



Value creation or destruction? Hedge funds as shareholder activists[☆]

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ARTICLE INFO

Article history:

Received 7 November 2007

Received in revised form 23 April 2008

Accepted 28 April 2008

Available online 7 May 2008

JEL classification:

G34

Keywords:

Shareholder activism
Corporate governance
Monitoring
Hedge funds

ABSTRACT

I examine the effects of shareholder activism by hedge funds from 1998–2005. When hedge funds accumulate more than 5% of a firm, they must file a regulatory disclosure with the SEC that indicates whether their investment intentions are active or passive. Firms which are targeted by hedge funds for active purposes earn larger excess stock returns and improvements in operating performance (ROA) than a control group of firms that are targeted by the same hedge funds for passive purposes. These operational improvements appear to be driven by the divestiture of under-performing assets. I examine the organizational structure of the hedge funds and find that funds engaging in activism are more likely to have longer lock-ups and withdrawal notification periods than their non-activist peers; indicating that liquidity concerns may be an important determinant in the efficacy of activism. Finally, I document that the returns to the hedge fund are larger for their active blocks than their passive blocks, indicating that activist shareholders may use higher returns to mitigate the cost of their monitoring effort.

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1. Introduction

The separation of ownership and control in public firms gives rise to the possibility of agency conflict between the firm's managers and shareholders (Berle and Means, 1932; Jensen and Meckling, 1976). To the extent that this agency cost is large, it can have a damaging effect on shareholder value. One possible solution to mitigate agency costs is that of shareholders monitoring the firm's management. However, while monitoring may reduce agency costs and improve firm value, this effort is not without cost and the benefits from monitoring are enjoyed by all shareholders (Grossman and Hart, 1980).

Theory suggests that large shareholders (hereafter referred to as Blockholders) may be able to overcome this potential free-rider problem, given their increased equity stake in the firm (Shleifer and Vishny, 1986). Yet, most empirical studies of overt monitoring or activism efforts by pension funds, mutual funds, and shareholder groups, have produced little evidence consistent with the theory.¹ While activists appear able to force small changes in the target firm's governance structure, there is little evidence that activism yields meaningful increases in share value or operating performance (Karpoff, 2001).

Legal scholars (e.g., Bratton, 2006; Briggs, 2007; Kahan and Rock, 2006; Partnoy and Thomas, 2006) argue that hedge funds may have better incentives to monitor a firm's management and board than previously studied financial intermediaries. While the well-documented growth in the hedge fund industry has been accompanied with an increase in the number of cases of activism by hedge funds, little is known about the success or failure of hedge funds as activists.

Hedge funds have a unique organizational structure that differs from that of mutual funds or pension funds. A hedge fund manager's ability to earn performance-based compensation, lock-up investor capital, and use leverage and options to increase effective ownership stakes may increase the incentives of the hedge fund manager to monitor and affect strategy at the target firm.

[☆] This paper is based on my dissertation at Arizona State University. I am grateful for early comments and support from Jeff Coles (Chair), George Aragon, Herb Kaufman, Laura Lindsey, and Sunil Wahal; for the assistance of the editor Jeffrey Netter and two anonymous referees; for useful suggestions from workshop participants at Arizona State University and seminar participants at the IMN Hedge Fund Activism and Shareholder Value Summit. All errors are my own.

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¹ Previous studies of shareholder activism by pension funds, mutual funds, and shareholder groups include, but are not limited to, Opler and Sokobin (1995), Strickland et al. (1996), Karpoff et al. (1996), Smith (1996), Wahal (1996), Del Guercio and Hawkins (1999), Parrino et al. (2003), and Barber (2006).

Hedge funds further differ from pension funds and shareholder groups in that they have the ability to ultimately acquire the target firm if management and/or the board does not acquiesce to their demands. Accordingly, a hedge fund's organizational form and corresponding managerial incentives are likely to result in a more credible threat to target firm management and ultimately the market, resulting in meaningful wealth effects for target firm shareholders as a result of activist campaigns.

I exploit distinctions in the blockholder's legal filing requirements with the SEC to conduct a novel test of activism. This approach enables me to directly address several important questions. First, does shareholder activism by hedge funds result in systematic wealth creation in target firms? Second, does a hedge fund's organizational form (e.g., compensation and lock-ups) and corresponding propensity to exercise bargaining power affect their likelihood of pursuing activist efforts? And finally, is the activist investor able to mitigate the free-rider problem on their costly effort?

I identify 197 unique hedge fund families which engaged in at least one case of share holder activism during the time period. I define shareholder activism based on the blockholder's choice of the required SEC filing. Once the hedge fund surpasses the 5% ownership threshold, it must file with the SEC.² Investors, who have specific plans to influence the firm, or, have plans of influencing the firm or its management in the future, file a schedule 13D with the SEC. I classify these blocks as active. Investors, who attest that they have purchased the shares for investment purposes only, with no intent to affect the firm or its management, are considered passive and file a less cumbersome short form 13G with the SEC. For the 197 unique hedge fund families, I collect all 13D filings for 1998–2005. As a control group, I obtain the passive blockholdings, 13G, made by the *same* group of hedge funds. This step is an important dichotomy in the research design of this paper and the other contemporary work on hedge fund activism. Examining the differences between the same blockholder's passivist and activist holdings allows me to isolate the effects of shareholder activism, insofar as selection ability is the same across filing types. That is, in both cases the fund has made a sizeable equity position in the firm and in both cases this revelation to market may signal the fund's private information about the value of the firm. However, if the market attributes value to the activist efforts of the fund, one would expect the market to react more positively to activist filings than passive.³

I find that firms targeted by hedge funds for active purposes earn larger, positive event window returns than firms targeted by hedge funds for passive purposes. Firms targeted by activists earn a 3.39% excess return surrounding the filing date; while firms targeted by passivists earn a 1.64% excess return (differences in means are statistically significant at the 1% level). Additionally, I find that for firms targeted by activists, there is a large, positive 1.22% increase in operating efficiency (ROA) in the year following the acquisition by the hedge fund. I provide indirect evidence that this result is driven by a reduction in assets more so than an increase in cash flows. I find no meaningful evidence that hedge funds pursue myopic behavior (e.g., increase leverage or deplete cash levels) in an effort to raid the firm's long-term value.⁴

While the previous literature on activist campaigns by pension funds and shareholder groups finds little in the way of systematic wealth creation as a result of the activist campaign, shareholder activism by hedge funds is associated with significant, positive wealth effects in target firms. This raises the possibility that differences in the organizational form of hedge funds contributes to the effectiveness of activism. I find that hedge funds which pursue activist strategies employ organizational structures which enable them to mitigate liquidity constraints in their investment portfolio. Specifically, hedge funds with longer lock-up and redemption notification periods are more likely to initiate activist campaigns. These results are consistent with the view that relatively costless redemption of shares by a financial intermediary's investors (e.g., mutual funds shareholders) may reduce the ability or incentive of the fund manager to engage in lengthy activist battles.

Finally, I find that the hedge funds themselves earn larger holding period returns on their active blocks than their passive blocks. The average annual return to activist holdings is 8%–21% larger than the returns to passive holdings. The lack of a reliable proxy for monitoring costs (e.g., effort of the manager and opportunity costs) makes it difficult to comment on the net gains to activism. Nonetheless, observing the revenue function of the activist is insightful, even in the absence of the cost function. To my knowledge, this is the first paper which empirically documents that active blockholders earn additional compensation which may be used to offset their monitoring costs. At the least, these results are helpful in explaining why, in equilibrium, we observe activist efforts by minority shareholders.

