

The Returns to Hedge Fund Activism

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This article is an augmented version of “Hedge Fund Activism, Corporate Governance, and Firm Performance,” forthcoming in the *Journal of Finance*. We have added additional analysis on hedge fund performance and present some results that are not contained in our earlier work.

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Abstract

Hedge fund activism is a new form of arbitrage. Using a large hand-collected data set from 2001 to 2006 we find that activist hedge funds in the U.S. propose strategic, operational, and financial remedies and attain success or partial success in two-thirds of the cases. The abnormal stock return upon announcement of activism is approximately seven percent, with no reversal during the subsequent year. Target firms experience increases in payout, operating performance, and higher CEO turnover after activism. We also find large positive abnormal return to the self-reported hedge fund activists during our sample period. The abnormal return significantly exceeds the returns to all hedge funds, the returns to equity-oriented hedge funds and is robust to alternative risk adjustments and selection biases.

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The Returns to Hedge Fund Activism

Alon Brav, Wei Jiang, Frank Partnoy, and Randall Thomas¹

Hedge fund activism is a new form of arbitrage. Using a large hand-collected data set from 2001 to 2006 we find that activist hedge funds in the U.S. propose strategic, operational, and financial remedies and attain success or partial success in two-thirds of the cases. The abnormal stock return upon announcement of activism is approximately seven percent, with no reversal during the subsequent year. Target firms experience increases in payout, operating performance, and higher CEO turnover after activism. We also find large positive abnormal return to the self-reported hedge fund activists during our sample period. The abnormal return significantly exceeds the returns to all hedge funds, the returns to equity-oriented hedge funds and is robust to alternative risk adjustments and selection biases.

In this paper, we analyze the most extensive and thoroughly documented dataset of hedge fund activism to date, extending from the beginning of 2001 through the end of 2006. We find that hedge funds increasingly engage in a new form of shareholder activism and monitoring that differs fundamentally from previous activist efforts by other institutional investors. In particular, we find that hedge fund activism is a new form of arbitrage that generates large positive abnormal returns for both shareholders in the target companies and those in the activist hedge funds. This strong performance is robust against a range of asset pricing models including controls for size, book to market, and momentum effects.

When we compare the returns to self-reported activist hedge funds with those to the S&P 500 index, we find that our activism index tracks the S&P 500 index very closely through mid-2000, but then departs significantly upward. Moreover, since 2003, activist funds have outperformed not only the S&P, but also equity-oriented hedge funds.

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Author Note: This article is an augmented version of “Hedge Fund Activism, Corporate Governance, and Firm Performance,” forthcoming in the *Journal of Finance*. We have added additional analysis on hedge fund performance and present some results that are not contained in our earlier work.

Some, but not all, of the positive returns are from the market's favorable reaction to the announcement of activism, which is consistent with the view that activism creates value. The filing of a Schedule 13D revealing an activist fund's investment in a target firm results in large positive average abnormal returns, in the range of 7 percent to 8 percent, during the (-20,+20) announcement window. The increase in both price and abnormal trading volume of target shares begins about 10 days prior to the 13D's filing. We find that these positive returns at announcement are not reversed over time. Activism that targets the sale of the company or changes in business strategy, such as refocusing and spinning-off noncore assets, is associated with the largest positive abnormal partial effects.

We examine hedge fund strategies in detail in order to analyze the factors that contribute to the large returns. Hedge fund activists tend to target companies that resemble "value" firms, with low market value relative to book value, although they are profitable with sound operating cash flows and return on assets. Payout at these companies before intervention is lower than that of matched firms. Target companies also have more takeover defenses and pay their CEOs considerably more than comparable companies. Relatively few targeted companies are large-cap firms. Targets exhibit significantly higher institutional ownership and trading liquidity. These characteristics make it easier for activists to acquire a significant stake quickly.

