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VALUE CREATION AND PROMINENT SHAREHOLDER ACTIVISTS

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ABSTRACT

The topic of shareholder activism has continued to gain popularity and interest across the financial community over the past several years. It's an incredibly interesting mode of investing that comes with a significant amount of controversy. Companies targeted by activist investors feel tremendous amounts of pressure as the competency of their leaders is called into question for all shareholders to see. With its way of shaking things up and its increased popularity, the effectiveness of this unique mode of investing has been studied more and more in the last decade.

This paper seeks to add to these studies by determining whether or not prominent activist investors are able to create value in the companies they target in both the short-term and long-term. The prominent activist hedge fund managers targeted in this study are Bill Ackman, Nelson Peltz, Daniel Loeb, Philip Falcone, and Carl Icahn. There are previous studies that focus on shareholder activism in general, that study a single activist, and that study hedge fund activism. This study attempts to determine the effectiveness of these prominent activist hedge fund managers by building off of the phenomenal research completed by those before me.

This study finds that prominent activist hedge fund managers create value in their targets in the short-term, but not in the long-term. Several of the abnormal returns calculated are statistically significant at the 0.1, 0.05, and 0.01 significance levels. This conclusion is similar to those found by other studies. Several prior studies on hedge fund activism have concluded that the short-term announcement period returns in target companies are abnormally positive, and this has been widely accepted by the academic community. However, there are little to no studies that have concluded that activists are able to create value in the long-term. This supports the idea that activist hedge fund managers only invest to turn a quick profit and have little incentive to improve target company performance in the long-term.

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Chapter 1

Introduction to Shareholder Activism

The business of finance is a controversial one. In the last decade, the financial world has seen more scrutiny than at any point in its history. Wall Street's entanglement with Main Street has caused those completely uninterested in finance to become critical of its workings. The media has further increased its focus on the financial world as it continues to gain widespread interest. From mortgage-backed securities and collateralized debt obligations made popular by the financial crisis, to mass layoffs in private equity showcased during the 2012 presidential elections, to accounting scandals, insider trading, and Ponzi schemes headlined by Enron, hedge funds, and Bernie Madoff, the world of finance has become one of the most controversial industries on the planet. A highly controversial field within finance and investing that may not be as familiar to those without a finance degree is shareholder activism.

I. Definition of Shareholder Activism

An activist shareholder can be defined as an individual, institution, or entity of any kind that uses an ownership stake in the stock of a corporation to place pressure on its management to make changes. These changes vary widely based on the ultimate goals of the activist. Some activists pressure corporations to be more socially responsible. This is common for institutions and municipalities as it is possible for them to have a stake in keeping a certain area or community environmentally-friendly. Social activist investors could demand changes that range from categories such as environmental conservation and pollution to investment in foreign countries.[1] Another type of activist, the kind I plan to be the focus of this thesis, is determined to force management to make changes that will be most beneficial to shareholders. Demands could range from the replacement of management, to a dividend increase, to a spinoff. Anything that the activist believes could create value for shareholders will be the subject of conversation between investors and management. It is also common for activists to try to replace current board members with ones they believe could do a better job influencing management to cut costs, increase revenues, return more capital to shareholders, etc.

II. History of Shareholder Activism

Shareholder activism has been around for quite some time now. The notion became prevalent in the early 1900's when large financial institutions played active roles in corporate governance. This meant representatives from these financial institutions holding seats on the corporate boards of firms they wished to influence or provide direction regarding strategy. This all changed in 1933 with the passing of the Glass-Steagall Act. The provision that impacted shareholder activism was Section 16 and 5(c), which prevented banks that were members of the Federal Reserve from investing in equity securities. The prospects of shareholder activism took another 180 degree turn in 1942 when the SEC introduced what is known today as rule 14a-8. The rule permitted the shareholders of a corporation to write proposals to be included on the corporate ballot.[2] It was from this point until the mid-1980's that the presence of shareholder activists grew. The presence largely consisted of individual activists until the 1980's, where institutions made their presence felt. The 1980's also bred a number of prominent individual activists among the likes of Carl Icahn, Nelson Peltz, T. Boone Pickens, and Ronald Perelman.

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[1] McGuire, Craig. "What Is a Shareholder Activist?" *TheShareholderActivist.com*. The Shareholder Activist, n.d. Web. 12 Dec. 2012. <http://theshareholderactivist.com/tools-for-shareholder-activists/what-is-a-shareholder-activist-2/>.

[2] Gillian, Stuart, and Laura T. Starks. "The Evolution of Shareholder Activism in the United States." (2007): n. pag. *Social Science Research Network*. Web. 22 Jan. 2013. <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=959670>.

The 1990's saw pension funds rise to prominence among institutional investors in shareholder activism. This trend has continued through today, as massive pension funds such as CalPERS and CalSTRS have played a large role in shareholder activism. The mixture of parties taking an active role in corporate governance has continued to evolve. The most recent entrants into the realm of shareholder activism include hedge funds and private equity firms. These relatively new players have made their presence known with their voluminous and frequent activity. The combination of individuals, institutions, hedge funds, and private equity firms has resulted in a highly active group of shareholder activists that seeks to influence corporations to return more capital to shareholders.

III. Trends in Shareholder Activism

With shareholder activism having grown since the early 1900's, expect a continued upward trend in its popularity. This can be attributable to a number of factors ranging from politics to regulation. There has been increasing support for shareholder rights in both the public forum and political arena. Politicians have largely been supportive of shareholder rights in incentivizing corporations to focus on creating value for shareholders. This makes sense seeing that payouts to shareholders lead to double taxation, or a significant source of income for the government. These payouts also lead to higher discretionary income for investors and thus boost the economy.

There is also a plethora of current and potential regulatory changes meant to enhance the ability of activists to pursue their objectives. The implementation of E-proxy rules simplifies the voting process and also brings down costs in proxy solicitation. There are a number of additional legislative and SEC regulatory proposals focusing on proxy access and disclosure that further aid the process for shareholder activists. Subsequent statutory and SEC proposals on executive compensation, director qualifications, and proxy solicitations seek to increase value for shareholders.

The growth in shareholder activism will also be led by an increase in shareholder proposals. This will be brought on by measures that may incentivize activists to get involved and begin influencing decisions. The newly passed "Say-on-Pay" provision of the Corporate and Financial Institution Compensation Fairness Act of 2009 will provide further incentive for shareholders to vote their proxies.[3] Shareholder activists will also focus their efforts on the declassification of corporate boards. Boards are classified, or staggered, if board members are up for re-election at different times. For example, three board members may be up for re-election this year, while three others will be up for re-election next year. This puts time on the side of the corporation and inhibits an activist from obtaining a majority of board seats in any single year. This is why shareholder activists can focus on the declassification of boards to avoid this situation. Shareholders will also be focusing intently on the separation of the CEO position and Chairman of the Board position. In many corporations today, one person stands as both the CEO and Chairman of the Board. This can be detrimental to a company because this particular structure makes one person the proverbial judge, jury, and executioner. One person has the power to make all decisions. Shareholders focus on separating the positions to make sure that the Chairman of the Board is someone that solely represents the interests of shareholders. Shareholders will also be pushing for the implementation of majority voting for the election of directors to the board. In an uncontested election, only one vote is necessary for a candidate to win a seat on the board, whereas a majority vote election would ensure that the votes of shareholders count. Another bone of contention for shareholders will be their rights to call special shareholder meetings. Shareholders will also be submitting proposals to eliminate supermajority voting in hopes of curbing company efforts to prevent takeovers. In addition,

[3] Demont, Valerie, Matthew Greenberg, Steven R. London, James D. Rosener, and Richard De Rose. "Trends in Shareholder Activism: Responsibilities of Directors and Management." *PepperLaw*. Pepper Hamilton Attorneys at Law, 5 Aug. 2009. Web. 15 Jan. 2013. <http://www.pepperlaw.com/webinars/080509ShareholderActivismWebinar_final.pdf>.

shareholders will be fighting to improve and revitalize Shareholder Rights Plans, or "poison pills." This is simply another way shareholders can work to restrain company efforts to prevent takeovers.

IV. Goals and Objectives

In writing this paper, I plan to determine whether or not prominent activist hedge fund managers create value, whether it is in the short-term or the long-term. In order to accomplish this, I will be researching five prominent activist hedge fund managers and their individual success in creating value among their respective target companies. This will involve sifting through hundreds of initial 13D filings, collecting stock prices of these target companies and their competitors at various dates to form event windows, and then calculating abnormal returns for these event windows to determine if the hedge fund managers have created value in the short-term or the long-term. An aggregation of the data collected for each individual activist hedge fund manager will determine generally whether or not prominent activist hedge fund managers are able to create value in their target companies.

