

Hedge Fund Activism on Dual Edges: A Comprehensive Study

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Abstract: This comprehensive study explores hedge fund activism (HFA), its impact on corporate governance, and shareholder value. It outlines the operational mechanisms of HFA, including target selection, share acquisition, influence exertion, and pushing for change. The study also delves into HFA's aggressive investment strategies, contrasting them with traditional funds. It examines HFA's positive impacts, such as improved corporate governance and shareholder value, and negative consequences, like short-termism and increased market volatility. The paper further analyzes HFA through an ESG lens, highlighting its potential to disrupt CSR practices and affect employee health. Case studies of Yahoo and J.C. Penney illustrate both the successes and failures of HFA. The study concludes by suggesting areas for future research and action, emphasizing the need for a balanced approach to harness HFA's benefits while mitigating its risks.

Keywords: Hedge fund activism; dual edges; comprehensive study.

1. Introduction

Hedge funds aim to achieve absolute returns that surpass benchmark interest rates (Goetzmann and Brown, 2003). Before 2000, hedge funds predominantly depended on fund managers to identify and exploit arbitrage opportunities for returns. Hedge fund investment strategies include market neutral, buy and hold, fund of funds, convertible arbitrage, risk arbitrage, trend following, and global macro, among others. Market neutral strategies, which employ quantitative models to maintain multiple long and short positions concurrently, aim to shield investments from stock market volatility. However, this approach relies heavily on the performance of selected stocks and has not consistently produced significant excess returns (Amenc and Curtis, 2003). With the decline in arbitrage opportunities in recent years, many hedge funds have shifted towards alternative arbitrage strategies, with hedge fund activism (HFA) gaining prominence as an active approach. HFA involves funds using their shareholder status to actively influence the management and operations of a company, aiming to enhance corporate governance and performance. That works at least fueled by hedge funds' high-return ambitions and dissatisfaction with traditional governance models and slow companies. These hedge funds activists apply pressure on the target companies to instigate rapid reforms aimed at increasing the value of the company, allowing them to realize large returns for their investors.

There has been a lot of attention and a great debate surrounding the recent increase in HFA within financial markets. Proponents claim that HFA should bring about positive changes in the company in terms of improvement of corporate governance, more effective management, better allocation of assets, and a larger increase in shareholder value. They argue, for example, that hedge funds help resolve the conflicts of interest within companies and increase the transparency and accountability of management, which effectively promotes and establishes a rational decision-making process (Ribeiro and Machado Santos, 2011). HFA, on the other hand, also has some risks and negative consequences. Critics say that this might lead companies to focus on short-termism at the expense of long-term growth and innovation. Besides, activist campaigns could produce market turbulence, increase operating expenses, and antagonize other constituencies. This means that the impact of HFA is equal to a double-edged sword that would guide firms toward favorable results and create undesirable repercussions.

The following study is thus purposed to undertake a detailed investigation into the role and impacts that HFA play within the concerned financial markets, with critical evaluation of the positives and negatives of its effect on corporate governance and performance from an ESG perspective, and delve into strategies that could realign these effects to be in line with the best interests of the firm and its shareholders. Through insight into the mechanisms, benefits, risks, and particular instances of HFA, this paper seeks to make its contribution toward the understanding and evaluative assessment of HFA.

2. An Analysis of the Operational Mechanisms and Investment Strategies of HFA

2.1. Operational Steps of HFA

The process of HFA typically unfolds through the following steps (Mike Burkart and Amil Dasgupta,2020):

(1). Selecting target companies: Basically, the hedge fund activists identify the companies they consider as either undervalued or having poor management through comprehensive research in the market. More than often, they basically have solid basics, though not reflecting in the stock price due to factors such as poor management decisions, inaccurate market positioning, or suboptimal asset allocation.

(2). Acquisition of Shares: Activists acquire shares through purchases made in the open market or through private negotiations with major shareholders. The acquisition is most often substantial enough to afford them significant influence in the company's decision-making processes, and occasionally on the board of directors.

(3). Influence: Upon stake acquisition, the activist seeks a meeting with the management of the company to present to the managers his or her visions for the company's future. If the management resists his proposals, it would likely step up the pressure through more aggressive measures, such as a proxy fight to win a board position or public criticism of his management practices.

(4). Push for change: Should the level of influence be high, an activist will advocate for any reform that would be beneficial, either to enhance corporate governance or to divest non-core assets, reduce costs, repurchase shares, or increase dividends or to conduct a strategic reorganization to strengthen the value and performance in the market.