Finally, we find that hedge fund activists are not short-term in focus, as some critics have claimed. Their median holding period for completed deals is about one year, calculated as from the date a hedge fund files a Schedule 13D to the date when the fund no longer holds a significant stake (5 percent) in a target company. Analysis of portfolio turnover rates of the funds in our sample suggests holding periods of closer to 20 months.

The paper proceeds as follows. Section I provides the institutional background, a brief review of the literature on shareholder activism, and the key characteristics of the sample. Section II looks at the stock market's reaction to hedge fund activism and target firm average return subsequent to announced activism. Section III analyzes the profitability of activism by measuring fund abnormal return. We present our conclusions in Section IV.

I. Hedge Funds and Shareholder Activism

What is a hedge fund? Although there is no generally agreed-upon definition of a hedge fund, hedge funds usually are identified by four characteristics: (1) they are pooled, privately organized investment vehicles; (2) they are administered by professional investment managers with performance-based compensation and significant investments in the fund; (3) they are not widely available to the public; and (4) they operate outside of securities regulation and registration requirements.² Most crucially, hedge funds avoid much regulation, including the Investment Company Act of 1940, by having a relatively small number of sophisticated investors.

Hedge fund activists have four important advantages over other types of engaged, monitoring investors. First, unlike other institutional investors, hedge fund managers have sharper incentives to generate positive returns than their counterparts at other institutions.³ A typical hedge fund charges its investors a fixed annual fee of two percent of its assets plus a twenty percent performance fee based on the fund's annual return. Second, hedge funds may hold undiversified portfolios consisting of large block holdings in individual companies and may use leverage and derivatives, strategies that are prohibited for many institutional investors. Third, hedge funds may require that investors agree to "lock-up" their funds for period of two years or longer, whereas mutual funds are required by law to sell securities within one day of an investor redemption request. Finally, hedge fund managers are unregulated and typically suffer fewer conflicts of interest than managers at other institutions. Each of these factors gives hedge fund managers more freedom to engage in activism than other categories of investors.

The lack of a central database of activist hedge funds has hindered research on hedge fund shareholder activism. Private hedge fund databases include primarily non-activist funds, and exclude some activist funds. As a result we were forced to create our own database.

² A Securities and Exchange Commission roundtable discussion on hedge funds considered fourteen different definitions. See SEC Roundtable on Hedge Funds (2003), <http://www.connective.com/events/sechedgefunds/>. Partnoy and Thomas (2007) describe the distinguishing characteristics of hedge funds in greater detail.

³ Although private equity and venture capital funds also have powerful incentives to generate positive returns, those funds are distinguished from hedge funds because of their focus on particular private capital markets. Private equity investors typically target private firms or going private transactions, and acquire larger percentage ownership stakes than hedge fund activists. Venture capital investors typically target private firms exclusively, with a view to selling the company, merging, or going public, and therefore they invest at much earlier stages than both private equity and activist hedge funds. There is overlap among private equity, venture capital, and hedge funds, and some funds pursue multiple strategies.

Fortunately, we were able to take advantage of two securities law requirements that apply to hedge funds which require them to publicly disclose their holdings in their portfolio firms. First, Section 13(d) of the Securities Exchange Act of 1934 requires that any investor, including a hedge fund, must file a Schedule 13D with the SEC within ten days of acquiring more than five percent of any class of securities of a publicly traded company if they have an interest in influencing the management of the company.⁴ Second, Section 13(f) of the Securities Exchange Act of 1934 provides that institutional investors who manage more than \$100 million must file a Form 13F each calendar quarter setting forth the number of shares they hold in exchange-traded companies. Hedge fund activists with significant assets under management must make quarterly Form 13F filings to report their holdings.