Chapter 2

Literature Review

Each of the academic papers detailed in this literature review have contributed to my analysis and determination of whether prominent activist investors create or destroy value. Each of the authors of these papers has served as a pioneer in the research of hedge fund activism, while I have been the fortunate beneficiary of such thoroughly detailed research.

The first paper, written by Venkiteshwaran, Iyer, and Rao has paved the way for most of my research. It essentially has served as the guide and blueprint that I have been able to emulate in my own research methodology. The second paper, written by Greenwood and Schor, was for Venkiteshwaran, Iyer, and Rao what they were for me. Greenwood and Schor are true pioneers in the field of hedge fund activist research and their tremendous efforts in writing the paper detailed below has allowed for many informative academic pieces to follow. They were able to conclude that the market reacts so positively to the announcement of an activist hedge fund's involvement in a target company because the activist increases the chances of the target company being sold. The third paper, written by Brav, Jiang, Partnoy, and Thomas, concludes that activist hedge fund managers are most successful when they target inefficiencies by advocating for a sale of the company or a spin-off, as opposed to debt restructuring or a dividend increase.

The literature reviews of each of these three academic papers are detailed below to provide insight into existing research in the activist hedge fund field at the time of this writing.

I. Is Carl Icahn Good for Long-Term Shareholders?[4]

In the paper, the authors seek to determine whether or not the famed activist investor, Carl Icahn, creates long-term value in the companies he targets. It is widely published that activist investors produce abnormal returns for the companies they target in the short-run. Well-documented evidence has shown that upon public announcement of an activist's stake in a target, the target will see abnormal returns of 7-10%. Even given the general acceptance by the academic community of the abnormal announcement period returns, it is widely believed that activist investors do not create long-term value. Many believe the activists use a simple "pump-and-dump" strategy, meaning they build up their stakes in the target companies, convince the board of directors to improve shareholder returns, and then quickly turnaround and sell their stake in the target. While this leads to a handsome profit for the activist, a lot of times it will leave the company in distress.

A. Hypothesis

The authors hypothesize that Carl Icahn creates long-term value for shareholders of target companies more often than not. Long-term value can be broadly defined as changes in corporate policy and increases in long-run profitability and value.

B. Data

The study examines all companies targeted by Carl Icahn from 1995-2007. The authors identified targets by searching for Schedule 13D filings, which must be filed with the SEC by anyone who has acquired a 5% beneficial ownership stake in a company. This turned out to produce 33 initial 13D filings involving 33 different targets. In order to determine Icahn's success in implementing his objectives, they collected the reasoning behind his ownership in a

[4] Venkiteshwaran, Vinod, Subramanian Iyer, and Ramesh P. Rao. "Is Carl Icahn Good for Long-Term Shareholders? A Case Study in Shareholder Activism." (n.d.): n. pag.*Social Science Research Network*. Web. 10 Nov. 2012. <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1733800>.

target, which can be found in the Schedule 13D. They also collected the size of Icahn's initial holding in each target, the exchange the target was trading on upon investment, the 4th level of SIC industry classification, and any amended filings after the initial Schedule 13D.

In order to determine whether or not Icahn was successful in creating long-term value, the authors collected a number of operating metrics from COMPUSTAT. They compared the various operating statistics to industry and size matched control firms. For each target firm, they identified all the incumbent firms in the same 4-digit SIC industry as per COMPUSTAT. They then found the absolute difference between the target firm and the corresponding industry member's Net Sales. From there, they retained the firms with the minimum absolute difference in Net Sales.

In observing the market reaction to the disclosure of Icahn's investment in target firms, the authors used three different event windows to estimate abnormal returns. They use a 3-day event window, which includes the day before and day after initial filing, a 21-day event window, which includes 10 days before and 10 days after the initial filing, and a 41-day event window, which includes 10 days before and 30 days after the initial filing.

The authors also calculated announcement period returns for three different subsamples (companies that were delisted within 18 months of initial filing, companies that were acquired or taken private within 18 months of initial filing, and those that survived as independent firms).

The authors also observed changes in corporate policy and performance in the first two years after the filing of the initial Schedule 13D for targets that remained independent for at least 18 months after the filing. They calculated the changes in these characteristics over two different time windows; the first shows the change from the fiscal year prior to the initial filing to the fiscal year after the initial filing, while the second shows the change from the fiscal year after to two years after the filing.

Additional data collected includes the Stated Purposes found in the initial Schedule 13D filing. This was done in order to perform analysis seeking to examine whether or not Icahn was able to achieve his Stated Purposes in an effort to evaluate efficacy of his efforts. They searched news articles up to two years following the date of the initial filing to determine whether or not the Stated Purposes were actually achieved.

C. Conclusion

Of the three subsamples, the most positive immediate 3-day response was to the target companies that ended up being delisted. On the other hand, the 3-day response to the target companies that were acquired or taken private within 18 months was just 4.3%, and only 7.5% in the surviving firms that remained independent. This conclusion is different from the findings of a Greenwood and Schor study which found that gains from hedge fund activism seemed to be attributable to the target companies that were acquired or taken private.

In an attempt to identify observed changes in corporate policy and performance as a result of the activism, they found no significant changes in targets' profitability, capital expenditure, returns to shareholders, cash balances, or leverage.

The most significant conclusion arrived at by the authors is the significant difference in post-investment stock price performance between Icahn targets that were acquired, and those that were not. The acquired targets registered a positive abnormal return of almost 25% from the time of Icahn's disclosure of his investment to the sale of the company. At the other end of the spectrum, the surviving firm subsample returned negative 60%. These results are consistent with the idea that hedge fund activists, such as Carl Icahn, practice a "pump and dump" investing strategy. The authors postulate further that this could also be explained by the idea that Icahn targets companies that will benefit from new management, while those that push back and don't cooperate (i.e. remain independent and resist Icahn's proposals) are viewed by shareholders as having little prospects for increased shareholder return.

In seeking to determine whether or not Icahn was effective in accomplishing the Stated Purposes outlined in the initial Schedule 13D filings, the authors concluded that he was successful in almost 30% of his endeavors. He was the most effective in meeting corporate governance objectives, blocking mergers, and redirecting corporate strategy. In looking at the subsamples, it appeared that Icahn was most successful in completing his objectives with the surviving targets. The research showed that Icahn was successful, at least partially, in almost 60% of his investments.

Another conclusion made was in regards to the variety of industries and strategies involved in Icahn's investments. He had major investments in 22 different industries, ranging from oil and gas and airlines to pharmaceuticals and high tech. In some investments, he began as a passive investor, turning active, while in others he started out with a proxy fight or threat to remove board members.

In summary, the study concludes that the efforts of hedge fund activists like Carl Icahn have been beneficial to target company shareholders.

D. Unresolved

The study was not able to provide reasoning behind why the companies that remained independent performed as poorly as they did. The authors hypothesized a few ideas, but the aim of the study was not to determine the reasoning behind the phenomenon. They mention in the conclusion that someday further research might explain whether these independent surviving companies performed poorly as a result of activist targeting and pressure, or that they were victims of stubborn management teams that successfully defended their companies against activism at the expense of shareholders.

II. Investor Activism and Takeovers[5]

The paper is largely focused on hedge fund activism in the sphere of subsequent acquisition of target companies. The authors show that the well-documented large positive abnormal returns seen by activist targets upon announcement of activism are attributable to the ability of the activist to force the target into a takeover. Similar to the conclusion by Venkiteshwaran, Iyer, and Rao, Greenwood and Schor find that announcement returns and long-term abnormal returns are significantly positive for targets acquired, whereas they are not significantly different from zero in targets that remain independent at least 18 months after the initial filing of the Schedule 13D.

A. Hypothesis

The authors hypothesize that activism creates value by improving the target firm as a going concern, either by firing management, or by forcing management to institute operational, financial, or governance reforms. They also suggest that returns to investor activism are driven by activists' success at getting target firms taken over, which induces the idea that the high returns documented around the announcement of activism reflect investors' expectations that the target firm will be acquired at a premium to the current stock price.

The study also suggests that activists simply target companies that already have a higher probability of being taken over. If nothing is done to improve the target, the announcement period returns simply reward the activist investor for being good at picking undervalued stocks. The authors make the point that the targets could be potential acquisition targets regardless of activist intervention and those that are eventually taken over would have been taken over with or without activist ownership.