Contemporary work by Becht et al. (in press), Klein and Zur (in press), Brav et al. (in press), and Boyson and Mooradian (2007) also focus on shareholder activism efforts by hedge funds. Using a case study approach, Becht et al. (2006) find that activism efforts by the Hermes U.K. Focus Fund results in large, positive excess returns to target firms. In work most closely associated with this paper, Klein and Zur (in press), Brav et al. (in press), and Boyson and Mooradian (2007) study large cross-sections of hedge fund activism. Similar to the findings of this paper, they find that activist targeting by hedge funds results in positive excess returns to the target firms at the filing announcement.

However, these studies focus solely on the activist efforts by hedge funds (and activist efforts by non-hedge fund investors in the case of Klein and Zur (in press)). Only examining activist campaigns by hedge funds, while interesting, makes it difficult to draw conclusions that indeed *activism* leads to an increase in firm value or operating performance. An alternative hypothesis would be

² A detailed discussion of these filing requirements is available from the author upon request.

³ It is possible that collecting passive block holdings from hedge funds which have shown a propensity to take activist positions in the past may result in a selection bias, given that the market may assign some probability of future activism from these funds. However, this bias should limit my ability to distinguish differences in performance between the two filing types; it does not.

⁴ The rise of activism by hedge funds has caused concern among many corporate boardrooms. In a recent letter to clients, famed corporate lawyer Martin Lipton characterized hedge fund activism as follows, "...the No. 1 issue for directors is anticipating attacks by activist hedge funds seeking strategy changes by the company to boost the price of the stock...Expose the attackers for what they are, self-seeking, short-term speculators looking for a quick profit at the expense of the company and its long-term value."

that these hedge funds select better investments than non-hedge fund shareholders (French and Ko, 2006). Therefore, observing positive excess returns around the filing date or improvements in operating performance could be the result of selection ability rather than the result of activism. By comparing the activist and passivist investments made by the same group of hedge funds, this paper is able to directly address the question of whether activism creates value.

2. Shareholder activism

Dlugosz et al. (2006) document that in 2001 the average S&P 1500 firm had 1.97 outside blockholders (>5% ownership) who collectively owned 18% of the firm. While these blockholders seem capable to assume the role of corporate monitor, much of the previous literature on activism and blockholders yields little evidence that blockholdings by these institutions typically results in activist efforts which produce large-scale value creation.⁵ Possible explanations as to why we do not observe a measurable impact from activism include conflicts of interest on behalf of the monitor (Romano, 1993; Davis and Kim, *in press*), a blockholder's desire to "walk away" from the investment rather than spend costly effort to monitor management (Parrino et al., 2003), and an inability of researchers to accurately capture the initial moment that the market becomes aware of the activist's efforts (Gillan and Starks, 1998; Karpoff, 2001).

Alternatively, it could simply be the case that activist threats by pension and mutual funds are not viewed as credible by target firm management, and therefore the market. Even in the case of shareholder proposals, firm management is often not bound to comply with shareholder vote (e.g., remove anti-takeover provisions). As such, overt threats of activism may be viewed as unlikely to result in a systematic reduction of agency costs in the target firm.

2.1. How hedge funds differ as corporate monitors

Recent work by legal scholars argues that the organizational characteristics of hedge funds make them a likely candidate to engage in shareholder activism.⁶ The unique organizational features and lack of regulation for hedge funds as compared to mutual funds or pension funds make for an interesting laboratory to study shareholder activism.

Hedge funds are typically not subject to the ERISA or "prudent man" regulations, nor are they required to maintain high levels of diversification in order to receive preferential tax status like mutual funds. Hedge funds are not subject to the same liquidity constraints of mutual funds. Mutual funds are required to maintain sufficient liquidity in their portfolio to allow for daily withdrawal requests from fund shareholders. Hedge funds are able to "lock-up" investor capital for extended periods of time, and often require investors to give notice well in advance of any withdrawal. Successful activist campaigns may require funds to hold large, illiquid blocks for extended periods of time; liquidity concerns impose costs on the mutual fund which are less evident for hedge funds (Aragon, 2007; Coffee, 1991; Bhidé, 1993).

Pension and mutual funds are typically bound by charter to not use leverage or derivative instruments. Hu and Black (2007) speculate that hedge funds routinely use leverage and options to gain increased effective ownership in target firms. To the extent that increased economic or voting power may increase the probability of success in activist campaigns, a hedge fund's ability to use of leverage/options may be advantageous to the activist.

Pension and mutual fund manager compensation is typically composed of less direct performance-based compensation when compared to that of hedge fund managers.⁷ Hedge fund managers receive an incentive fee which is typically equal to 20% of the fund's annualized returns. To the extent that activism is a value increasing activity, but requires costly effort by the fund manager, the hedge fund manager will receive higher marginal compensation for their increased effort.

Finally, I argue that hedge funds have a definitive tool in their arsenal which increases their relative negotiating power with the firm's management or board. Specifically, if the hedge fund is displeased with the operating or governing ability of management or the board; it can simply offer to buy the firm. In essence, if the market for *partial* corporate control is not a sufficient disciplinary mechanism, the hedge fund may have the market for *complete* corporate control at its disposal. I identify 29 cases of activist hedge funds which offered to buy the firm entirely at some point during their tenure.⁸ While the funds rarely follow through with the buyout transaction, the funds which threatened to buy out the firm almost uniformly reach settlements with the target firm whereby they achieve some or all of their stipulated requests and these cases result in the largest event return to the target firm when compared to other requests by the blockholder.

These characteristics are largely consistent with the results of Holderness and Sheehan (1985) and Bethel et al. (1998) who find that firms targeted by a group of activist blockholders, many of whom were well-known corporate raiders, experienced share value and operating performance increases following the block purchase. Raiders such as Carl Icahn, Irwin Jacobs and Boone Pickens routinely threatened to acquire the entire firm, perhaps largely as a negotiating tool to achieve their activist agenda.

Hedge funds serve as a hybrid between delegated portfolio managers, like pension funds and mutual funds, and those of traditional corporate raiders. Hedge funds have increased incentives and negotiating power that pension funds, mutual funds, and shareholder groups simply do not possess. These differences give rise to the possibility that organizational form may be an important determinant in the success or failure of shareholder activism.

⁵ Romano (1993), Opler and Sokobin (1995), Strickland et al. (1996), Karpoff et al. (1996), Smith (1996), Wahal (1996), Del Guercio and Hawkins (1999), Parrino et al. (2003), Barber (2006) and Davis and Kim (*in press*) among others.

⁶ See Bratton (2006), Briggs (2007), Kahan and Rock (2006), Partnoy and Thomas (2006).

⁷ Golec (1992) and Deli (2002) find that only 6–7% of mutual funds companies offer performance-based compensation contracts to the investment advisor.

⁸ This may understate the power of the hedge fund in seeking ultimate change in the firm. In 80 additional cases, the hedge fund specifically demands that the firm sell all or a portion of the firm to an outside bidder.

3. Experimental design and sample construction

I focus on the initial filing decision of a 5% blockholder to construct my sample of activist and passivist blockholdings. Specifically, shareholders who attest that they have no intentions of influencing the firm or its management but only acquired the block for investment purposes, file a Schedule 13G filing with the SEC. I classify these blocks as *passive*. Investors who are unwilling to give up the option of affecting the firm or its management in the future, or who have specific plans to affect the firm, file a Schedule 13D filing with the SEC. I classify these blocks as *active*. Capturing both passive and active blocks by the same hedge fund proves particularly useful in constructing a control group of firms from which to isolate the effects of activism.