With these steps, hedge fund activists hope to push through changes that improve the operational efficiency and market competitiveness of target companies in the shortest period possible, which results in value creation for the investors. This aggressive investment approach has spurred extensive debate and research into its long-term effects on the market.

2.2. HFAs' Aggressive Investment Strategies

This flexibility and diversity point to investment strategies differentiates HFAs in the financial market from traditional funds. HFAs do not only invest in basic stocks and bonds but also trade derivatives, including options and futures, and use complex financial strategies, such as short selling and leveraged operations. It is this varied portfolio and strategy that will allow the HFAs to pursue positive investment returns across different market conditions, yet managing their risks.

As the wheels of economic development roll and financial innovations increase, there is growing cognizance by institutional investors, banks, and traditional fund companies of the pivotal role HFAs are playing in financial markets. Therefore, strategies employed by HFAs have gained considerable attention. On the human side, HFAs tend to reduce agency conflicts and focus on the long-term development of the target company. Furthermore, HFAs bring activism with them as part of the new mechanism of corporate governance to bring about reforms in corporate operations and financial regulation. Why HFA is not like the traditional investment strategy could be summarized as follows:

(1). **Financial Incentives:** An HFA manager adopting an activist strategy, in most circumstances, is interested in the profit mission with deep financial incentives. In general, a hedge fund receives a portion of the returns, which represent excess returns, for the performance of the fund, in addition to a fixed management fee (e.g., 20%). Additionally, it is common for HFA managers to be investing their own assets in the fund. Thus, this compensation structure opposes significantly that of mutual or pension fund managers, which obviously did not partake in excess returns and, as a result, did not have incentives to have a high focus placed on the financial performance of the target firm, given its impact on the fund's long-term value.

(2). **Regulatory Environment:** HFAs operate under lighter regulation because they market primarily to institutional clients or a select group of affluent individual investors, not the general public. Consequently, hedge funds employing activist strategies are not bound by stringent fiduciary standards like those under the Employee Retirement Income Security Act (ERISA). This regulatory flexibility permits hedge funds to intervene more assertively in portfolio companies. For example, unlike other institutional investors, hedge funds are not legally required to maintain a diversified portfolio, allowing them to concentrate their holdings significantly in a few target companies. Additionally, they can utilize derivative securities or engage in margin trading to hedge or leverage their investments, presenting substantial advantages for activist shareholders.

(3). **Conflict of Interest:** Activist hedge funds generally encounter fewer conflicts of interest compared to other institutional investors, such as peer funds and pension funds, which often engage in various business dealings or pursue non-financial objectives with their portfolio companies. Hedge fund managers are less likely to face such conflicts. Recent research indicates that, unlike mutual funds and pension funds, hedge funds are capable of significantly influencing corporate boards and management due to their organizational structure and incentive systems (Anup Agrawal and Yuree Lim, 2022). Hedge funds employ managers at high salaries to oversee unregulated capital pools. Freed from the regulations that bind mutual funds and pension funds, hedge funds can maintain highly concentrated positions in several companies, employing leverage and derivatives to expand their influence.

(4). **Activist Strategy:** The objective of an activist strategy is to generate excess returns through enhanced corporate governance. Unlike typical hedge fund strategies that capitalize on arbitrage across various markets and invest in diverse classes of securities, derivatives, and commodities, an activist strategy involves acquiring a minority interest in a publicly traded company to influence its operations, increase its value, and elevate its stock price. Additionally, hedge funds often include lock-up clauses that prevent investors from withdrawing their principal. Assuming hedge fund activists maintain their investments in a target company for over a year to sustain their strategy, these clauses grant managers increased flexibility to pursue medium- and long-term investment objectives.

3. Analysing the positive and negative impacts of HFA with an ESG perspective

3.1. Positive impact on optimizing corporate governance

HFA positively influences corporate governance by mediating management decisions and controlling agency risks, thereby enhancing shareholder value. Brav (2008) analyzed a sample of 1,059 hedge funds adopting activist strategies between 2001 and 2006, focusing on their objectives, the characteristics of the target firms, and the market's response. Other researchers have examined HFA's effects on firm performance (Boyson and Mooradian, 2007; Clifford, 2008; Klein and Zur, 2009) and its role in corporate mergers and acquisitions (Greenwood and Schor, 2009). This body of literature supports changes in corporate governance through activist strategies from two angles: firstly, by altering the firm's growth strategy via indirect investments such as asset divestitures of outdated capacities. Bethel et al. (1998) studied activist stakes in Fortune 500 firms during 1980-1989, finding that activists often target firms with low return on assets and price-to-book ratios, observing excess returns around the announcements of equity subscriptions. Secondly, activists compel firms to lower