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[5] Schor, Michael, and Robin M. Greenwood. "Investor Activism and Takeovers." (2007): n. pag. *Social Science Research Network*. Web. 15 Dec. 2012. <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1003792>.

Finally, the authors hypothesize that activist target success is dictated by the amount of takeover interest in the market. If there is a strong appetite for acquisition throughout the market, the target companies will do well, but if the market is not ripe for acquisitions, the target companies will do poorly.

B. Data

The study consists of a compilation of all Schedule 13D and DFAN filings for the 13 year period from Q3 1993 and Q3 2006. The authors restrict this sample by cross-referencing the 13D filings with a list of investment managers that had filed a Schedule 13F holdings report at some point. This is done to eliminate corporate crossholding from the data set and still maintain activist portfolio investors. Then, targets are excluded that are closed-end funds, along with firms that aren't identifiable on CRSP at the time of the initial filing. To further whittle down the data set, any targets that have "Passive Investment" listed as a stated purpose in their initial 13D filing are excluded.

In order to determine whether or not the target companies are simply strong acquisition candidates, regardless of activist intervention, the authors form a matching portfolio based on industry, size, and pre-activism return.

Abnormal announcement returns in target companies are calculated as the difference between the return on the target and the return on a matching portfolio. Matching portfolios are formed based on industry, size, and market-to-book ratios. Because COMPUSTAT data doesn't exist for all the companies in the sample, the authors form a surrogate portfolio. In order to do this they start out with a 100-day return, ranging from 110 days prior to the initial Schedule 13D filing to 10 days prior to the filing. They estimate the factor loadings of target firm returns on the Fama and French HML, SMB, and market return factors. If they were unable to find pre-event data to estimate the factor loadings, they simply used the CRSP value-weighted market for the match portfolio.

The authors also calculate monthly abnormal returns using the exact same method illustrated above ranging from 25 months prior to the initial filing to 1 month prior.

In an effort to determine how the target firms respond to an activist's requests, they collected data on outcomes after each event by poring over 13D filings, communications between management and the activist, and newswires for any information on the outcome. They also checked to see whether the firm was acquired or merged in the year after activism by looking at the CRSP delisting code and date to see if it fell within 18 months of the initial filing.

In order to determine changes in operating performance over the long-term in firms that remained independent, the authors collect various accounting variable ranging from capital expenditures to return on assets.

Seeking to find out whether or not activists increase the probability of acquisition of target firms, the study matches each activism target with a firm in the same industry of similar size and past returns. They track each of the firms for 18 months following the initial Schedule 13D filing, checking to see whether the firm has been acquired or delisted.

In hopes of determining whether or not takeover interest in the broader market has an effect on the success of activists, the authors first collect a sample of target companies owned by activist investors. They then analyze the returns of these positions over four periods: pre-crisis, the week where credit spreads first spiked and Chrysler and Boots fail to find adequate funds to secure buyouts, the week where Home Depot cuts its price in a buyout, and the full crisis period from July to August.

C. Conclusion

The study concludes that matching firms are less likely to be acquired within the next year in relation to the targets of activism. It is found that activists actually increase the probability of takeover by 11%.

The study finds that returns are positive when the activist indicates a desire to "Engage Management," requests an asset sale or tries to block a merger, and wages a proxy fight. On the other hand, returns are not significantly different from zero when the activist targets capital structure issues, corporate governance, corporate strategy, or proposes a spinoff. This shows that activists only generate significant positive returns when they are successful in getting a company acquired or taken private.

The authors find that abnormal returns ranging from one month prior to the initial Schedule 13D filing to 18 months after the filing are significant and just over 10 percent. They observe that a large portion of these returns are coming from the last 15 months of the observed period, suggesting that on average, the market underreacts to announcements of activism. This observation could also be explained by the idea that long-term abnormal returns simply reflect an undervaluation of the target.

Interestingly, the study finds that events for which an acquisition was announced or completed earn post-filing abnormal monthly returns of about 26%, which is a reflection of the takeover premium paid by the acquirer. On the other hand, for the events not involving an acquisition, post-13D filing returns are not significantly different from zero.

As it turns out, any changes in operating return on assets, leverage, capital expenditures, dividends, assets, and shares outstanding do not appear to have a significant correlation with returns, which is consistent with the previously-stated hypothesis that activists are largely unable to create long-term shareholder value with the exception of an acquisition.

The authors find that acquisition rates are much higher in activist targets compared to matched firms. They are able to conclude that activists increase the probability of acquisition by roughly 11%.

In looking to find whether broader market takeover interest has an effect of the positions held by activist investors, the authors are able to conclude that many activists saw the value of their portfolios drop during periods when market takeover interest fell. This confirms the idea that the targets were targeted in hopes of spurring an acquisition.

D. Unresolved

One issue unaddressed in this paper is whether or not shareholder activism associated with acquisitions creates long-term value for acquiring company shareholders.

III. Hedge Fund Activism, Corporate Governance, and Firm Performance[6]

This paper, through collecting a comprehensive data set on hedge fund activism events from 2001-2006, seeks to answer several unanswered questions. Previous research looks at activism from through the sphere of institutional activism, while this paper tackles it from the hedge fund perspective. It seeks to find out which firms activists target, how those targets respond, how the market reacts to announcements of activism, whether or not activists succeed in implementing their objectives, whether or not activists are short-term in focus, and how activism impacts firm performance.

A. Hypothesis

The authors address the idea that positive announcement period returns in companies targeted by activist hedge funds are only a function of the hedge fund's identification of undervalued companies, not their potential for value creation. The authors then hypothesize that the announcement period returns are a result of more than just the hedge funds' abilities to identify undervalued companies.

The authors also hypothesize that the size of the abnormal returns measured in the target companies are a function of to what degree the activist hedge fund has been successful in carrying out its stated objectives.

[6] Brav, Alon, Wei Jiang, Frank Partnoy, and Randall Thomas. "Hedge Fund Activism, Corporate Governance, and Firm Performance." *The Journal of Finance* 62.4 (2008): n. pag. 1 Aug. 2008. Web. 1 Dec. 2012. <https://faculty.fuqua.duke.edu/~brav/RESEARCH/papers_files/BravJiangPartnoyThomas2008.pdf>.

B. Data

In the data collection process, the authors started out by sifting through initial Schedule 13D filings from 2001-2006. With this wide range of data, they narrow it down to just hedge funds by process of elimination and through the search of news articles. Once this subsample was formed, they also searched news articles for instances of activism, as there are some cases in which an initial 13D filing is not filed (i.e. less than a 5% stake in the target company).

C. Conclusion

Through their research, the authors find that the market reacts favorably to activism in the short-term. The announcement of the initial filing of a Schedule 13D results in large positive average abnormal returns, ranging from 7-8% with an announcement window of 41 days (20 days prior to filing through 20 days after filing). The authors also found that these returns were not reversed over time, as there was no evidence of a negative abnormal drift during the one year period following the initial filing of the Schedule 13D. Taking it one step further, the authors conclude that stock prices of target firms decline upon the exit of a hedge fund only when it has been unsuccessful, indicating that the information reflected in the positive announcement reaction illustrates the market's expectation for success in activism.

The study finds that activists who target the sale of the company or changes in business strategy, such as spin-offs, are associated with the largest positive abnormal effects of 8.54% and 5.95%. This can be translated into the idea that hedge funds are able to create the most value when they see significant inefficiencies. On the other hand, the market's reaction to objectives such as debt restructuring, recapitalization, dividends, and share repurchases is positive, but insignificant. Similar results were found regarding objectives involving takeover defenses, the replacement of CEO's, board independence, and CEO compensation. It was also concluded that hedge funds with a history of success were able to generate higher returns, along with hedge funds who initiated an activist campaign with hostility.

D. Unresolved

While the paper encompasses quite a few topics regarding hedge fund activism, it doesn't specify data with regards to individual activist hedge fund managers. Due to the nature of their data collection period in relation to the time of writing, the authors do not address the long-term effects activist hedge funds have on target companies or whether value is created or destroyed in the long-term. Without the long-term effects going unaddressed, the paper thus is unable to distinguish between short-term announcement period returns and long-term gains created through successful shareholder activism. Overall, Brav, Jiang, Partnoy, and Thomas have written an impressive paper on hedge fund activism at a time long before the industry gained as much popularity as it holds today. The authors have addressed many and left out very few topics regarding hedge fund activism.