I collect a dataset of hedge fund activists from the Dow Jones Newswires “CFA Weekly Summary Of Key 13D Filings To The SEC”. I add to the sample by searching Factiva for the following text strings: “hedge fund and shareholder activist” or “hedge fund and shareholder activism” or “hedge fund and 13D”. From this sample, I confirm that the activist in each filing is indeed a hedge fund through the fund’s webpage, other web searches, or published media reports.

This selection criterion yields a sample of 197 distinct hedge funds with at least one case of shareholder activism. From this sample of funds, I then collect *all* blockholdings (passive and active, as well as their amendments) purchased by the fund from 1998–2005 through the SEC website. This search yields 2185 unique firm–fund blockholdings. I exclude financial firms and regulated utilities (Fama–French 30 Industries 20 and 29), yielding a final sample of 1902 firm–fund observations.⁹ These blocks are comprised of 1114 passivist blocks and 788 activist blocks.¹⁰

From both the 13G and 13Ds, I collect the date in which the fund crossed the 5% barrier, the date the 13G/13D was filed with the SEC, the identity of the firm in which the fund acquired the block, the identity of the blockholder, and the percentage of shares owned by the blockholder. For those blocks in which I am able to observe the blockholder’s exit, I collect the date on which the blockholding dropped below 5% and the date when the filing was disclosed to the SEC. From each 13D I collect the stated purpose for the funds’ investment in the firm (i.e., talk with management, seek board representation, replace the CEO). Further, any changes to the fund’s purpose or intentions must be disclosed in subsequent amendments. From each subsequent 13D amendment filed by the fund, I note whether there has been a material change in the funds stated purpose for investment and the filing date on which the amendment was filed. This allows me to track the block from inception to end, as well as track any changes in activism intent over the life of the block.

The choice in experimental design to compare the active and passive declarations for a given fund is largely unique to the literature. As such, some time should be spent discussing the blockholder’s decision to truthfully disclose its investment intentions by filing the correct blockholder filing. One question which arises is why an active blockholder doesn’t simply file as passive thereby not disclosing their activist intentions to the market. There exists evidence that the SEC and target firms utilize the court system to enforce truthful disclosure by blockholders (see, e.g. *Ronson Corp. v. Steel Partners II* (2005) and *SEC vs. Montgomery Medical Ventures, LP* (1996)). Not surprisingly, many of the cases of activism antagonistically pit target firm management against the hedge fund. Firms which are the subject of activist targeting often seek to discredit the blockholder in the court of law and use perceived misstatements in the blockholder’s 13G/13D filing as the basis of the lawsuit. Conversations with several hedge fund activists reveal a similar story. The hedge funds are aware of their negative perception by firm management and often the financial media. As such, their lawyers are extremely cautious to not file a disclosure with the SEC which could be viewed as misleading. Empirically, I find a sample of 104 observations where the hedge fund changes its filing type from that of a passive blockholder (13G) to that of an active blockholder (13D), further indicating that blockholders are aware of the legal ramifications of their filing type and change their SEC filings if their investment intentions change.

To the extent that blockholders truthfully disclose when they have intentions of actively monitoring the firm, a further question which arises is whether there is any cost in simply always filing as an activist to remove any ambiguity in their stated intentions. Therefore, utilizing the 13D filing as the basis of activist event might be misleading if funds simply file as activist to mitigate future legal action. While this form of misrepresentation is not illegal, it can be costly to the blockholder. The 13D is a longer form which requires greater disclosure by the manager and requires filing within 10 trading days.¹¹ One particular cost this form imposes on the manager is revealing all trading in the target firm made by the fund over the last 60 days. Once the blockholder has filed the initial 13D, they must file amendments to this form any time their equity position changes $\pm 1\%$. When a firm plans to increase or decrease its position in a given firm, this increased disclosure reveals those intentions to the market and as such is likely to negatively impact the fund’s execution prices on building or reducing its block.

4. Empirical results: target firms

4.1. Summary Statistics

Table 1 shows the distribution of both activist and passivist blockholdings throughout the sample period. The number of total blockholdings by hedge funds has more than doubled over the time period, consistent with the rise in assets under management in the hedge fund industry over the same period. The percentage of activist blocks over the sample period remains fairly constant.

⁹ Results are robust to their inclusion.

¹⁰ In addition, I exclude blocks which were formed in REITs and closed-end funds. While these firms are certainly the targets of activism, they are outside the focus of this paper. For an analysis of these firms, see Bradley et al. (2005).

¹¹ A SC 13G requires the fund to disclose their holding within 45 calendar days after the year in which they acquired the block.

Table 1

Distribution of blockholdings across time

Year	All blocks	Passive blocks	Active blocks	Active blocks as a % of all blocks
1998	204	122	82	40.2
1999	168	106	62	36.9
2000	130	67	63	48.5
2001	181	110	71	39.2
2002	208	114	94	45.2
2003	243	137	106	43.6
2004	311	193	118	37.9
2005	457	265	192	42.0

The table presents the distribution of block purchases by year. The period of interest is 1998–2005. The year in which the initial block filing was filed is considered the purchase year.

While there has been a rise in the number of activist campaigns over time, much of this rise appears consistent with a general increase in the size of the industry over the same period.

Table 2 reveals the distribution of hedge fund activism across Fama-French 30 industries. With the exception of tobacco products, there is at least one case of activism in each of the 30 industries. Activist blockholders cluster in Personal/Business Services, Financial, Healthcare, and Business Equipment. Similar results are observed for passivist blockholders. I observe high levels of specialization by industry for the same hedge fund activist (i.e., 56% of each fund's activist campaigns occur in the fund's modal Fama-French 30 industry). Further, 21% of the funds in the sample with multiple activist campaigns focus their efforts in only one industry. This suggests that the skill of an activist is not ubiquitous; rather fund managers may possess industry-specific monitoring skills which lower the start-up costs of monitoring.

Table 3 reports summary statistics for all target firms in the sample. I compare differences in target firm characteristics by the blockholder's stated agenda (active versus passive). Accounting variables have been industry-adjusted based on the median of the firm's Fama-French 30 industry. In the year prior to the blockholder's targeting, firms targeted by activists have significantly larger average ROA and ROE, but lower market to book ratios than firms which are targeted by passivists. Additionally, I calculate the firms market adjusted excess returns over the 1-year period leading up to the purchase of the block. Differences in means reveal that firms targeted by passivists outperformed firms targeted by activists by 19.45% in the year leading up to the targeting.

Table 2

Distribution of block purchases by Fama-French 30 industries

Industry description	FF industry	All blocks	Passive blocks	Active blocks	% of active blocks
Food products	1	31	13	18	58.1
Beer and liquor	2	3	2	1	33.3
Tobacco products	3	1	1	0	0.0
Recreation	4	56	34	22	39.3
Printing and publishing	5	14	7	7	50.0
Consumer goods	6	22	11	11	50.0
Apparel	7	19	8	11	57.9
Healthcare	8	240	156	84	35.0
Chemicals	9	24	16	8	33.3
Textiles	10	10	5	5	50.0
Construction	11	41	26	15	36.6
Steel	12	22	12	10	45.5
Fabricated products and machinery	13	42	24	18	42.9
Electrical equipment	14	22	7	15	68.2
Autos	15	23	15	8	34.8
Aircraft, ships, railroads	16	12	10	2	16.7
Precious metals	17	22	16	6	27.3
Coal	18	12	7	5	41.7
Petroleum	19	53	39	14	26.4
Utilities	20	22	12	10	45.5
Communications	21	86	55	31	36.0
Personal/business services	22	384	229	155	40.4
Business equipment	23	202	124	78	38.6
Paper	24	33	18	15	45.5
Transportation	25	52	35	17	32.7
Wholesale	26	85	54	31	36.5
Retail	27	116	74	42	36.2
Restaurants and hotels	28	50	26	24	48.0
Financial	29	259	145	114	44.0
Other	30	94	46	48	51.1

The table presents the distribution of blockholdings by FF30 industry over the period 1998–2005. Passive blocks are defined as blockholders filing Schedule 13G. Active blocks are defined as filing Schedule 13D. The clustering below includes both regulated utilities and financials for illustrative purposes. These blocks have been excluded in further analysis.