To construct a comprehensive, independent sample of hedge fund activism based on these securities filings, we first purchased a list of all 11,602 Schedule 13D filers during the period 2001-2006 from LiveEdgar. We culled hedge funds from that list by inspecting the names and descriptions of the filers as reported on these filings, searching the internet, and then telephoning remaining filers we were unable to categorize initially. We excluded filers who made only one Schedule 13D filing during the sample period and did not indicate an explicit purpose, and we also excluded events focused on bankruptcy, risk arbitrage, and closed-end funds.⁵

Given the amount of capital required to acquire a 5 percent stake in a large-cap company, the Schedule 13D-based search could bias the sample toward smaller targets. At very large firms, some hedge funds have engaged in activism with less than a 5 percent stake in the target company. We therefore used the Thomson Financial Form 13F database to add events involving companies with market value of greater than \$1 billion (roughly the median market capitalization of NYSE listed firms during the relevant times), and with ownership by a hedge fund in our sample of greater than two percent.

Our final sample consists of 236 hedge funds we had identified, and their 1,059 events involving 882 target companies. For each event we gathered information about the filing date,

⁴ In particular, Item 4 of Schedule 13D requires the filer to declare its reasons for acquiring the shares, particularly if the intention is to engage in merger and acquisition activity, seek a sale of any material amount of the issuer's assets, pursue a change in its capitalization or dividend policy, or propose other types of corporate changes.

⁵ This study was focused on hedge fund activism in regular corporations. See Bradley, Brav, Goldstein, and Jiang (2007) for an exclusive study on shareholder activism in closed-end funds.

ownership, purchase cost, and purpose from the Schedule 13D filings of the fund. We supplemented this data with extensive news searches in Factiva using the hedge fund and target company names as key words. From the news articles, we gathered information that was frequently not available in the securities filings, such as the hedge fund's motive, the target's response, and the development and resolution of the events. At various stages during this process, we have also shown our list of hedge funds to participants in the hedge fund industry and obtained comments and suggestions for additions or deletions. We also used additional SEC filings, such as the Schedule 14A, when they were available to obtain further information on some of the interventions.

A. Objectives of Hedge Fund Activism

Table I summarizes the stated objectives that the activist funds provide when they announce activism in their target firms as well as the associated success (and partial success) rates. Hedge fund activists' professed motives can be classified into five major categories, each containing multiple subcategories. With the exception of the first category, where the hedge fund makes only the general statement that it seeks to maximize shareholder wealth, the objectives are not mutually exclusive as one activist event can target multiple issues. We classify an event as successful if the hedge fund achieves its main stated goal, or as a partial success if the hedge fund and the company reach some settlement through negotiation that partially meets the fund's original goal.

[Insert Table 1 here]

The last four overlapping categories in Table 1 describe four specific objectives: changes to firm capital structure; altering firm business strategy; seeking a sale of the target company; and making improvements to firm corporate governance. The first grouping includes activists pursuing objectives related to payout policy and capital structure. In 12.7 percent of all events, they seek to reduce the target's excess cash, increase leverage, or increase dividends and share repurchases. In an additional 6.1 percent of events, activist hedge funds pursue debt restructuring or recapitalization, or try to stop or reduce new equity offerings.

Category two covers activists seeking changes in business strategy, which we break out into five subcategories. The first of these subgroups covers operational efficiencies, such as cost cutting, which is present in 12.4 percent of events, and goes on to report on activism seeking restructuring and spinoffs in another 9.1 percent of events. Roughly ten percent of the sample involves activists targeting merger decisions, by both acquirers and targets. These events differ from risk arbitrage in that the activist intervenes to press for better terms or to try to stop a deal. Finally, subgroup number five illustrates that in a small number of events, activists make proposals to improve the firm's growth strategy.

The third very important group relates to activists pursuing the sale of the target company. Most of these cases, 14.0 percent of the sample, involve efforts to sell the company or its assets to a third party. A smaller number (4.2 percent) involve a buyout or going private transaction where the activist is the potential acquirer.