IV. Conclusion

The academic papers detailed above have been extremely helpful in allowing me to form a hypothesis with regards to the value created by activist hedge fund managers. In forming my hypothesis, I was able to look back on the works of these authors and determine for myself whether or not I believed prominent activist hedge fund managers create value.

The detailed and well-documented work of these authors has also allowed me to structure my analysis efficiently and effectively. I was able to research the methodology implemented by the authors of the aforementioned papers through their explanations, citations, and footnotes. This allowed me to form the basis of my data collection, analysis, and research methodology. I implemented much of the data collection process by mirroring the efforts of Venkiteshwaran, Iyer, and Rao. I also benefitted from the work of these three authors by using most of the same event windows as they did when looking at target stock price returns around the announcement of a hedge fund manager's activist involvement. Greenwood and Schor provided me with important background knowledge on shareholder activism in general. Examples include short-term announcement period return gains seen in target companies, the ability of activist hedge fund managers to influence targets by increasing chances of sale, and the struggles faced by target companies that remained independent long after an activist hedge fund manager's exit from the stock. This knowledge allowed me to form a reasonably informed hypothesis that led to thorough research supported by that of other esteemed authors of the subject. Brav, Jiang, Partnoy, and Thomas provided me with the idea to look at value creation through both a short-term and long-term lens. I this provides unique perspective to the growing category of research that is hedge fund activism.

Chapter 3

Background on Prominent Activists

Hedge funds have very quickly become the next big thing in the world of finance. Their rise to prominence has come through periods of prosperity, but also through periods of despair, and at the expense of others. One of the most significant drivers for the recent popularity of hedge funds has been the emergence of stories of managers making billions by betting against the housing market leading up to the financial crisis. The idea that anyone can get so rich by making a single bet has created a buzz around the industry and led to growth in the number of hedge funds across the country. There are a vast amount of strategies implemented by thousands of hedge funds across the country that vary from long/short to distressed debt to event-driven. Some hedge funds cover multiple bases and take on several different strategies. The focus of this paper is of course, on those that are involved in activist investing. The names and faces of these activist investors have been plastered across financial news headlines, as they have all amassed significant amounts of wealth by shaking things up at the very top of well-known companies.

I. William Ackman

Bill Ackman is the founder of the well-known activist hedge fund Pershing Square Capital Management. Ackman started out in the investment business upon graduation from Harvard Business School when he and a fellow graduate started Gotham Partners. The young firm garnered a lot of attention and investment after its unsuccessful, yet highly publicized bid for Rockefeller Center. This brought on a string of successful years for the firm that led to its peak of $500 million in assets under management.[7] The firm's success, however, wouldn't go without

[7] "Bill Ackman's Pershing Square: Profile & Biography." *Market Folly*. N.p., 8 July 2009. Web. 1 Mar. 2013. <http://www.marketfolly.com/2009/07/bill-ackmans-pershing-square-profile.html>.

controversy. New York's Attorney General Eliot Spitzer opened up an investigation into the firm's trading practices. The investigations found nothing, but led to the fall of Gotham Partners and caused a hit to Ackman's reputation.

A couple of years later, Ackman started the hedge fund he has become well-known for, Pershing Square Capital Management. He founded the firm in 2003 with $54 million in capital, much of it his own. From $54 million in assets under management back in 2003, the highly successful activist hedge fund has grown to over $10 billion.[8] The hedge fund stepped into the spotlight early on with Ackman's role as an activist with the fast-food chain Wendy's International. Demanding higher returns to shareholders, Ackman was able to convince Wendy's to spin off Tim Horton's. Tim Horton's had a highly successful initial public offering which was very profitable for Wendy's shareholders, especially Ackman and Pershing Square. Ackman has played in activist roles in other companies such as Target, Borders, J.C. Penney, and Canadian Pacific Railway.

II. Nelson Peltz

Nelson Peltz had an unorthodox start to his business career. Peltz dropped out of the University of Pennsylvania to join the family business as a truck driver. He delivered produce and frozen foods to different restaurants in New York. When Peltz started out driving trucks, the company was earning about $2.5 million in revenue. His father relinquished control of the company to Peltz and fifteen years later, the company was publicly held, earning $150 million in revenue.

Peltz began to make his name as an activist investor when he and a business partner formed an investment partnership that ended up taking control of Triarc Companies. At the helm of Triarc, Peltz was able to buy Snapple from Quaker Oats for about $300 million and was then

[8] "Pershing Square Capital Management." *FindTheBest*. N.p., n.d. Web. 1 Mar. 2013. <http://investment-advisors.findthebest.com/l/29972/PERSHING-SQUARE-CAPITAL-MANAGEMENT-L-P>.

able to turn it around and sell it to Cadbury for about $1 billion.[9] This impressive sale gave Peltz a boost of publicity and respect in the marketplace. Triarc is now known as Wendy's company, the familiar fast-food chain targeted by Bill Ackman.

Several years later, Peltz would found Trian Fund Management, the hedge fund he has become famous for running as an activist investor. The hedge fund has done extremely well and has garnered spotlight for its investments and significant positions in companies such as Family Dollar Stores, H.J. Heinz, and Tiffany & Co.

III. Daniel Loeb

Daniel Loeb comes from an interesting family background, as his father was the general counsel for Williams-Sonoma and his great-aunt was the creator of the Barbie doll and co-founder of toy-maker Mattel Inc. Loeb went to the University of California at Berkeley for two years and then finished his degree in Economics at Columbia University.

Upon graduating, Loeb worked for several different firms, including Citigroup, Warburg Pincus, and Jefferies & Company. He was able to shine in the spotlight at Jefferies & Company by making high returns for his investors. In one particular case, he stumbled upon a particular product held by Lambert Drexel in the midst of its bankruptcy. After thorough research, he realized the asset was severely mispriced. He acted by getting the company to sell the assets, which led to an eventual return upwards of 1200 percent realized by his investors.[10]

Loeb was able to show off his talents and surround himself with some of the best in the business while he was working at Citi. He developed and benefitted significantly from these relationships and felt that it was time to start his very own firm. This was the birth of the hedge fund he has become well-known for running. Thus, Third Point Management was born in 1995

[9] Deighton, John. "How a Juicy Brand Came Back to Life." *Harvard Business School*. N.p., 4 Feb. 2002. Web. 1 Mar. 2013. <http://hbswk.hbs.edu/item/2752.html>.

[10] "Third Point." *Hedge Fund Letters*. N.p., n.d. Web. 16 Feb. 2013. <http://www.hedgefundletters.com/category/third-point/>.

with just $3.3 million in seed capital from friends and family. The long/short activist hedge fund has been tremendously successful since its founding and has ballooned to over $11 billion in assets under management.

Loeb's style of investing is an interesting one that has proven many times over that he is not afraid to make a splash in the investment world. If ruffling some feathers will lead to significant returns to shareholders and his investors, he will certainly do just that. Loeb is most famous for the letters that he writes to management teams of the companies he targets. A large portion of the letters share a similar tone that highly critical of the way a particular management team has been running its company. This controversial style has led some to praise him for his productive shareholder activism, and others to criticize him for serving as a distraction to management teams. Regardless of opinion, Loeb's style has led to his collection of many profits and climb to the top ranks of hedge fund managers. His current net worth is about $1.5 billion and he has become well-known for his dealings with companies such as Yahoo! and IHOP.

IV. Philip Falcone

Just like most of the aforementioned prominent hedge fund managers, Philip Falcone made his way into the business world with an interesting background. Falcone's father walked out on the family early on, which left Falcone's mother to singlehandedly raise nine children while earning 80 cents an hour at a shirt factory.[11] Falcone grew up as a stand-out hockey player, which landed him a spot on the varsity team and as well as an Economics degree from Harvard. He even played a year of professional hockey in Sweden until his career was finished by way of injury.

Upon graduating in 1984, Falcone made his first appearance in the business world as a trader at Kidder, Peabody, & Co. From there, he bounced around between a couple of different

[11] Serres, Chris. "From Iron Range Hockey Hero to Wall Street Star." *StarTribune*. N.p., 6 July 2008. Web. 1 Mar. 2013. <http://www.startribune.com/business/22949299.html?refer=y>.

places including First Union and Barclay's. Throughout this time he was able develop a skill set with regards to leveraged finance and distressed debt investing. This has been the basis of much of the investing he does to this day.

