Journal of Corporate Finance 40 (2016) 296–314

Contents lists available at ScienceDirect

Journal of Corporate Finance

journal homepage: www.elsevier.com/locate/jcorpfin

The second wave of hedge fund activism: The importance of reputation, clout, and expertise☆

C.N.V. Krishnan [a], Frank Partnoy [b], Randall S. Thomas [c,*]

[a] Case Western Reserve University, Cleveland, OH 44106, USA
[b] University of San Diego, San Diego, CA 92110, USA
[c] Vanderbilt University Law School, Vanderbilt University, Nashville, TN 37235, USA

ARTICLE INFO

Article history:
Received 28 March 2016
Received in revised form 15 August 2016
Accepted 17 August 2016
Available online 20 August 2016

Keywords:
Hedge funds
Shareholder activism
Hedge fund reputation
Proxy fights
Lawsuits
Post-intervention performance

ABSTRACT

Using a large dataset of hand-collected information on activist interventions from 2008 to 2014, we examine why certain hedge funds succeed in the face of competition. We document that the top hedge funds succeed, not merely because of how they select targets, but because they acquire a reputation for what we label “clout and expertise.” These hedge funds do not intervene more frequently; to the contrary, activists with more interventions are associated with lower returns. Instead, top activists have a demonstrated ability to succeed in difficult interventions by targeting large firms, launching successful proxy fights, filing and winning lawsuits, pressuring target boards through the media, overcoming anti-takeover defenses, and replacing board members. These activists' successes appear to result more from board representation, improved performance, and monitoring management than from capital structure or dividend policy changes.

1. Introduction

Hedge fund activism remains an important phenomenon. Several papers have studied an initial wave of hedge fund activism, through 2008, and have found that activists achieved substantial success during this period.[1] However, studies of this first wave of hedge fund activism suggested that activism might be in decline as the market for activism grew, competition increased, and the most viable opportunities for interventions declined.[2] This raises questions about how and why some hedge fund activists were able to achieve success in the face of increased competition. We address these questions by examining a second wave of hedge fund activism during the period 2008–2014.

☆ We thank seminar participants of American Law and Economics Association 2016 Annual Meeting, 2016 International Conference of Financial Engineering & Banking Society, Fordham, Loyola, Notre Dame, University of San Diego, University of Southern California, Vanderbilt University, an anonymous referee, and the editor for helpful comments and suggestions.
* Corresponding author.
E-mail address: randall.thomas@Law.Vanderbilt.edu (R.S. Thomas).

[1] Clifford (2008); Brav et al. (2008); Bebchuk et al. (2013); Klein and Zur (2009), and Becht et al. (2014), for example, suggest that hedge fund activism generated significantly higher announcement period abnormal stock returns than a control sample of passive block holders, and that hedge fund activists have achieved measurable success, at least in terms of traditional metrics such as Tobin's Q. Bebchuk et al. (2013) find that hedge fund activism through 2007 was followed by improved operating performance during the post-intervention 5-year period.

[2] Brav et al. (2008), for example, find that as hedge fund activism became more common, the average abnormal returns at the filing of a Schedule 13D dropped, from 15.9% in 2001 to 3.4% in 2006. Bratton (2010) finds some evidence to support this conclusion, showing that when the sample in Bratton (2007) is expanded to cover through mid-2009, the successes of the hedge fund activists are less robust. Gantchev et al. (2014) analyze interventions through 2011, and report an average cumulative abnormal return of 5%, as compared to returns in the range of 7% for earlier periods.

http://dx.doi.org/10.1016/j.jcorpfin.2016.08.009
0929-1199/© 2016 Published by Elsevier B.V.

The period 2008–2014 is a particularly important sample period to study. It represents the period after the financial crisis, which distorted various aspects of market interventions, and after the first wave of activism with its well-documented high, but declining, stock returns. Moreover, this period ends just before the recent disruptions in the market for hedge fund activism, including substantial losses and failed interventions during 2015. Accordingly, 2008–2014 is the appropriate period for examining whether the characteristics of activism changed, and why certain hedge funds were successful.

The literature on hedge fund activism has largely focused on the characteristics of target firms and the changes brought about in target firms by activists. However, the characteristics – and reputations – of the activists remain unexamined. We seek to shift the literature's focus from the targets of activism to the activists themselves. Who are the most reputed hedge fund activists, and what do they do? How do they achieve success, in the face of extreme competition during the second wave of activism?