Table 3

Ex-ante characteristics of target firms by block type

		Active (13D)		Passive (13G)		Difference 13D–13G
ROA	Mean	–7.52%***		–11.82%***		4.30%***
	Median	–2.71%***		–4.27%***		1.56%***
	N	665		967		
ROE	Mean	–8.53%***		–15.06%***		6.53%
	Median	–5.49%***		–8.71%***		3.22%***
	N	663		967		
M/B	Mean	0.07		0.41***		–0.35***
	Median	–0.21***		1.81		–2.02***
	N	663		973		
Leverage	Mean	6.25%***		6.35%***		–0.09%
	Median	1.41%***		–1.58%***		2.99%
	N	668		970		
Cash	Mean	7.18%***		11.76%***		–4.58%***
	Median	1.33%***		4.36%***		–3.03%***
	N	668		975		
Payout ratio	Mean	–1.42%***		–0.88%***		–0.54%
	Median	0.00%		0.00%		0.00%
	N	662		963		
Market cap (MM)	Mean	402.68	–	444.79	–	–42.11
	Median	101.26	–	153.03	–	–51.78***
	N	664		973		
Firm age (Years)	Mean	4.19	–	3.71	–	0.48***
	Median	4.44	–	3.92	–	0.51***
	N	788		1114		
Market adjusted return	Mean	–20.86%***		–1.41%	–	–19.45%***
	Median	–21.87%***		–4.91%	–	–16.96%***
	N	627		961		
Run up (–13, –1) months	Mean					
	Median					
	N					
Size of the block %	Mean	8.38%	–	7.40%	–	0.99%***
	Median	6.35%	–	6.10%	–	0.25%*
	N	788		1114		

The table sets forth the descriptive statistics for both active and passive blocks from 1998–2005. Passive blocks are defined as blockholders filing Schedule 13G. Active blocks are defined as blockholders filing Schedule 13D. Data is obtained from CRSP and Compustat. Variables are calculated in the fiscal year prior to the block's formation. Accounting variables (ROA, ROE, MB, Leverage, Cash flow, and Payout ratio) are industry-adjusted for the median Fama-French 30 value. The Active and Passive blocks columns test the null hypothesis that the difference between the target firms accounting variables and the median industry level is equal to 0. The last column provides differences in means and medians between the 13D and 13G filings. Differences in median *p*-values are obtained using Wilcoxon Signed Rank test. *, **, *** correspond to *p*-values of 10%, 5%, and 1% level, respectively.

One suggested motive for hedge fund activism is that hedge funds are interested in creating short-term value by raiding the company's cash and making the firm pay large dividends at the expense of long-term value (Klein and Zur, *in press*). I find that firms targeted by activists actually have lower levels of cash and statistically indistinguishable payout ratios relative to their passively targeted peers (Table 3). If hedge fund activists were interested in raiding a firm's cash, it seems unlikely that the funds would target low-cash firms to do so.

4.2. Short-run excess returns

Table 4 reports the 5-day (–2, +2) CARs of the target firm during the window surrounding the blockholder filing.¹² I find that firms targeted by both passive and active blockholders experience positive and significant excess returns surrounding the filing date. Revealing block ownership in a firm may be viewed as a positive signal to the market (regardless of the investor's intent), given that the institutional investor may be perceived to have better information about the quality of the firm.¹³ If, however, the market views shareholder activism as providing additional value to the target firm, one would expect to see larger excess returns to firms targeted by activist blockholders than firms targeted by passivist blockholders.

In Panel A, Table 4, differences in means and medians reveals that the market reacts more favorably to firms targeted by activists than firms targeted by passivists. Firms targeted by activists earn a mean CAR of 3.39% around the filing date. While, firms targeted by passivists earn a smaller mean CAR of 1.64% around the filing date. Differences between the two are statistically significant at conventional levels. In an effort to equate differences in filing requirements, in Panel B I restrict the sample of passive blocks (13G) to those which are filed within 10 trading days of crossing the 5% threshold to account for filing delays. Additionally, to remove possible confounding events from multiple hedge fund blocks in the same firm, I include only those firms in which there were no other hedge fund blocks (passive or active) within 2 years of the filing date. The event study results and their inferences are similar to those obtained in Panel A.

¹² The results, which are omitted for brevity, are robust to other event windows, including: (–5, +5), (–1, +1), and (–1, 0). I choose to report (–2, +2) based on apparent leakage of the blockholder filing up to 2 days prior to actual file date.

¹³ Further, the passive holdings in my sample are held by hedge funds which by definition have taken at least one activist stance in their history. It is possible that the market may anticipate future activism efforts, even for the passive holdings.

Table 4

Short-run excess returns surrounding blockholder filing

	Mean	Median	% positive	N
Panel A: event window (−2, +2) CARs estimated using market model returns (all blocks)				
Active (13D)	3.39%***	1.68%***	62.8	648
Passive (13G)	1.64%***	0.52%***	54.1	957
Difference (13D–13G)	1.75%**	1.16%***		
Panel B: event window (−2, +2) CARs estimated using market model returns (only “clean” filings)				
Active (13D)	3.40%***	1.63%***	62.3	484
Passive (13G)	1.53%***	0.48%***	54.6	557
Difference (13D–13G)	1.87%**	1.15%***		
Panel C: event window (−2, +2) CARs for change of filing from passive (13G) to active (13D)				
Change from 13G to 13D	1.98%*	1.73%**	60.6	104

The table presents event window CARs surrounding the initial blockholder filings. The 5-day window of (−2,+2) is considered, where day 0 is the initial filing date with the SEC. Excess returns are defined as the difference in target firm return and the firm's expected return based on the market model. Model parameters are estimated over the window (−150, −31) against the CRSP value-weighted index. Panel A considers all active and passive blocks within the sample. In effort to equate the differences in filing requirements between the 13D and 13G, in Panel B I exclude all 13G observations which were not filed within 10 trading days of acquiring the block. Additionally, blocks which are formed in targets which have been the subject of a hedge fund block within the last 2 years are omitted. In Panel C, I examine the change of filing type from Passive to Active. Specifically, the blockholder originally filed their block as a passive investment, however, at some point their investment intent changed and the blockholder sought a more active role in the firm. By law, the blockholder must change their filing type to Active. Standard errors are clustered for both hedge fund and year. *p*-values for medians are obtained using the Wilcoxon Signed Rank Test. *, **, *** correspond to *p*-values of 10%, 5%, and 1% level, respectively.

In unreported tests, I separately control for both hedge fund and year effects and find that the larger event window returns associated with activist filings is robust to the inclusion of both. Further, I explore the relation between the cross-sectional variation in the hedge funds' reported agenda for activist blocks and the event window returns. Much of the gains from activism are driven by the cases where the hedge fund requests that the firm sell off part of its assets or the entire firm. Firms targeted by activists with a stated intention of selling firm assets or buying the firm, on average earn an additional 3.7% in event returns around the filing. Given that pension funds and mutual funds are typically unable to threaten to acquire the firm, while hedge funds have this option at their disposal; this important difference in organizational form may be consistent with why we observe activism campaigns by hedge funds producing more pronounced wealth effects than previously studied financial intermediaries.