The last and biggest category covers events where the activist targets one or more of a range of governance objectives. The most common focus is on the board independence, where hedge funds seek to install more independent directors, or better investor representation, at targeted firms. This happens in 15.0 percent of all cases in the sample. Other less common corporate governance goals include rescission of takeover defenses, improved disclosure, and improved compensation policies, each of which is found in about 5 percent of the events. Finally, hedge fund activists state that they are seeking to oust the targeted firm's CEO or chairman in 5.6 percent of all events.

Overall, hedge fund activism achieves full or partial success in roughly two-thirds of events. Activists achieve their major stated goals in 40.6 percent of cases, and obtain partial success 25.8 percent of the time. Although not shown in the table, overall success rates in non-hostile cases are roughly comparable to those in hostile cases, although complete success is more likely and partial success is less likely in non-hostile situations. These results suggest that a negotiated compromise is the likely outcome in hostile cases.

B. Targets of Hedge Fund Activism

Turning next to the characteristics of the firms targeted by hedge fund activists, Table 2 shows that hedge fund activists resemble “value investors.” The first three columns of Table 2 provide descriptive statistics for selected characteristics of firms targeted by activist hedge funds, while the remaining three columns show the differences between targeted firms and a set of industry/size/book-to-market matched firms for each of these variables. The targets of activism were firms with lower market value relative to book value, better ROA, lower payouts to shareholders, and more takeover defenses, than comparable non-targeted firms. These firms had greater institutional investor ownership and more analyst coverage, indicating that their shares tend to be in more sophisticated hands and trade in more liquid markets than comparable non-targeted firms. Target firms were profitable with sound operating cash flows and returns, and tended to have low levels of R&D spending plus a higher degree of diversification than non-targeted firms.

[Insert Table 2 here]

Overall, the potential problems that hedge funds identify at targeted firms are more often issues that are generalizable to all firms, such as changes in governance and payout policies, rather than issues that are specific to one or a small number of target firms, such as slipping sales of a particular product. Targeted firms do not seem to suffer from serious operational difficulties.⁶ They are actually profitable and enjoy handsome cash flows. The potential problems that these companies face are likely related to the agency problem of free cash flows, such as relatively low dividend yield and diversifying investments that might not be in the best interest of shareholders. Governance issues, including rescinding takeover defenses, ousting CEOs, promoting board independence, and curtailing executive compensation, are also commonly cited as reasons for activism.

These characteristics are important to the results presented here, because they suggest that hedge fund activists are implementing general strategies at well understood firms that market participants are likely to appreciate. Focusing on issues that are generalizable to other

⁶ We exclude from our sample firms where the hedge funds are engaging in distress-related activism.

potential target firms also helps hedge funds lower the marginal cost of launching activism at a new company (Black (1990)). Hedge funds generally avoid “opaque” and complicated businesses, such as those with high levels of R&D, to avoid delays in the resolution in the market price of the intervention’s impact. This is consistent with the predictions of Kahn and Winton (1998) that investor intervention is most likely at firms where improvements will rapidly be reflected in the share price.

Hedge fund activists almost never acquire control blocks. Instead, the overwhelming majority of our events involved purchase of between 5-10 percent of target shares. For the entire sample, the median initial stakes of activists are roughly 6 percent of target firm equity securities, costing about \$12 million dollars, in constant 2006 terms. Although some investors prefer to keep their ownership stakes below the 5 percent trigger for Schedule 13D filings (these events are included in our sample if are mentioned in news articles), hedge fund activists generally seek to exceed that level of ownership, in part because Schedule 13D filings frequently generate media interest and publicity, but also because the act of filing, and the potential legal liability associated with any disclosures made in a Schedule 13D, reinforce an activist hedge fund’s credibility with investors. Conversely, hedge fund activists generally prefer not to acquire stakes of 10 percent or more, because 10 percent ownership triggers the short swing profit provisions in section 16 of the 1934 Exchange Act as well as presenting other issues.