At the start of the new millennium, Falcone left Barclay's and eventually decided to start his own firm. This firm would come to be known as Harbinger Capital, the hedge fund that has served as the investment vehicle through which Falcone has done his activist investing. The extent of Falcone's activist investing typically involves electing members to corporate boards, but oftentimes will be to influence the management teams of companies going through or coming out of bankruptcy. This can be attributed to the expertise Falcone developed in leveraged finance and distressed debt early on in his career.

While Falcone has certainly made a name for himself as an activist investor, much of his fame among investment and finance communities comes from his remarkable success in betting against the housing market during the financial crisis. Through his purchases of credit default swaps in 2006, Falcone was able to realize personal gains of $1.5 billion in 2007 alone.

V. Carl Icahn

Carl Icahn is the most well-known activist hedge fund manager among the five covered in this paper, and probably among all activist hedge fund managers. Icahn grew up in Queens as the son of a struggling opera singer turned cantor and a teacher.[12] He was admitted to Princeton University, where he obtained a degree in philosophy. Upon graduation, Icahn went to medical school, but after a couple years realized it was not for him. He dropped out and joined the army. Shortly thereafter, he came back to New York where he pursued a career on Wall Street.

Icahn only worked for an employer for a handful of years. The employer was called Dreyfus & Company. It is there that Icahn became familiar with options and convertible

[12] Icahn, Carl. "About Me." *The Icahn Report*. N.p., n.d. Web. 1 Mar. 2013. <http://www.icahnreport.com/report/about.html>.

arbitrage. After his tenure with the company, Icahn had managed to save up enough money to buy his own seat on the New York Stock Exchange and set up shop as Icahn & Co. Inc. This was his very own brokerage firm, which he would eventually use to start buying stakes in companies.

Icahn now runs the hedge fund, Icahn Capital, which he has used as an investment vehicle to build up large positions in companies and influence the management teams of those very companies. Icahn has been the most profiled activist hedge fund manager in history. This could be a function of the intensity of conflict that arises when he decides to go head-to-head with a management team in a fight for the rights of shareholder returns, or it could be a function of the sheer volume of targets he's taken an activist role in.

Icahn has been known as a corporate raider since the 1980's and has amassed a fortune by building up stakes in undervalued and mismanaged companies to turn a profit by demanding improvements and returns to shareholders. He is quite literally the icon of activist investing and has paved the way for others to follow down his raucous investing path. He has taken an activist role in companies such as Blockbuster, The Clorox Company, and Forest Laboratories.

Chapter 4

Hypothesis

I. Hypothesis I

Based on the literature reviews of the academic papers mentioned previously, along with the reading of several other articles and papers on the subject of hedge fund activism; value is created in target companies in the short-term. This holds true among even the most prominent hedge fund activists, both individually, and as a collective group.

While there will likely be variation in degrees of value creation or destruction among the group of activist hedge fund managers, the data will still show that value is created among target companies in the short-term. Investors and the market as a whole will see activist involvement as a positive sign for the target company.

II. Hypothesis II

Even though value will be created by activist hedge fund managers in the short-term, it will be destroyed in the long-term. Target companies will experience an increase in stock price upon announcement of the activist involvement, but sentiment will turn negative over the long-term if the activist is unable to implement his stated objectives. Little or no improvements will be seen over the long-term in targets' operating or profitability metrics. The objectives with more influence on the performance of the target in the long-term include a sale of the company and spin-offs. This hypothesis is supported by and based off of the work of Brav, Jiang, Partnoy, and Thomas.

It is important to note that the data sampled may be representative of prominent activist hedge fund managers, of which there are very few, but may not be representative of the broader base of activist hedge fund managers, or hedge fund managers in general. The hypothesis being tested is solely focused on the value creation or destruction in companies targeted by prominent activist hedge fund managers, or those that are relatively well-known throughout the investing and finance communities. The sample of activist hedge fund managers chosen is meant to be representative of some of the best in the business and I recognize that the selection of the five names profiled above is subject to my biases regarding the best activist hedge fund managers. While there are not many prominent activist hedge fund managers studied in this paper, there is a plethora of target companies, as each of the fund managers selected has spent many years involved in hedge fund activism.

Chapter 5

Sample Selection

I. Data Gathering Process

In order to begin the data gathering process, I had to start out at the SEC's website. Sec.gov is where all of these initial 13D filings can be found. I first identified each of the five prominent activist hedge fund managers and their respective hedge funds. I searched each individual hedge fund for a list of initial filings ranging from the years 2000 through 2011. This search narrows the list of 13D filings to initial filings and amended filings. From here, I simply scrolled through the lists of filings and picked out each initial 13D filing.

Once that I had a list of all the initial 13D filings for each of the five prominent activist hedge fund managers ranging from the years 2000 through 2011, I was able to sift through each individual filing and pull out three key pieces of data. The first, and most important piece, was simply the date of the initial filing. This would be the critical starting point for analyzing the data that would ultimately lead to results. The second piece was the size of the initial acquired stake. This is a number represented as a percentage of the target company in which the activist hedge fund manager has built a stake. This is important because it can potentially paint us a picture of what the activist has in mind for the target. For example, if the stake is very high, say around 30%, then the activist has built a significant position in the company and presumably plans to enforce his will. The third piece of data pulled from the initial 13D filing comes from the section discussed earlier called "Purpose of Transaction." This is what truly gives us an idea of the intentions of the activist hedge fund manager. It allows us to discern whether or not the activist is taking on an activist role or if he is simply buying a stake in the company because he believes the shares are undervalued and he wishes to realize a passive profit. Each of these three key pieces of information will help tremendously in determining whether or not prominent activist hedge fund managers create value.

In seeking to find out whether or not prominent activist hedge fund managers create value, we need to see how the stock price of each target reacts when an activist's ownership stake in that target becomes public information. We also need to look at the performance of the stock price over the course of time in order to see whether the activist hedge fund manager's activist investment role has caused the company to perform better or worse than it normally would. In order to accomplish this feat, we can't simply look at the stock price over the course of time and conclude that if the price went up, the activist created value for the target and if the price went down, the activist destroyed value for the target. While this method may turn out to ring true for some companies, it has many flaws. The most important flaw is that it doesn't account for the plethora of other factors that could be affecting the movement of the nominal stock price of the target. For example, say that during a period that an activist hedge fund manager takes on an activist role in a target, the market crashes as a result of a detrimental earthquake. The incompetent method will result in data that shows the nominal stock price falling steeply during the activist's investment period. The results will incorrectly attribute this steep decline and destruction of value to the activist's involvement when in reality it was due to the earthquake.

While it is impossible to account for all the factors that could potentially affect the target company's stock price during the period of activist involvement, there is a feasible method for accounting for many of them. The most reasonable and feasible method for accounting for as many outside factors as possible is to record relative performance instead of nominal performance. We will define relative performance as the target company's stock price performance compared to that of its peers. While this method does not account for company-specific events or occurrences that could skew data, it does account for anything that happens in the broader market. It also accounts for any unwanted factors that occur within the target's industry. The is the closest we can feasibly get to accounting for all outside factors when looking to see whether an activist hedge fund manager's involvement in a target company leads to the creation or destruction of value.

There are a number of different ways of going about finding and selecting a target company's peer group. The method I used was very simple, but other methods can get a little complicated. For example, in Greenwood and Schor's paper, "Investor Activism and Takeovers," they first attempt to identify matching stocks for each target based on size, industry, and the book-to-market ratio. This becomes complicated when no data exists for certain firms. When this occurs, they create a surrogate portfolio. They do this by starting with 100 days of returns, from 110 days prior to the initial 13D filing to 10 days prior to the initial 13D filing. They then estimate factor loadings of target firm returns using the Fama and French HML, SMB, and market return factors. The formula is listed below:

Figure 5.1

$$R_{it+1}^{\text{Match}} - R_{t+1}^{F} = \hat{b}_i HML_{t+1} + \hat{c}_i SMB_{t+1} + \hat{d}\,(R_{t+1}^{M} - R_{t+1}^{M})$$

There are a few times where there is not enough pre-event data to estimate the factor loadings so when this is the case, they substitute the Center for Research in Security Prices (CRSP) value-weighted market index for the match portfolio instead.[13] This can get quite complicated and time consuming.