4.3. Change of blockholder filing type

I track all changes in the blockholder's filing amendments and changes in filing type to provide a unique robustness test to whether activism creates value in target firms. I identify a sub-sample of 104 passivist hedge fund blockholders which later change their filing type with the SEC to that of an activist. That is, at the initial moment that the hedge fund crossed the 5% threshold, it had no intentions of influencing the firm or its management. Over time, however, a material change in its investment intent occurred and the fund wanted to become more active in the firm's business. By law, the hedge fund must change its filing type to active (13D). This sub-sample is particularly useful in addressing the causality issue of whether activism creates value in the target firm. If the positive excess returns we observe at the blockholder filing date were simply because hedge funds pick better investments, than we would not expect the change of filing type to convey any new information to the market. If however, shareholder activism creates value in the target firm, we would expect to observe a positive excess return around the change of filing type.

From Panel C of Table 4, we see that firms where the blockholder simply switches from a passive to an active stance in the target firm receive a positive 1.98% mean excess return at the date of the activist filing. It should be noted that in most cases the blockholder does not purchase nor sell any additional shares around this filing. Therefore, the only information revealed to the market is the change of filing type.¹⁴

4.4. Operating performance

Given that firms targeted by activist blockholders experience larger excess returns around the filing of a block acquisition than those of firms targeted by passivists, a reasonable question is whether activism is associated with improved operating performance. Much of the previous literature on shareholder activism has found limited evidence of improvements in operating performance (see, e.g., Karpoff et al. 1996; Smith, 1996; Strickland et al. 1996; Wahal, 1996; Del Guercio and Hawkins, 1999; Klein and Zur, in press). Table 5 reports industry-adjusted changes in operating performance as set forth in Barber and Lyon (1996). Specifically, I calculate median industry-adjusted operating variables controlling for prior operating performance. I calculate changes in operating variables from the year prior to the block acquisition.¹⁵ Table 5, reveals that firms targeted by activist blockholders experience a median increase in ROA

¹⁴ In unreported results, it does not appear that the market anticipates this changing of filing type. There is no statistically distinguishable difference in CARs for passive blockholding which later went active and those that did not. Further, I identify 37 cases of activists which change their filing type from active to passive. In unreported results, the CARs around this filing date are not statistically different than zero.

¹⁵ To control for the timing of the changes in operating performance, I calculated changes in operating performance from the year the block acquisition took place as well. The unreported results are similar.

Table 5

Changes in industry-adjusted operating performance following the blockholding

Operating variable	Passive/Active	Statistic	Year (+1)	Year (+2)	Year (+3)
ROA	13D	Mean	1.22%	1.81%*	0.89%
		Median	0.83%**	0.67%	0.65%
		N	326	225	161
	13G	Mean	-2.30%***	-0.66%	1.94%
		Median	-0.34%*	-0.07%	-0.08%
		N	516	368	259
	Difference (Mean)		3.52%***	2.47%*	-1.05%
	Difference (Median)		1.17%***	0.74%*	0.74%
EBITDA	13D	Mean	-50.69***	-33.51	-133.03*
		Median	-3.27**	-4.37*	-2.34
		N	326	225	161
	13G	Mean	-35.64***	-47.07***	-42.80**
		Median	-5.68***	-6.55***	-6.28**
		N	516	369	260
	Difference (Mean)		-15.06	13.56	-90.23
	Difference (Median)		2.41	2.18	3.94
Assets	13D	Mean	-740.68***	-1547.76***	-1863.87***
		Median	-65.70***	-112.60***	-130.83***
		N	330	227	162
	13G	Mean	-176.72***	-481.11***	-434.48***
		Median	-48.33***	-63.18***	-68.40***
		N	519	373	260
	Difference (Mean)		-563.96***	-1066.65**	-1429.39*
	Difference (Median)		-17.37***	-49.42***	-62.43***
Cash	13D	Mean	-0.94%	-0.79%	-2.24%*
		Median	-0.45%	-0.74%	-1.14%*
		N	330	227	162
	13G	Mean	-1.41%**	-0.82%	-1.58%
		Median	-0.76%**	-0.82%	-1.78%**
		N	519	372	259
	Difference (Mean)		0.47%	0.03%	-0.00657
	Difference (Median)		0.31%	0.08%	0.64%
Leverage	13D	Mean	0.81%	0.37%	-0.04%
		Median	1.25%**	1.35%	1.32%
		N	329	226	160
	13G	Mean	0.87%	2.40%**	3.42%***
		Median	0.79%	1.01%**	1.24%***
		N	513	369	256
	Difference (Mean)		-0.06%	-2.03%	-3.46%*
	Difference (Median)		0.45%	0.34%	0.08%
Dividend yield	13D	Mean	0.24%***	0.05%	-0.04%
		Median	0.00%	0.00%	0.00%
		N	323	222	157
	13G	Mean	0.00%	-0.04%	0.10%*
		Median	0.00%	0.00%	0.00%
		N	512	367	257
	Difference (Mean)		0.24%*	0.09%*	-0.14%
	Difference (Median)		0.00%	0.00%	0.00%

The table presents changes in the target firm's industry-adjusted operating performance for the 1-year, 2-year, and 3-year period following the formation of the block of (Barber and Lyon, 1996). The year of comparison is the fiscal year prior to the acquisition of the block. The industry-adjusted performance is the difference between the target firm's accounting variable and the median (FF30) industry return. To remove concurrent targeting of the same firm by other activist hedge funds, firms subsequently targeted by another hedge fund over the next 2 years are excluded. The changes are reported in percentage points. Median *p*-values are obtained from the Wilcoxon Signed Rank Test. All variables are Winsorized at the 1% level. *, **, *** correspond to *p*-values of 10%, 5%, and 1% level, respectively.

of 1.17 percentage points over firms targeted by passivists. Similar results are observed for the 2-year period following the block acquisition. In unreported results, I find similar evidence for changes in industry-adjusted ROE. These results are in contrast to Klein and Zur (in press), who find no improvement in operating performance. Possible reasons for the differences in the findings may include differences in control group, sample size, and the fact that Klein and Zur (in press) focus on the most aggressive forms of hedge fund activism. It is possible that firms subject to the most aggressive forms of activism are in the most distress and may be unlikely to turn around their operations within a year of being targeted.¹⁶

I break down the ROA formula into its two simple elements to examine if the improvement in operational efficiency is driven by an improvement in cash flows, a reduction in assets, or both. Firms targeted by both activist and passivist blockholders experience a reduction in EBITDA in the year following the block acquisition, however, differences in means and medians between the two groups are not statistically distinguishable. Conversely, firms targeted by activist blockholders experience larger decreases in total

¹⁶ Klein and Zur (in press) only focus on improvements in operations in the year following being targeted by the hedge fund.

assets than firms targeted by passivist blockholders. Thus, the improvements in operational efficiency are caused by a reduction in firm assets, more so than an improvement in cash flows.

These results offer indirect evidence that while firms targeted with both activist and passivist blockholders are associated with asset divestitures, firms targeted by activist blockholders are associated with larger asset sell-offs, with little impact on operational cash flows, than firms targeted by passivists. These results are largely consistent with the findings of Bethel et al. (1998).