Finally, median hedge fund activist holding periods are in the range of one year or more. Focusing on the subsample of the completed events where the fund is reported to have significantly reduced its ownership level below the five percent level of ownership, we find that the median duration from the first Schedule 13D filing to “exit” is 369 days. The 25th and 75th percentile figures for the full sample are 169 days and 647 days. This, however, excludes 47.6 percent of the sample for which we are unable to find exit information because of the recent nature of the investments. Focusing solely on the events in which hedge funds have exited grossly underestimates the unconditional duration of hedge funds’ investment in the target companies. However, even this one-year investment horizon is longer than the short-term trading periods claimed by early critics of hedge fund activism. We do an additional analysis using the Form 13F quarterly filings of holdings and find that the median annualized equity long position turnover rate is 55 percent for our sample hedge funds, implying an average holding period of 22 months.

II. Short- and Long-Run Market Reactions to Hedge Fund Activism

A crucial question about hedge fund activism is whether it achieves its stated goal of creating value for shareholders. In this section, we examine stock market returns, both short-term announcement event-day returns and the long-run returns. Our analysis addresses the question of how the market perceives the effect of hedge fund activism on shareholder value and whether the long-run measures are consistent with the market's perception.

A. Short-Run Market Reactions

Figure 1 plots the average abnormal buy-and-hold return during the (-20, 20) window surrounding the activist hedge funds' Schedule 13D filings.⁷ The average abnormal return is 7.2 percent. Sixty-two percent of the events have a positive abnormal return in the (-20, 20) window.

[Insert Figure 1 here]

About half of the total abnormal return, approximately 3.5 percent, is achieved during the ten days prior to filing, which means it takes place before public disclosure of the activist's five percent investment stake, or the public announcement of an activist campaign (for events with less than the five-percent stake). Likewise, abnormal share turnover also is high during this pre-disclosure period. The abnormal return on the filing day and day after filing is another approximately 2.0 percent. Thereafter, the abnormal return increases steadily to a total of 7.2 percent by twenty days after the filing date. On average, information related to hedge fund activism appears to begin to be reflected in share prices and trading volumes before the Schedule 13D filing date.

Some hedge funds file a Schedule 13D after publicly announcing their activist intentions while they hold fewer shares, while other funds do not begin engaging in activism until after they have filed a Schedule 13D. To test whether the Schedule 13D filing date is an accurate proxy for the date when activism first becomes publicly known, we separately examined a subsample of 246 events in which the Schedule 13D disclosed new information not previously available. The

⁷ The abnormal return is the return in excess of the buy-and-hold return on the value weighted NYSE/AMEX/NASDAQ index from CRSP, from 20 days prior to the Schedule 13D filing date to 20 days afterwards the filing date.

returns of this sample were similar to those depicted in Figure 1, with a slightly higher abnormal return of 8.4 percent.

The early stock price increases are consistent with the timing of purchases by hedge fund activists who buy during the ten-day window before the filing date, because investors are not required to file Schedule 13Ds until ten days after the transaction that causes them to breach the five percent ownership threshold. However, some critics of hedge fund activism have suggested that the pattern of early abnormal returns, before the filing date, stems from “tipping,” in which the hedge fund activist tells a small numbers of investors about its plans before the filing date, or “wolf pack” investing, in which several hedge funds, which do not formally coordinate, learn about the lead hedge fund’s activities before its 13D is filed and buy into the target firm early. Hedge fund activists deny engaging in these activities, and our data and analysis does not permit us to test either theory.⁸

These short-term abnormal returns necessarily underestimate the value of ex post success by hedge fund activists. If share prices increased by the full expected benefit of activism, hedge fund activists would have no incentive to continue to hold their stakes and expend resources on activist strategies. Instead, they would simply sell. Yet hedge fund activists indeed continue to hold and engage in activism. Accordingly, the initial abnormal return reflects the “partial” expected value of activism based on investors’ estimate of the probability that the hedge fund will implement its activist plans. Later, as the hedge fund activist achieves (or fails to achieve) its goals, the target share price will increase (or decrease) accordingly.