In order to keep the process relatively simple, I took a different approach. For target companies that were publicly traded, I used a group of competitors that were listed as such in Yahoo! Finance and that were grouped within the same industry. For companies that were

[13] Schor, Michael, and Robin M. Greenwood. "Investor Activism and Takeovers." (2007): n. pag. *Social Science Research Network*. Web. 15 Dec. 2012. <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1003792>.

private, I had to use the COMPUSTAT database. I searched for the target company's 4-digit Standard Industrial Classification (SIC) code. SIC codes are used by government agencies, such as the SEC to classify certain industries. Once I located the target company's 4-digit SIC code, I did a search for each company listed under that exact SIC code. From here, I simply pulled a group of peers that were comparable to the target company. For both the public and private target companies, I tried to gather anywhere from four to eight competitors to form a peer group, or matching portfolio. Sometimes this was impossible, as there were only two to three competitors available, however, this was rarely the case.

Once I had gone through the process of forming peer groups or matching portfolios corresponding to each of the target companies for each of the five profiled activist hedge fund managers, it was time to collect security prices.

II. Time Period Rationale

While security prices are readily available for all publicly traded companies, they are not easily accessible for companies that have gone bankrupt, been acquired or taken private, or that have been delisted from their respective exchange. In order to gain access to these hard-to-get security prices, I was granted access by the Pennsylvania State University to Wharton Research Data Services. Wharton Research Data Services houses a number of different databases. For the purposes of collecting a plethora of security prices, the COMPUSTAT database was the one for the job.

The next task at hand was to determine at which dates I would want to collect the stock prices of the target company and its peers. There is a lot of variability and importance in choosing the dates from which to collect the stock prices. In "Is Carl Icahn Good for Long-Term Shareholders? A Case Study in Shareholder Activism," Venkiteshwaran, Iyer, and Rao use three different event windows to determine announcement period returns surrounding an initial 13D filing. They used a three-day event window including the day before and the day after the initial filing date, a 21-day event window starting 10 days before the initial 13D filing date and ending 10 days after, and a 41-day event window starting 10 days prior to the initial 13D filing date and ending 30 days after.[14]

I wanted to look at value creation through both a short-term lens and long-term lens. In order to accomplish this, I gathered data over the course of several different event windows. This way my biggest problem would be having too much data, not a lack of data. I ended up collecting security price data to form six different event windows. The first three would mirror Venkiteshwaran, Iyer, and Rao. These three different event windows were a three-day event window including the day before and the day after the initial 13D filing date, a 21-day event window starting 10 days before the initial 13D filing date and ending 10 days after, and a 41-day event window starting 10 days prior to the initial 13D filing date and ending 30 days after. Each of these three event windows is dedicated to analyzing announcement period returns. They are short-term focused. The analysis of these three event windows will lead us to determine whether or not prominent activist hedge fund managers are able to create value in the short-term. I used the other three event windows to focus on the long-term performance of the target companies. The first event window included security prices one year prior to the initial 13D filing and one year after. The second of the long-term event windows included security prices one year after the initial 13D filing date and two years after the initial 13D filing date. The last of the long-term event windows included security prices one month prior to the initial 13D filing date and 18 months after. This long-term focus is meant to determine whether or not these five prominent activist hedge fund managers are about to create value in their target companies over the long-term.

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[14] Venkiteshwaran, Vinod, Subramanian Iyer, and Ramesh P. Rao. "Is Carl Icahn Good for Long-Term Shareholders? A Case Study in Shareholder Activism." (n.d.): n. pag.*Social Science Research Network*. Web. 10 Nov. 2012. <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1733800>.

The inclusion of both the short-term focus and the long-term focus will allow us to gain a better and more wholesome understanding of whether these prominent activist hedge fund managers create or destroy value in their target companies. This will give us the ability to discern how the market perceives activist investing and whether or not the market differentiates between activist investors.

III. Abnormal Return Calculation

Once the securities prices for each target company and its peer group were gathered across the six different time windows, I was able to move on to calculating returns. The return calculation was simple; it was just the price at the end of the event window divided by the price at the beginning of the event window, minus one. This was done for each target company and each of the peers of the respective target companies. Once all of these nominal returns were calculated I was able to begin calculating abnormal returns.

An abnormal return can be defined as the difference between an expected return and an actual return. This said difference between expected return and actual return is critically important in finance. It is very similar to the idea of relative performance. For example, a hedge fund manager might nominally return a large positive amount for the year. This nominal amount, while it means that the hedge fund manager returned a large positive amount of money, is no indicator of his performance in the market. When looking at what the hedge fund manager was expected to return, an adjustment for risk, and how well the market performed, we can see how well he actually performed for the year. It is this same idea that forces us to look at abnormal returns when determining whether these prominent activist hedge fund managers create or destroy value in their target companies over both the short-term and the long-term. In order to do this, we simply take the median nominal return of the peer group and classify it as the expected return mentioned in the definition above. From here, we simply subtract the expected return, or median peer group return, from the observed nominal return of the target company. This gives us the abnormal return for each target company over each of the six different event windows.

Once each of the abnormal returns was calculated, it was time to organize and aggregate all of the data. With so much of it, this was somewhat time consuming, but once the process had been completed the data was ready to be analyzed.

IV. Securities and Exchange Commission

The Securities and Exchange Commission, or SEC, is a federal agency that is responsible for oversight and regulation of the securities industry in the United States. The SEC, like many other federal agencies, was a product of the Great Depression. Coming out of such a crisis, President Roosevelt created the SEC to regulate the stock market to make sure nothing like the Great Depression would ever happen again.

The SEC has many functions, responsibilities, oversights, and jurisdictions. For the purposes of this paper, the SEC's main focus will be the regulation of the securities industry. Part of this regulation involves making sure that investing is transparent. Transparency in investing is critically important for all investors, from pension funds to owners of Scottrade accounts. Without transparency, no one would have faith in the markets, which would inhibit its ability to function as a free market.

A large and important part of the transparency in the stock market lies within the issue of corporate governance among individual companies whose stock trades publicly on these exchanges. It is of utmost importance to know who is running a company and for what reasons if you are a prospective investor in a particular publicly traded stock. For example, a company's majority owner may be that particular company's native government. If this is the case, then the aforementioned government might act in the interests of that particular country's citizens. Whatever the major shareholder's interests may be, it is important as an investor to determine whether or not they are in the interest of shareholders. If the answer is yes, then corporate governance is not a concern to the investor. If the answer is no, then the investor will want to be cautious in going forward with an investment in the company or should simply look elsewhere depending on their risk profile.

In order to make sure that a high level of transparency is maintained, the SEC requires the filing of a Schedule 13D by anyone who builds up a stake of 5% or more in a public company.

V. Schedule 13D

A Schedule 13D, or simply, a 13D, is as mentioned above, an SEC filing that must be filed by an person or entity that amasses a stake of 5% or more in a publicly traded company in the United States. The 13D must be filed within ten days of the date in which the 5% threshold is reached. This ensures the prompt notification of the public of a potentially substantial change in corporate governance in a company that an investor might be looking to invest in or already has invested in.

It is important to note the distinction between an initial 13D filing and an amended 13D filing. Everything explained with regards to the 13D is referring to an initial 13D filing. The initial filing must be amended if anything changes from the perspective of the filer. Changes include a new reason for investment or an increase or decrease of 1% ownership in the stock.

There are several sections that can be found in each and every 13D filing, the most important of which is the section titled “Purpose of Transaction.” It is this section that will be of the most interest to current and prospective investors in companies who are seeing 13D’s filed. Many times the “Purpose of Transaction” section will simply say that the filer thinks the securities are undervalued and is simply buying them for investment purposes. Other times the section will detail that the filer wants to wage a proxy fight with the company in order to elect new board members with the ultimate goal of returning capital to shareholders. When appropriate, there will often be any correspondence between the filer and the company attached to the 13D filing. A good example of this could be an activist's letter to the company's board of directors demanding that the CEO be fired due to his incompetence and inability to lead the company through the current business environment.

Schedule 13D filings are incredibly useful when researching the work of activist investors because they provide a starting point from which we can gather data. There is no other universally standard way to decipher when activist investors take an activist stance in a company or build a significant ownership stake in a company. When looking through a value creation lens, we can use the date of the initial filing of the 13D as the date in which the activist investor first invests in a target.

Chapter 6

Data Results

I. Short-Term

When news of an activist investor's involvement in a target company breaks and becomes public information, the stock price of the target will often rise. It has been widely accepted among the academic community that this is indeed the case for the majority of instances of shareholder activism.

Venkiteshwaran, Iyer, and Rao, in their paper, "Is Carl Icahn Good for Long-Term Shareholders," found that Carl Icahn created value through his activist efforts in his target companies in the short-term. Their data concluded that the abnormal return for companies targeted by Icahn was about 7% in a three-day event window, 14% in a 21-day event window, and 17% in a 41-day event window.[15] This supported their hypothesis that Icahn was able to create value in his target companies. This was certainly the case in the short-term.