As pointed out by Karpoff (2001), blockholders tend to target poorly performing firms which may experience asset divestiture and/or restructuring in the absence of activism by the blockholder. Therefore, attributing an increase in operating performance to activism can prove quite difficult. I present evidence consistent with this idea, given that firms targeted by both activist and passivist blockholders experience large drops in asset levels in the years following the block acquisition. The firms targeted by activist funds, however, actually have better operating performance in the year prior to the block acquisition than those targeted by passivist funds. This implies that if the observed decreases in asset levels were simply a reversion to the mean based solely on poor prior-year performance, one would expect to observe greater divestitures in the sample of firms targeted by passivist blockholders.¹⁷ I observe the opposite. Firms targeted by activists are associated with better operating performance in the year prior to the block acquisition and greater subsequent asset divestitures and improvements in ROA than firms targeted by passivists, indicating that improvements in operations are consistent with activist efforts.

4.5. Changes in disciplining measures: the cases of cash, leverage, and dividends

Large levels of free cash flow can create incentives for managers to take on negative NPV projects (Jensen, 1986). To the extent that excess free cash flow creates agency costs in the firm, managers can commit to payout cash through dividend increases, share repurchases, or increases in leverage in an effort to mitigate the cost.

In Table 3, I report that firms targeted by activists tend to have industry-adjusted payout ratios and leverage which are statistically indistinguishable from those of firms targeted by passivists. However, firms targeted by activists actually have smaller cash levels than those of firms targeted by passivists. These results on whole are somewhat surprising in that firms targeted by activists do not appear to exhibit greater potential for agency costs as the result of free cash flow. If anything, these firms appear less prone to the potential for agency costs given their lower cash levels and equivalent payout and capital structure policies when compared to firms targeted by passivists.

Nonetheless, it is interesting to note what changes, if any, occur following a block purchase by a hedge fund. In Table 5, I report changes in cash, dividend yield and leverage when compared to the year prior to the block acquisition. The results are mixed. Firms targeted by both passivist and activist blockholders tend to decrease their levels of cash and increase their use of leverage in the years following the block. These firms experience decreases in cash levels of 1.41 percentage points and 0.94 percentage points, respectively; and increases in leverage of 0.87 percentage points and 0.81 percentage points, respectively. However, differences in means and medians between firms targeted by activists and passivists are statistically indistinguishable from each other for both variables.

On the other hand, I note small increases in changes in the dividend yields of firms targeted by activist blockholders. Firms targeted by activists increase the dividend yield by 0.24 percentage points in the year (+1) following the acquisition of the block. Differences in means reveal weak evidence (p -value = .10) that firms targeted by activists tend to increase their dividend yield more so than firms targeted by passivists.

Roughly 75% of the passive and active blocks in my sample do not pay dividends in the period of study. Therefore, small increases in average dividend yield may indicate meaningful increases in economic magnitude. In unreported results, I split the sample into firms that paid dividends prior to the block and those that did not. I ran separate analysis on these two groups to determine if firms which paid dividends ex-ante were more likely to increase or decrease their dividends based on the filing type of the blockholders, and whether firms which did not pay dividends ex-ante were more likely to initiate dividends based on the filing type of the blockholder. In both cases, I am unable to reject the null hypothesis that changes or initiations in dividends are related to blockholder type.

Collectively, the results on the relation between the filing type of the blockholder and the agency cost associated with free cash flow are mixed. Based on accounting measures, it is difficult to say that firms targeted by activists appear more susceptible to agency costs of free cash flow. Further, it appears that firms targeted by both activist and passivist blockholders take actions which reduce management's access to free cash flow following the acquisition of the block; including lowering cash levels through the payment of dividends and increasing leverage.¹⁸ I present only modest evidence that firms targeted by activists tend to enact changes which may reduce agency costs more so than firms targeted by passivists; namely there is weak evidence that firms targeted by activists increase dividends in subsequent years more so than firms targeted by passivists.

4.6. Long-run stock performance

It is possible that the complete benefits (or costs) to activism can only be revealed over time. I find that in over 25% of the activist blockholdings, the activist files a follow-on 13D amendment which reveals a material change in the nature of the activism. Further,

¹⁷ Additionally, employing the Barber and Lyon (1996) approach to operating performance measures, controls for prior year operating performance, should help to mitigate this concern.

¹⁸ These results could be viewed as consistent with Klein and Zur (in press) who find that hedge funds force firms to pay out cash and increase leverage. Due to differences in control groups, however, I present evidence that this result is consistent with hedge fund block investments in general and not specifically to shareholder activism by hedge funds.

Table 6

Average monthly excess returns from calendar-time Fama-French 3 and 4 factor models

Portfolio	Window (months)	Alpha	MKT	SMB	HML	UMD	R ²
Panel A: calendar-time regressions of firms targeted by activists							
Active 13D	(0,12)	0.015***	1.053***	0.835***	0.405***		68.16%
	(0,12)	0.019***	0.878***	0.945***	0.327**	-0.331***	74.84%
	(0,24)	0.010***	1.010***	0.836***	0.290**		74.35%
	(0,24)	0.013***	0.874***	0.921***	0.229**	-0.257***	78.64%
	(0,36)	0.011***	0.983***	0.802***	0.302***		75.58%
	(0,36)	0.013***	0.862***	0.878***	0.249***	-0.230***	78.45%
Panel B: calendar-time regressions of firms targeted by passivists							
Passive 13G	(0,12)	0.005	1.269***	0.876***	0.378***		77.61%
	(0,12)	0.007*	1.170***	0.938***	0.333***	-0.187***	79.35%
	(0,24)	0.008**	1.198***	1.034***	0.202*		86.10%
	(0,24)	0.010***	1.100***	1.096***	0.157	-0.186***	87.73%
	(0,36)	0.008**	1.275***	1.001***	0.270***		87.41%
	(0,36)	0.007*	1.170***	0.938***	0.333***	-0.187***	79.39%
Panel C: calendar-time regressions of long/short portfolio of activist targets minus passivist targets							
Long active/short passive	(0,12)	0.003	-0.110*	-0.024	0.004		5.83%
	(0,12)	0.004	-0.149**	0.001	-0.014	-0.075*	9.03%
	(0,24)	-0.001	-0.096**	-0.103**	0.034		19.66%
	(0,24)	-0.001	-0.117**	-0.090*	0.025	-0.038	21.01%
	(0,36)	-0.001	-0.148***	-0.103**	0.006		27.11%
	(0,36)	-0.001	-0.157***	-0.097**	0.002	-0.018	27.41%

The table presents the average monthly excess return using the calendar-time approach. For each month, I include all blocks which are held for the specified time period. The average equal weighted monthly return is then regressed against the Fama-French 3 and 4 factor model. The estimated intercept (alpha) provides the average monthly excess return to the target firms of the blockholder. The time periods of interest are the 1-year, 2-year, and 3-year period following the purchase of the block. Panel A includes firms targeted by activists (13D). Panel B includes firms targeted by passivists (13G). In effort to determine the gains to activism, in Panel C I create a long/short portfolio which each month goes long firms targeted by activists and short firms targeted by passivists. The alpha of this model yields the average monthly excess returns to activism. *, **, *** correspond to *p*-values of 10%, 5%, and 1% level, respectively.

a popular argument is that activists tend to only focus on short-term gains at the expense of long-term firm value (e.g., Marty Lipton's, 2005 letter to clients). Therefore, to address these issues and to compare with previous studies on the long-run returns to shareholder activism, (e.g., Del Guercio and Hawkins, 1999; Barber, 2006, among others) I calculate the long-run returns to the firms targeted by both activists and passivists.

I estimate long-run excess returns using the calendar-time portfolio approach with the Fama-French 3-factor and the 4-factor models supplemented with the Carhart (1997) momentum factor, respectively.¹⁹ The intercept term provides a test of the null hypothesis that the average monthly excess return on the calendar-time portfolio is zero.