agency costs by means such as increasing dividends, loans, or share buybacks from excess retained cash. Jensen (1986) discussed how free cash flow can lead to agency conflicts, suggesting that managers often misuse cash for unnecessary asset expansion. He emphasized using excess retained cash for dividend distribution or expanding leverage to reduce agency costs. Michael Albert (2003) confirmed that activist strategies effectively mitigate agency conflicts, noting that targeted firms retained significantly more cash than non-targets and experienced a substantial reduction in excess cash post-agency contests, often via special dividends. This data was gathered after the Jobs and Growth Tax Relief Reconciliation Act of 2003 in the U.S., which further incentivized hedge funds to enhance returns through dividends. Unlike the perception of short-sightedness, the activist strategy aims for long-term profitability. Initially, target companies might not exhibit superior returns, with metrics like net earnings per share and return on assets possibly declining. However, these companies distribute a large portion of their net profit as dividends and take on significant debt, reducing agency costs and fostering long-term sustainability.

In conclusion, HFA introduces a new model of corporate governance that provides more suitable financial incentives and structures than those of past institutional investors, focusing on long-term investments without sacrificing sustainable growth for short-term gains. The success of hedge funds in improving the governance and operations of their target companies significantly enhances shareholder value and benefits the activists themselves, creating a win-win scenario.

3.2. The counterproductive effects of HFA on social responsibility

HFA has undoubtedly benefited companies and shareholders by promoting better corporate governance, enhancing shareholder value, and facilitating strategic restructuring. On the other hand, it also evokes controversies and risks that require a cautious weighing of its benefits and detriments. The following discussion aims at elaborating on HFA and its potential beneficial impacts and risks. Companies, shareholders, and regulators will no doubt require measures by them to balance the benefits and detriments of HFA.

The study that follows U.S. data for 2000-2016, according to Prof Mark DesJardine (Pennsylvania State University), Prof Emilio Marti (Erasmus University Rotterdam), and Prof Rodolphe Durand (HEC Paris), finds that HFA is nearly twice more likely to target socially responsible firms than others. Firms with high corporate social responsibility (CSR) performance become targeted ones. For these firms, a CSR score two standard deviations above the industry average increases the likelihood of targeting from 3% to 5%. The findings also suggest that companies focusing on CSR but superficially addressing such issues are more prone to being targeted. A few interviews with the hedge fund managers led the researchers to conclude that the radical HFA often views the CSR initiatives as an unnecessary expenditure that kind of retards their aspiration to maximize short-term shareholder value. As a result, those companies branded 'wasteful' are the juiciest targets for radical activists whose business model involves repositioning the company to get short-term shareholder returns. Notably, socially responsible companies that effectively communicate their operational and financial strategies are relatively less likely to be targeted.

This study implies that while aggressive hedge funds can disrupt CSR practices, they also make companies more susceptible to being targeted due to their CSR activities. This insight is crucial given the heightened focus on activist hedge funds in recent years. According to Activist Insight, 839 companies were targeted by at least one activist hedge fund in 2019. JPMorgan Chase Bank (2015) posited that "since the global financial crisis, it can be argued that HFA has profoundly influenced companies' strategic and financial decisions."

In summary, while HFA can instigate positive changes for companies, it also poses risks and potential negative impacts by prioritizing short-term gains at the expense of fulfilling CSR commitments.

4. The impact of ideologically influenced HFA on multi-stakeholder interests

In today's global financial markets, companies face mounting pressure from investors to enhance their value propositions, with even high-performing companies not being exempt. Last year, for instance, London-based TCI Fund Management publicly called for Google to reduce its workforce and payroll expenses. This was followed by CEO Sundar Pichai announcing 12,000 layoffs two months later. Institutional investor activists (IIAs), predominantly hedge funds and mutual funds, often position themselves as guardians of shareholder value. They hold management and boards accountable for perceived devaluations or inefficiencies. By publicly criticizing companies and exercising their voting rights, IIAs exert substantial influence despite typically holding less than 10 percent of a company's shares. While HFA often improves a company's financial performance in the short term, it can negatively affect other stakeholders. Specifically, institutional HFA has been associated with increased workplace injuries and illnesses, a phenomenon that is exacerbated when both the activist and the corporate board lean towards illiberal political ideologies. The pursuit of profit by investors, therefore, may compromise employee health and safety. This study will explore this issue from three angles and offer recommendations for improvement.