The data summarized in Table 6.1 shows that together, the five prominent activist hedge fund managers were able to produce abnormal returns for their target companies. The data shows abnormal returns of about 2% in the three-day event window, 7% in the 21-day event window, and 5% in the 41-day event window. This shows that value is created by the prominent activist hedge fund managers for their target companies in the short-term. It is also worth noting that all five of the hedge fund managers created positive abnormal returns in their targets. Table 6.1 also

[15] Venkiteshwaran, Vinod, Subramanian Iyer, and Ramesh P. Rao. "Is Carl Icahn Good for Long-Term Shareholders? A Case Study in Shareholder Activism." (n.d.): n. pag.*Social Science Research Network*. Web. 10 Nov. 2012. <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1733800>.

illustrates each individual activist hedge fund manager's mean and median abnormal returns across each of the six different event windows.

Table 6.1

	Abnormal Returns					
	3-Day Period	21-Day Period	41-Day Period	2-Year Period	1-Year Period	19-Month Period
Ackman						
Average	13.56%	15.62%	14.26%	-1.58%	6.74%	10.27%
Median	3.54%	8.73%	4.46%	7.55%	-15.46%	0.19%
Peltz						
Average	1.66%	4.70%	5.75%	25.76%	2.47%	13.95%
Median	1.24%	5.43%	5.23%	27.60%	6.82%	12.18%
Loeb						
Average	1.54%	7.04%	8.05%	2.99%	2.82%	-0.37%
Median	1.80%	4.72%	8.67%	-21.26%	-5.15%	-16.25%
Falcone						
Average	-2.36%	6.31%	9.18%	126.45%	123.83%	34.62%
Median	0.42%	9.58%	4.78%	-33.31%	-2.63%	-10.19%
Icahn						
Average	2.16%	6.01%	5.86%	0.15%	-5.63%	-19.89%
Median	1.88%	7.25%	5.74%	-14.59%	-1.18%	-14.66%
Total						
Average of Averages	3.31%	7.94%	8.62%	30.75%	26.04%	7.72%
Average of Medians	1.78%	7.14%	5.78%	-6.80%	-3.52%	-5.74%
Median of Averages	1.66%	6.31%	8.05%	2.99%	2.82%	10.27%
Median of Medians	**1.80%**	**7.25%**	**5.23%**	**-14.59%**	**-2.63%**	**-10.19%**

Explaining why this value is created is when things start to get complicated and convoluted. There are so many potential factors that it is nearly impossible to pinpoint and determine exactly why value is created in the short-term. In "Investor Activism and Takeovers," Greenwood and Schor argue that these abnormal returns are realized because activists are often able to force their target companies into acquisitions.[16] Thus, when an activist investment becomes public information, investors buy up the stock with hopes that the target company will soon be acquired. The acquisition of the target company would result in a profit for investors if the premium paid is substantial.

Another potential explanation as to why shareholder activists cause positive abnormal announcement period returns is that investors truly believe that the activist will be successful in returning capital to shareholders. Whether it is through an increased dividend, an asset sale, or cost cutting that improves margins, and thus profitability, shareholder activists will do whatever it takes to try and return more capital to shareholders. It's certainly possible that investors support these notions and believe activists will be successful more often than not.

While the reasoning as to why an activist investor is able to create value in the short-term may be ambiguous, the fact that value is created is certain. Positive announcement period abnormal returns of all three short-term event windows clearly show that prominent activist hedge fund managers create value in the short-term.

II. Long-Term

Seeking to determine whether or not activist hedge fund managers create value in the long-term becomes a little more difficult than doing the same for the short-term. This is due to the fact that there are more factors involved. The biggest hindrance is the changing status of the target companies. It is rare for a target company to be delisted, go bankrupt, or get acquired in just a month after an activist investor files a 13D. It is much more common to see target companies be delisted, go bankrupt, or get acquired a year, 18 months, or two years following an activist investor's initial filing of the 13D. This makes it more difficult to gather data and judge whether or not an activist investor has created value for the target in the long-term.

[16] Schor, Michael, and Robin M. Greenwood. "Investor Activism and Takeovers." (2007): n. pag. *Social Science Research Network*. Web. 15 Dec. 2012. <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1003792>.

A number of scholars have tried several different ways to determine whether or not activist investors create value in the long-term. In "Is Carl Icahn Good for Long-Term Shareholders," Venkiteshwaran, Iyer, and Rao look at operating statistics of target companies and see whether or not they have improved over the course of activist ownership. They found no significant improvements to target company operating performance over the long-term. Like me and Greenwood and Schor, they also looked at long-term stock price performance. Interestingly, they found a large discrepancy in long-term performance between targets that were acquired and those that remained independent. They concluded that Icahn target companies that were acquired in the 18 months following an initial 13D filing recorded abnormal returns of 25%. This sharply contrasted with the negative 60% returns recorded by the target companies that remained independent after 18 months.[17] This is supportive of Greenwood and Schor's hypothesis that investors and the market believe that activist investors create value by increasing a target company's chances of being acquired. It's also supportive of the idea that activist investors implement what's known as a "pump and dump" strategy. This means that they build up their positions in target companies, advocate for returns to shareholders, and then sell all of their stock to make a quick profit. This then leaves the target company hanging out to dry and sets them up for poor performance.

The data I have collected, shown in Table 6.1, conclude that prominent activist hedge fund managers do not create value over the long-term. This is based on the negative stock price performance seen over the three long-term event windows surrounding the activist investors' initial filing of the 13D. The median return in target companies over the one-year, two-year, and 19-month event windows are -15%, -3%, and -10%, respectively. Taking a closer look at the

[17] Venkiteshwaran, Vinod, Subramanian Iyer, and Ramesh P. Rao. "Is Carl Icahn Good for Long-Term Shareholders? A Case Study in Shareholder Activism." (n.d.): n. pag.*Social Science Research Network*. Web. 10 Nov. 2012. <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1733800>.

data, it appears as if Bill Ackman and Nelson Peltz had the most success in creating long-term value, but collectively, the prominent activist hedge fund managers do not create long-term value. The average of the abnormal returns of targets of Philip Falcone is skewed upward due to just a couple of companies.

III. Hypothesis I

The collection and analysis of the data has confirmed my hypothesis that prominent activist hedge fund managers create value in the short-term. This is supported by the conclusions of several other academic papers on the subject.

As mentioned previously, it has been widely accepted by the academic community that when news of activist involvement in a target company becomes public information, investors receive the news positively and the stock price of the target company rises. This has been reiterated in my research regarding short-term announcement period returns in targets of activist hedge fund managers.

IV. Hypothesis II

My data collected and research regarding the subject of long-term value created among target companies by activist hedge fund managers clearly shows that no such value is created. Again, this supports both my hypothesis and the findings of many other academic papers regarding the topic of long-term value creation. The paper mentioned several times throughout this thesis written by Venkiteshwaran, Iyer and Rao serves as a caveat to this idea that long-term value is not created by activist hedge fund managers. However, they specify that value is only created in the long-term if the company is acquired or taken private. They point out a large discrepancy in performance between the target companies that are acquired or taken private within 18 months of an activist hedge fund manager's initial 13D filing and those that remain independent over that same time period.

V. Summary

While there was variation in the amount of value created or destroyed between individual activist hedge fund managers, the group as a whole produced abnormal returns in their target companies supportive of my hypothesis that the activist hedge fund managers were able to create value in the short-term but not in the long-term.

After careful analysis, aggregation, organization, and consolidation of the data I collected, my hypotheses have been upheld. The upholding of my hypotheses is not all that surprising of a conclusion, as signals that that would be the case were rather strong after having read through somewhat similar academic pieces written by others on the subject of shareholder activism.

Many of the abnormal returns calculated across the six different event windows for each prominent activist hedge fund manager are statistically significant at the 0.1, 0.05, and 0.01 levels. These results were found by running a Student's T-Test instead of a Z-Test due to the small sample sizes for each prominent activist investor. While not all of the abnormal returns calculated are statistically significant, the results still largely signal that the prominent activist hedge fund managers create value in the short-term, but not in the long-term. The breakdown of statistically significant abnormal returns can be found in Appendix A.