We show compelling reasons why some top activists are so successful: they acquire a reputation for having the ability to pressure managers in credible ways. We show that the top activists are not merely taking advantage of a superior ability to select target firms. Instead, we find that the most successful activists have acquired a reputation for what we label "clout and expertise," including the demonstrated ability to succeed in the most difficult interventions by targeting large firms, launching successful proxy fights, initiating lawsuits, pressuring target boards using the media, overcoming strong anti-takeover defenses, and replacing board members.

Our findings, in more detail, are as follows. We find that the hedge fund activism industry indeed has become larger and more dispersed during our sample period, with both more participants and more targets. Our sample includes 578 different activist hedge funds in contrast to the 236 activist hedge funds analyzed in Brav et al. (2008). The average size of equity positions taken by hedge fund activists is in the range of 8%, consistent with previous studies. Moreover, no hedge fund activist in our sample has a substantial share of the market.

Even those hedge fund activists with the largest numbers of interventions have relatively small market shares: the highest market share in terms of number of interventions is roughly 3%, and only a handful of activists have market shares of more than 1%. The industry market structure is somewhat more concentrated when interventions are measured based on the aggregate market capitalization of investments, but still only a couple of firms each year have market shares in the range of 10% and above; the vast majority of firms' market shares are below 1%. Based on Herfindahl-Hirshman Index measures, the hedge fund activism industry would not be considered highly concentrated, or even moderately concentrated. Accordingly, any abnormal returns are not likely due to monopoly or oligopoly rents.

However, we also find that the announcement period abnormal stock price returns from hedge fund activism are consistently and robustly high from 2008 through 2014. For example, during the 21-day event window, the average announcement period abnormal stock price return for interventions during 2013 is over 10%, and for our entire sample is over 7%, roughly the same as in studies of the first wave of hedge fund activism. We find that abnormal stock returns increase as the event window becomes longer, consistent with Brav et al. (2008) and Bebchuk et al. (2013).

What is the source of these extraordinary market returns for certain hedge funds in the face of competition? Put another way, to what extent are market reactions to hedge fund activists' interventions driven by their particular attributes and actions? These questions remain unanswered in the literature. We explore some possible answers by examining hypotheses about the characteristics and reputations of individual hedge funds. We ask whether one might better understand the market reaction to hedge fund activism by better understanding the activists themselves.

Specifically, we examine three measures of hedge fund reputation, constructed free of look-ahead bias, based on (1) frequency of intervention, (2) past success, and (3) financial clout and expertise. We find support for the use of each of these measures in various related literatures.

First, hedge fund activists might acquire positive reputations based on expertise they gain from intervening more frequently. For example, Gompers (1996); Gompers et al. (2008), and Ljungqvist et al. (2008) argue that younger venture capital firms may benefit from investing more frequently and rapidly in order to signal their skills and acquire a reputation. This "frequency of intervention" theory is consistent with the notion that participants in a wide range of areas – medicine, sports, business, and academia – acquire positive reputations based on the number of times they have been involved in the relevant procedures or practices.

Second, hedge fund activists might acquire positive reputations based on past performance, more specifically, high returns in the recent past. Zur (2008) makes the point that the market rewards hedge funds with a reputation for being successful, but does not reward hedge funds with a reputation for simply being aggressive. A long-standing literature (e.g., Stickel, 1992) establishes that there can be a positive relationship between returns and reputation in various contexts. This "past returns" theory is consistent with the notion that investment funds with strong past performance acquire positive reputations and therefore are welcomed with strong market returns in future interventions[3]; this theory is in line with the performance persistence argument for hedge funds put forth in Boyson et al. (2015) and Boyson et al. (2016).

Third, hedge fund activists might acquire positive reputations based on their financial clout and expertise. The literatures on private equity and venture capital (e.g., Hochberg et al., 2007, and Nahata, 2008) establish the importance of venture capital size, networks, and experience in investment performance. This "clout and expertise" theory is consistent with the notion that

[3] As an example, on January 25, 2013, Potomac (an activist with strong past returns) filed a Schedule 13D disclosing that they had accumulated a 9.8% stake in PLX, and had sent an open letter to PLX's board stating the belief that, "management must immediately commence a process of a thorough review of all strategic alternatives available to the Company and we do not believe that PLX should remain an independent public company." The 3-day, 7-day and 21-day announcement period abnormal market returns were 2.9%, 5%, and 18%, respectively.