4.1. HFA and employee health

This analysis begins by identifying IIAs from investor filings with the Securities and Exchange Commission (SEC). Data on workplace injuries and illnesses from the years 2002 to 2011 were then obtained from the Occupational Safety and Health Administration (OSHA).

Additionally, the study analyzes political campaign contributions made by fund managers and board members affiliated with IIAs, alongside other pertinent corporate data. By comparing businesses targeted by IIAs with those that were not, the research discovered that attacks by IIAs led to an 11.74% increase in the average rate of employee injuries and illnesses. For a business with 100 employees, this equates to an increase from an average of eight to nine cases annually. This impact is notably severe if the IIA is politically illiberal. The political orientation of the target firm's board also significantly influences the extent of the impact on employee health.

4.2. Conservative vs. liberal radicals

Previous research has predominantly focused on the financial ramifications of HFA, yet this study introduces ethical concerns about its escalating presence. The results indicate that activism aimed at enhancing corporate efficiency often increases employees' workloads and leads to more violations of safety and health regulations in the workplace. Evidently, the pursuit of profits by IIAs compromises employees' health. HFA is expanding beyond the US and Europe into Asia's capital markets. Although some institutional investors advocate for improved Environmental, Social, and Governance (ESG) performance, many IPAs appear to prioritize changes that bolster short-term financial outcomes. Our findings reveal that illiberal activists tend to reduce companies' ESG performance, highlighting that the effects of HFA on other stakeholders vary with the activists' political ideology. Additionally, activism may have unintended repercussions for companies; overworked and injured employees could become less satisfied, less productive, and more prone to leaving.

4.3. Prevention is better than cure

Preventing radicalization may prove to be less expensive and more effective than addressing its aftermath. Companies can adopt several strategies, such as regularly revising their business strategies and portfolios, managing stakeholder relations, engaging proactively with shareholders, and enhancing governance practices. Alongside these measures, this study suggests that companies should also consider the political ideologies of shareholders and board members. Awareness of how HFA impacts employee health could help prevent companies from implementing severe workforce reductions and increasing workloads. In the era of stakeholder capitalism, it is increasingly vital for companies to protect the interests of internal stakeholders alongside those of shareholders.

5. A Case Review in Contrasting Perspective and a Look at the Future of HFA

5.1. Case study in contrasting perspective

The offered case study provides a vivid account of the successes and failures of HFA. Herein, we present both successful and problematic instances of Hedge Fund Activism detailing the strategies being employed by the hedge funds and their effects on the targeted companies.

5.1.1. Success Case: Yahoo and Third Point LLC

In 2011, shares of Yahoo! began to be bought by Third Point LLC, which soon became one of the significant shareholders of the company. The hedge fund strongly criticized the management and the board of Yahoo! for their inefficiency and lack of strategic vision, advocating for substantial reforms. This followed a series of open letters, cooperation with other shareholders, and media campaigns that Third Point used to secure several board seats. Influenced by Third Point, Yahoo! undertook major changes, including replacing the CEO, restructuring the board, and divesting non-core assets. These actions resulted in a significant rise in Yahoo!'s stock prices and added value to the shareholders. This case exemplifies how HFA can effectively promote corporate governance improvements and strategic realignment.

5.1.2. Problematic Case: J.C. Penney and Pershing Square Capital (Pershing Square Capital Management)

Pershing Square Capital invested in U.S. retailer J.C. Penney in 2008 and, within a period of months, had taken board influence to record levels. A series of ambitious reforms was introduced by the hedge fund, including a new CEO, sales strategy, and rebranding. Despite their very best efforts, the transformations did not bring about better performance for J.C. Penney, rather they nose-dived its stock price. Pershing Square's aggressive approach was criticized for rushing and only superficially understanding the retail sector, as well as the specific challenges the company was facing. This culminated in a huge financial loss at exit. This case simply highlights the pitfalls HFA might encounter when thorough preparation and deep industry insight are lacking.

5.1.3. Strategy and impact assessment

In the Yahoo case, Third Point won through media influence, aggressive communication, and creating shareholder alliances in its favor over changes in corporate governance and strategic direction. The success of this strategy was based on strong communication lines evident between the hedge fund and the firm's management and shareholders, coupled with the clear vision of the company going forward. On the other hand, in the J.C. Penney case, the Pershing Square Capital strategy did not achieve the intended goals primarily because the features of the retail industry were misunderstood, and the reform measures were too radical. This failure really highlights the necessity for hedge funds to carry out due diligence on the industry background, company culture, and market conditions of the target company; to at the same time assess the feasibilities and long-term impacts of proposed reforms when engaging in activist investments.