Chapter 7

Conclusion

With the last decade having been the most controversial for the finance industry, the reserved spot for activist hedge fund managers in the conversation is somewhat warranted. On one hand, the hedge fund managers are able to create value in their target companies in the short-term. It's been found, however, that this is largely only the case when the target companies are acquired within 18 months of the activist hedge fund manager's initial involvement. While short-term gains may be a good thing for a small portion of the investing population, including the activist hedge fund managers themselves, the large majority of investors are left holding the stock of a company that is fundamentally worse off after the activist hedge fund manager has quickly come and gone.

This idea of a "pump and dump" strategy has been found to be the method of choice for activist hedge fund managers. They look to turn a quick profit by benefitting from the well-documented short-term announcement period gains. After making these gains, the activist is able to gauge whether or not a sale of the company is feasible. If their analysis proves to be correct and things run smoothly, the target company is acquired and profits are realized for all parties involved. However, if things don't run so smoothly or if the activist determines a sale of the company will be unlikely or too costly, he can profit off of the short-term gains. This usually leaves long-term investors holding the stock of a company that is now fundamentally worse-off than it was prior to any activist involvement. While value may in fact be created by the increased chance of sale of the company targeted, there is no making up for the target companies that are left independent whose faith is lost by investors.

I believe that the field of activist hedge fund investing is a fascinating one. There is so much to learn from the experiences, actions, and interactions between activist hedge fund managers and the companies they target. Activist investors appear to bring out the ugliest in some companies, while showcasing the value in others. Despite the long-term value destruction in many cases of hedge fund activism, it is clear that these fund managers have brought out the best in some companies through the facilitation and expedition of the sale process. The sheer presence of activist hedge fund managers in the marketplace has and will continue to keep publicly-traded companies on their proverbial toes and keep them from ignoring the interests of shareholders.

Appendix A

Statistical Analyses

	Statistical Analysis (Ackman)					
	3-Day	21-Day	41-Day	2-Year	1-Year	19-Month
N	13	13	13	9	5	7
Sample Mean (x)	12.69%	13.81%	13.36%	8.65%	27.14%	10.75%
Standard Deviation	0.3024	0.2423	0.3213	0.3473	0.8694	0.5596
Standard Error	0.0839	0.0672	0.0891	0.1158	0.3888	0.2115
Z-Score	1.6167	2.3247	1.6005	-0.1367	0.1732	0.4855
Population Mean (μ)	-0.87%	-1.81%	-0.91%	10.23%	20.40%	0.48%
Degrees of Freedom	12	12	12	8	4	6
Computed T-Stat	1.6167	2.3247	1.6005	-0.1367	0.1732	0.4855
Critical T-Stat (0.1)	1.782	1.782	1.782	1.860	2.132	1.943
Critical T-Stat (0.05)	2.179	2.179	2.179	2.306	2.776	2.447
Critical T-Stat (0.01)	3.055	3.055	3.055	3.355	4.604	3.707

	Statistical Analysis (Peltz)					
	3-Day	21-Day	41-Day	2-Year	1-Year	19-Month
N	7	7	7	4	6	6
Sample Mean (x)	1.13%	5.41%	4.62%	41.16%	-12.26%	20.24%
Standard Deviation	0.0213	0.0475	0.0552	0.0508	0.2045	0.2364
Standard Error	0.0080	0.0180	0.0209	0.0254	0.0835	0.0965
Z-Score	2.0680	2.6181	2.7586	10.1389	0.2960	1.4454
Population Mean (μ)	-0.53%	0.71%	-1.13%	15.40%	-14.73%	6.30%
Degrees of Freedom	6	6	6	3	5	5
Computed T-Stat	2.0680	2.6181	2.7586	10.1389	0.2960	1.4454
Critical T-Stat (0.1)	1.943	1.943	1.943	2.353	2.015	2.015
Critical T-Stat (0.05)	2.447	2.447	2.447	3.182	2.571	2.571
Critical T-Stat (0.01)	3.707	3.707	3.707	5.841	4.032	4.032

Statistical Analysis (Loeb)

	3-Day	21-Day	41-Day	2-Year	1-Year	19-Month
N	34	35	35	25	26	26
Sample Mean (x)	1.48%	7.90%	9.78%	32.35%	9.63%	-6.36%
Standard Deviation	0.0712	0.2066	0.2252	0.8714	0.6127	0.5927
Standard Error	0.0122	0.0349	0.0381	0.1743	0.1202	0.1162
Z-Score	1.2633	2.0171	2.1153	0.1715	0.2347	-0.0317
Population Mean (μ)	-0.07%	0.86%	1.73%	29.36%	6.81%	-5.99%
Degrees of Freedom	33	34	34	24	25	25
Computed T-Stat	1.2633	2.0171	2.1153	0.1715	0.2347	-0.0317
Critical T-Stat (0.1)	1.694	1.691	1.691	1.711	1.708	1.708
Critical T-Stat (0.05)	2.037	2.032	2.032	2.064	2.060	2.060
Critical T-Stat (0.01)	2.738	2.728	2.728	2.797	2.787	2.787

Statistical Analysis (Falcone)

	3-Day	21-Day	41-Day	2-Year	1-Year	19-Month
N	29	28	28	19	22	21
Sample Mean (x)	-2.35%	4.84%	6.81%	128.79%	132.71%	26.22%
Standard Deviation	0.1653	0.2103	0.2970	4.9465	3.0618	2.4657
Standard Error	0.0307	0.0397	0.0561	1.1348	0.6528	0.5381
Z-Score	-0.7691	1.5886	1.6352	1.1143	1.8969	0.6435
Population Mean (μ)	0.01%	-1.48%	-2.37%	2.34%	8.88%	-8.40%
Degrees of Freedom	28	27	27	18	21	20
Computed T-Stat	-0.7691	1.5886	1.6352	1.1143	1.8969	0.6435
Critical T-Stat (0.1)	1.701	1.703	1.703	1.734	1.721	1.725
Critical T-Stat (0.05)	2.048	2.052	2.052	2.101	2.080	2.086
Critical T-Stat (0.01)	2.467	2.771	2.771	2.878	2.831	2.845

Statistical Analysis (Icahn)	3-Day	21-Day	41-Day	2-Year	1-Year	19-Month
N	44	43	43	32	26	30
Sample Mean (x)	2.16%	7.89%	6.81%	-1.94%	-1.20%	-19.85%
Standard Deviation	0.0716	0.1936	0.2276	0.6104	0.6385	0.4171
Standard Error	0.0108	0.0295	0.0347	0.1079	0.1252	0.0762
Z-Score	1.9998	2.0341	1.6888	0.0135	-0.4498	-2.6119
Population Mean (µ)	0.00%	1.89%	0.95%	-2.08%	4.43%	0.04%
Degrees of Freedom	43	42	42	31	25	29
Computed T-Stat	1.9998	2.0341	1.6888	0.0135	-0.4498	-2.6119
Critical T-Stat (0.1)	1.682	1.682	1.682	1.697	1.708	1.699
Critical T-Stat (0.05)	2.018	2.018	2.018	2.042	2.060	2.045
Critical T-Stat (0.01)	2.698	2.698	2.698	2.750	2.787	2.756

Statistical Analysis (Total)	3-Day	21-Day	41-Day	2-Year	1-Year	19-Month
N	127	126	126	89	85	90
Sample Mean (x)	3.02%	7.97%	8.28%	41.80%	31.20%	6.20%
Standard Deviation	0.1434	0.2037	0.2506	2.4175	1.7352	1.2839
Standard Error	0.0127	0.0181	0.0223	0.2563	0.1882	0.1353
Z-Score	2.6031	4.3740	3.8614	1.2001	1.3838	0.5701
Population Mean (µ)	-0.29%	0.03%	-0.34%	11.05%	5.16%	-1.51%
Degrees of Freedom	126	125	125	88	84	89
Computed T-Stat	2.6031	4.3740	3.8614	1.2001	1.3838	0.5701
Critical T-Stat (0.1)	1.660	1.660	1.660	1.664	1.664	1.664
Critical T-Stat (0.05)	1.984	1.984	1.984	1.990	1.990	1.990
Critical T-Stat (0.01)	2.626	2.626	2.626	2.639	2.639	2.639

Appendix B

Size of Initial Acquired Stake

	Size of Initial Acquired Stake
Ackman	
Average	9.93%
Median	9.60%
Peltz	
Average	6.15%
Median	5.81%
Loeb	
Average	9.59%
Median	7.10%
Falcone	
Average	17.28%
Median	16.90%
Icahn	
Average	9.88%
Median	7.34%
Total	
Average	10.56%
Median	7.34%

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