after short-term gain, and so long-term shareholders should oppose them, but as activist Paul Singer argues, "This divisive framing is objectively false and has done harm to the goal of generating sustainable returns for all investors." All shareholders benefit from higher productivity and innovation. This doesn't mean that they should support every activist campaign – a diversity of viewpoints likely leads to better engagement than an activist acting alone. Instead, it stresses the power of different types of investors not viewing each other as the enemy, but instead working together.