These case studies clearly illustrate that HFA can indeed catalyze corporate governance reform, reaping an increase in shareholder value; however, it also involves risks and challenges that need to be factored into the implementation of an activist strategy.

6. The outlook of HFA

The future of HFA, therefore, is likely to remain influenced by a number of factors such as changes to the regulatory environment, adjustments in activist investor strategies, and of course, the evolution of the market landscape. Review of this material follows to assess the trends and likely impacts on future activism:

6.1. Regulatory changes

Inevitably, therefore, the global rise of HFA has come under more and more scrutiny from regulators, who may be considering tightening their grip on related activity through any number of regulatory measures. These could, for example, take the form of restrictions regarding hedge fund trading behaviors in the open market or mandates on hedge funds to disclose percentages of significant holdings. Besides, the potential market volatility and implications to corporate governance from activist actions may provoke regulators to introduce new rules, which will protect the interests of minority shareholders and enhance companies to grow in the long run. These represent huge potential game changers for HFA strategies and effectiveness.

6.2. Changes in activist investor strategies

Hedge fund activists may change their approaches depending on market circumstances and regulatory reform. For example, they might take a more cooperative attitude in dealing with the management of companies in devising common solutions, rather than taking on a confrontational attitude. It should also be able to move its focus to the long-term value it creates, rather than just short-term share price enhancements. Further, with the advance in data analytics and artificial intelligence, it is more likely that the hedge fund activists may take advantage of these technologies to more accurately find target companies and influence strategies.

6.3. Impact on corporate governance

This trend is expected to continue in light of HFA's increasing impact on corporate governance. The focus of activists has been on corporate governance and strategic direction, so an increase in communication and transparency by companies with their shareholders is likely. This might further optimize the corporate governance structure and enhance the protection of shareholders' interests. In this sense, HFA might also be a key driver in stimulating improvements in corporate performance regarding ESG issues, considering that these issues are increasingly recognized as crucial for corporations to survive over the long term.

6.4. Potential impact on the corporate landscape

HFA is poised to maintain a significant influence on the corporate landscape. As activists continue to scrutinize companies, we may witness an increase in corporate restructuring, mergers, and acquisitions. Such activities could alter the competitive dynamics within industries and lead to the emergence of new market leaders. Additionally, HFA might drive firms to enhance innovation and efficiency to adapt to evolving market demands and competitive pressures.

In summary, the future of HFA will be shaped by a combination of factors, including changes in the regulatory environment, adjustments in investor strategies, and the evolution of the market environment. HFA is likely to continue to influencing the enhancement of corporate governance efficiency, contributing to the growth of shareholder value, and driving the realignment of corporate strategies. However, attention must also be given to the potential risks and challenges it poses.

7. Summary

This study examines the mechanisms, benefits, risks, and future trends of HFA, specifically analyzing its impact on corporate governance and shareholder value through detailed case studies. The complexity and dual nature of HFA as an influential investment strategy necessitate careful consideration by firms, shareholders, and regulators of its advantages and disadvantages. While HFA significantly benefits companies by enhancing corporate governance structures, promoting shareholder value, and facilitating strategic reorganizations, it may also lead firms to prioritize short-term performance excessively, increase market volatility, and impose additional costs and distractions on target firms. The case studies illustrate that the success of HFA heavily relies on the strategic decisions of the activist investors and their profound understanding of the target company.

Given the impact of HFA, future research and action areas should include, but are not limited to:

- (1). Improvement of the regulatory framework: Investigating how to balance the positive and negative impacts of HFA through regulatory policies that protect minority shareholders' interests without restricting the beneficial role of hedge funds in enhancing corporate governance efficiency.
- (2). Long-term value creation: Exploring how HFA can more effectively promote long-term corporate development and innovation, beyond merely boosting short-term share prices.
- (3). Adaptation of Activism Strategies: Examining how hedge funds can adjust their activism strategies to evolving market conditions and regulatory landscapes to ensure effective communication and cooperation with company management.
- (4). Integration of ESG Factors: Considering how ESG factors can be incorporated into a hedge fund's activist decision-making framework to enhance performance in these areas.

In conclusion, as a significant market phenomenon, HFA has extensive implications for corporate governance and shareholder value. Firms, shareholders, and regulators need to deepen their understanding of HFA, carefully evaluate its potential benefits and risks, and implement suitable strategies to maximize its positive effects while mitigating potential adverse outcomes. Future research should persist in scrutinizing the trend of HFA and exploring how this strategy can be optimally leveraged to advance corporate governance and shareholder value.

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