Table 6 shows that the average monthly excess return, as measured by alpha, to firms targeted by activists is positive and statistically significant in each of the 1-year, 2-year, and 3-year periods following the acquisition of the block. From Panel A, we observe firms targeted by activists earn an average monthly excess return of 186 basis points in the 1-year period following acquisition of the block. Annualizing this figure implies that firms targeted by activists earn average, excess returns of 22.32% in the year following the acquisition of the block.

From Panel B we see that firms targeted by passivist blockholders also experience positive and statistically significant average excess returns in the 1-year, 2-year, and 3-year periods. Annualizing the monthly returns during the 1-year period yields an annual excess return of 7.80%.

In an effort to compare the average monthly excess returns of firms targeted by activists to those of firms targeted by passivists, I use the calendar-time portfolio approach to construct monthly portfolios which invest long in the firms targeted by activists and short in the firms targeted by passivists. A positive and significant loading on the intercept term, alpha, implies that the average monthly excess return to activism is indeed positive. From Panel C, we see that there is no evidence that the activism generates long-run abnormal returns. Namely, for the 1-year period following the acquisition of the block, activism yields an annual excess return of 4.68% which is statistically indistinguishable from zero at conventional levels. In the 2-year and 3-year periods following the acquisition of the block, a similar pattern emerges.

These results should be viewed with some caution. The estimation of the long-run returns is sensitive to both estimation window and choice of benchmark. In unreported results, I remove month 0 returns and begin estimating long-run returns one month following the block filing to remove the previously documented increase in stock price surrounding the filing date. This change in methodology has a meaningful effect on the interpretation of the results. While firms targeted by both activists and passivists continue to outperform the benchmark portfolio for up to 1 year after the acquisition of the block, I am unable to distinguish that excess returns earned by firms targeted by activists are statistically different from those earned by firms targeted by passivists. Further, for the 2-year and 3-year period following the filing, the returns to firms targeted by both activists and

¹⁹ I use the calendar-time portfolio approach to control for cross-sectional dependence among target firms (Brav, 2000). In unreported tests, I also estimated long-run returns using the CRSP value-weighted index and the size and book to market portfolio control firm approach. The results, and their inferences, are largely consistent with the results presented here.

Table 7

Logistic regression predicting shareholder activism by long–short and event driven hedge funds from 1998–2005

	Model 1	Model 2	Model 3
Intercept	0.0373	0.0195	0.0163
Management fee	–0.0040	0.0027	0.0041
Incentive fee	0.0012	0.0023	–0.0009
Redemption notice period		0.0046**	0.0064**
Lock-up period		0.0067***	0.0051**
Average leverage			–0.0088**
N	1598	1573	1206
Log-likelihood	0.88	13.68***	18.76***
Pseudo-R ²	0.00	0.05	0.08

The table presents a logistic regression where the dependent variable equals one if the hedge fund pursues at least one activist campaign (and zero otherwise). The data is obtained from TASS and CISDM. The samples of hedge funds which pursue activism are found solely in the long–short or event driven sub-category, therefore, I restrict the observations to hedge funds in only these two categories. Management fee is the annual fee limited partners must pay the hedge fund for operations. Incentive fee is the performance-based fee limited partners pay the hedge fund if the fund exceeds their benchmark return. Redemption notice period is the length of time (days) in which limited partners must notify the fund that they wish to remove their capital. Lock-up period is the length of time (months) in which limited partners must leave capital in the fund without possibility of removal. Average leverage is the annual average net leverage used by the hedge fund in the calendar year. The intercept represents the probability a long–short or event driven hedge funds pursue shareholder activism. The remaining coefficients represent the marginal probabilities implied by a one standard deviation change in the explanatory variable, holding all other variables at their mean value. *, **, *** correspond to *p*-values of 10%, 5%, and 1% level, respectively.

passivists are statistically indistinguishable from zero. Nonetheless, I provide evidence that firms targeted by activists do not earn smaller long-run returns than firms targeted by passivists (i.e., do not receive short-term price increases at the detriment of long-term value), and that not surprisingly, markets appear able to quickly price in the value of activism following the blockholder filing.

5. Hedge funds activists: organizational form and the free-rider problem

Most hedge funds do not pursue shareholder activism. Preliminary estimates are that roughly \$50 Billion of the \$1.4 Trillion hedge fund industry is dedicated to shareholder activism.²⁰ A merge of the long–short and event driven hedge fund categories in the TASS and CISDM hedge fund databases reveals that activist hedge funds represent only 3% of the categories.²¹ In light of the positive market response that activism appears to have on target firms, and the relatively few number of funds pursuing activism, two questions arise. Do hedge funds which pursue activist strategies exhibit organizational characteristics which differentiate them from those hedge funds which do not pursue activism? And, while the gains to the target firm may be positive, are the hedge fund activists themselves appropriately compensated for their costly effort in monitoring the firm?

5.1. The organizational structure of an activist hedge fund

In this section I seek to provide empirical evidence that hedge funds which pursue activist efforts exhibit characteristics in their partnership arrangements which are indicative of an increased bargaining position with target firm management. TASS and CISDM provide only an updated snapshot of each hedge fund's compensation and liquidity structure. The data in this section were obtained in April 2006.

Table 7 presents the results of a logistic regression of hedge fund activism on organizational characteristics which are likely to represent a hedge fund's incentives and ability to effectively monitor the firm. As explanatory variables I include the fund's compensation contract (both management and incentive fee), the hedge fund's ability to restrict limited partners' access to capital (both lock-up period and withdrawal notification period), and the fund's use of leverage (Hu and Black, 2007). I report the marginal probabilities based on one standard deviation change in each explanatory variable holding all other variables at the mean. From Model 2 and Model 3 of Table 7 it is apparent that shareholder activism is more likely for hedge funds which have a lower investor demand for liquidity. That is, activism is more likely to take place in funds that have longer lock-up periods and longer notification periods to withdraw capital (the associated coefficients are positive and statistically significant, at least at the 5% level). Moreover, the lengths of the lock-up and notification periods are significant in economic terms. A one standard deviation increase in the lock-period or notification period implies roughly a 30% increase in the likelihood the fund pursues activism. Activist funds are less likely to use higher amounts of leverage than their hedge fund peers. The coefficient on average leverage is negative and significant. This result is counter to the assertion of Hu and Black (2007) and indicates that increasing effective ownership through margin leverage may not be an important determinant of activism.²² Finally, Table 7 provides no evidence that activist hedge funds have compensation contracts (incentive or managerial fee) which differ from those of their hedge funds peers. Perhaps this result is not surprising given that an examination of TASS and CISDM reveals little cross-sectional variation in compensation contracts across funds.

²⁰ *Institutional Investor* (April 2007).

²¹ Due to self-reporting by hedge funds, TASS and CISDM (as do all hedge fund databases) provide a limited sample of the entire hedge fund universe. I am only able to match 61 of the 197 hedge funds in this sample to the combined TASS/CISDM database. Footnote 15 of Brav et al. (in press) reveals that they are only able to match 20–25% of their sample to TASS/CISDM.

²² Due to lack of data, I am unable to reliably test whether hedge funds use options to increase effective ownership, as posited in Hu and Black (2007).

Table 8

Holding period returns to the blockholder

Filing type	Mean	Median
Panel A: holding period returns from entry date to exit date		
13D	67.80%***	32.19%***
N	226	
13G	35.82%***	10.44%***
N	433	
Difference	31.98%***	21.75%***
Panel B: holding period returns using 1-year holding period		
13D	21.27%***	10.26%***
N	666	
13G	12.68%***	3.77%***
N	1031	
Difference	8.59%***	6.49%***
Panel C: holding period returns using last trade price if no sale date given		
13D	50.01%***	21.02%***
N	666	
13G	28.59%***	7.31%***
N	1031	
Difference	21.42%***	13.71%***

The table presents the non-risk-adjusted buy and hold returns to the blockholder. Panel A presents returns for the blocks where an observable entry and exit date is available. The holding period returns in Panel A are annualized to draw meaningful comparisons. Sale dates are not present for many of the blocks in sample, either due to the fact that the blockholder is still active in the firm or an exit filing is unavailable. In an effort to mitigate the possible truncation bias, Panel B and Panel C do not restrict the blockholder to file an exit filing. Panel B provides an unconditional one-year holding period for both the passivist and activist blockholdings. The values in Panel C assume that blocks without an exit filing are still active. The last trading date in the time series (December 30, 2005) is used as the sale price to calculate holding period returns. All panels include delisting returns (Shumway (1997) and Shumway and Warther (1999)). Standard errors for differences in means are clustered by hedge fund and year. Differences in median *p*-values are obtained from the Wilcoxon Signed Rank Test. *, **, *** correspond to *p*-values of 10%, 5%, and 1% level, respectively.

5.2. Estimating the gains to the blockholder

It can be shown that under certain conditions, blockholders may not expend the effort needed to become active in a firm given the free-riding problem of other shareholders earning similar returns without putting forth any effort (Grossman and Hart, 1980). In equilibrium, an activist blockholder must be compensated appropriately to put forth the costly effort to monitor the firm's management. Ultimately, what one would like to know is whether the returns to activism are at least as large as the cost of effort put forth by the activist. Unfortunately, estimating the cost of effort and the opportunity costs of the activist is extremely difficult. Nonetheless, observing differences in the revenue function of the activist and passivist can provide useful insights into the blockholder's cost-benefit dynamic. To provide evidence on the gains of activism to the blockholder, I calculate the raw holding period return to the hedge fund for both its activist and passivist blockholdings. If blockholders are able to earn higher returns on their active blocks than their passive blocks, this may provide evidence on why we observe shareholder activism in equilibrium.

I begin by calculating holding period returns for those blocks in which I can clearly identify a clean entry and exit date. I identify 433 passive and 226 active blockholdings with such dates.²³ The returns are annualized to draw meaningful comparisons.²⁴

Panel A, Table 8, presents evidence consistent with the idea that corporate monitors may earn higher returns which can help to mitigate the free-rider problem. The median annualized holding period return on the hedge funds' activist investments is 32.19%, while the median annualized holding period return for the hedge fund's passive investments is 10.44%. Differences in medians reveal that hedge funds' activist investments earn a raw, annualized return of 21.75% in excess of what their passive investments earn.

Based on the relative increase in the number of blocks in the later part of the time series, many of the hedge funds remained active in their positions at the end of the period. Further, for those blocks in which we do observe an exit date; we are more likely to observe a hedge fund sell only when the target firm has experienced a good return (Cochrane, 2005). Therefore, the results in Panel A are likely the subject of a truncation bias. In Panels B and C, I attempt to mitigate the truncation issue by not requiring an exit filing. In Panel B, I calculate holding period returns assuming an unconditional 1-year average holding period. In Panel C, if no exit filing is present I consider the last trading date in the time series (December 30, 2005) to be the sale date. While the size of the average holding period returns to both activism and passivism falls in both Panels B and C, the average gains to activism continue to be both positive and statistically larger than those from passivism.

A numerical example may help to put these gains in perspective. The average firm in the activist sample has a market cap of \$402MM and a block size of 8.62%. Using the most modest average excess return differential of 8.59% from Panel B, Table 8, would imply an average increase in wealth to the hedge fund of roughly \$2.98MM on its activist efforts. Assuming a performance fee of 20%, I further break down the direct gain to the hedge fund manager as \$595 K. This simplistic example gives some idea of the

²³ In all analysis of holding period returns, I include delisting returns (see, e.g., Shumway, 1997; Shumway and Warther, 1999).

²⁴ Annualizing the returns is necessary to make comparisons across different blockholder holding periods. Annualizing the returns, however, does not imply that the return to a blockholder which holds the stock for 3 months is necessarily scalable for the 1212-month period. Therefore, the magnitude of the annualized returns should be viewed with some caution.

ultimate dollar gains to the blockholder, as well as some threshold that the costs of monitoring would have to exceed for activism to no longer be optimal for the hedge fund.

As an interesting anecdote, I identify 6 activist funds in the sample that were actually reimbursed for their expenses paid in proxy battles. The average reimbursement was \$220,000. While these fees are largely intended to cover legal costs, they provide some evidence that activists may in fact, be able to recover some portion of their direct monitoring costs. To the extent that activists are able to recover fees for the *observable* cost of monitoring, we would expect the cost of monitoring to fall. Admittedly, it is probable that the *unobservable* costs (time and effort of the hedge fund manager, disclosing information to the public, etc.) dominate the cost of activism.

The need to annualize the returns in Panels A and C may overstate the true magnitude of the holding period returns to the blockholder. Further, the inability to observe the actual sale date for many of the blocks in the sample may overstate the actual holding period returns to the blockholder.²⁵ Nonetheless, these results provide a cursory look into the gains from activism and find that blockholders earn larger returns on their activist holdings to that of their passive holdings. These gains may be used to compensate the blockholder for their costly effort.

6. Concluding remarks

This study documents the relation between activism campaigns by hedge funds and the resulting value implications for the firms they target. The findings imply that shareholder activism, at least from hedge funds, is associated with positive wealth creation in target firms. This result lies in stark contrast to much of the previous work on activism by pension funds and mutual funds. Consistent with the recent claims made by legal scholars, the organizational characteristics of a hedge fund, including its ability to lock-up investor capital, appears to increase its incentives and relative bargaining power with the target firm's management and/or board. It is the market's recognition of this increase in power which may help to explain why the gains to activism by hedge funds are more pronounced than activist efforts by pension funds and mutual funds.

I find that firms targeted by activists earn larger excess stock returns at the filing window. Conditional on an activist campaign by the blockholder, the market responds favorably to more aggressive levels of activism than to less aggressive levels. Firms targeted by activists experience larger improvements in operating performance following the acquisition of the block than those of firms targeted by passivists. These improvements in operational efficiency are consistent with the removal of under-performing assets, as firms targeted by activists experience large decreases in total assets, while cash flows remain relatively unchanged. I find limited evidence that firms targeted by activists increase leverage or pay out cash in the years following the block acquisition more so than firms targeted by passivists.

I explore the organizational form and holding period returns of the hedge fund activists themselves. I find that hedge funds which pursue activism strategies tend to organize themselves such that they mitigate the need to maintain high liquidity for their investors. Specifically, hedge fund activists tend to be associated with longer lock-up and notification periods than their non-activist hedge fund peers, implying that organizational form may be an important determinant in successful activist efforts. Finally, I find that hedge funds earn larger investment returns on their activist blocks than their passive blocks. The evidence suggests that these gains from activism are not trivial and may be large enough to offset monitoring costs.

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²⁵ The experimental design of the tests in this paper may cause the truncation bias to be less worrisome. While the holding period returns for both the active blocks and passive blocks are likely to be overstated, the focus of this test is on the *difference* between the two. Therefore, assuming both holding period returns (activist and passivist blocks) are equally sensitive to the truncation bias, the bias on their difference may be less likely of a concern.

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