B. Longer-Term (One Year) Market Reactions

We next examine whether the short run price reaction is permanent as it is possible that the (-20, 20) abnormal returns are a manifestation of a temporary spike in prices, caused by buying pressure. We do so by running calendar-time portfolio regressions around the Schedule 13D filing date. If the longer-term market reaction is positive and permanent, it is unlikely that the short-term price impact was merely the result of buying pressure from the filing hedge fund or other hedge funds. In other words, if the announcement abnormal returns were due to trading

⁸ The hedge fund managers that we have spoken with point out that to do so would drive up their costs of accumulating their stake prior to announcing their activism.

friction, those returns should be reversed during longer windows. Yet, as we show below, they are not.

Table 3 sets forth the results of our calendar-time portfolio regressions. We form portfolios that buy shares of all firms that will be targeted by a hedge fund in the indicated period and then hold those shares throughout the specified window. For example, we form a (-3, -1) portfolio by buying all firms that will be targeted by a hedge fund in three months' time, and the firms are held for three months before selling. Similarly, we form a (1, 3) portfolio by buying all firms that were targeted by hedge funds one month earlier, and these firms are held for three months before selling. For each such portfolio we estimate a regression of the portfolio excess returns on the Fama-French RMRF, SMB, and HML factors and the momentum factor, MOM.⁹ Panels A and B of Table 3 set forth the results based on four-factor models with equal and value-weighting of firms' returns. We focus on the regression intercept, the alpha, as evidence for possible mean reversion in prices. Portfolios formed during pre-event windows are not implementable strategies, and are presented for purposes of comparing to the post-event stock return patterns.

[Insert Table 3 here]

The equal-weight model in Panel A shows a statistically significant event month alpha of 5.10 percent. The following (1, 3) month window alpha of 1.09 percent is also significant. The alphas are positive and revert to near zero during the nine months after filing. The pre-event alphas are negative, but not statistically significant. The 13D-filing month alpha for the value-weight model in Panel B is lower and not statistically significant, whereas the pre-event alphas are negative and significant. These results suggest that larger firms receive a less favorable response than smaller targets. The value weighted alphas revert to near zero during the year after filing.

Overall, the calendar time regressions suggest that the short-term abnormal returns are not market overreactions. Instead, the price that incorporates the event-window abnormal returns

⁹ We include the Fama and French RMRF, SMB, and HML factors and the momentum factor, MOM. We obtain these factor returns and monthly risk-free rates from Ken French's web site at Dartmouth College.

is sustained during longer periods of time. The positive market reaction is also consistent with ex post evidence of overall improved performance at target firms. This is supported by Brav, Jiang, Partnoy and Thomas (2008) findings of ex post real long term improvement in return on assets and operating profit margins at target firms two years after intervention, as well as total payout increases and book value leverage increases on average, from the year before to the year after an announcement.

III. Aggregate Returns to Hedge Fund Activists

In addition to examining market reactions to activism, we also consider the returns activists earn. Given that activist funds bear most of the cost of intervention but only receive a small proportion of the direct gain (the typical holdings of these funds in the target companies are 5-10 percent), it is natural to ask whether such activities are also profitable to the activist funds (and, as a result, to the investors in these hedge funds). If one views activist investing as a new form of arbitrage, this question is interesting for at least two reasons: First, profitability by activist hedge funds is a necessary condition for their survival and long-term viability. Like any other arbitrage strategy, profitability tends to decrease with competition, as the number of hedge funds engaging in activism has been increasing steadily over the past few years. A finding of equilibrium level of profitability ensures that hedge fund activism will remain a staple of corporate governance in the foreseeable future.

Second, if markets are efficient, abnormal returns to an investment strategy should persist only when activists have private information. In the conventional setting, superior information is about the value of the firm that is assumed to be out of the control of the investors (and unknown to the market). In the context of activist investing, the value of the firm could be potentially affected by the activist's action. As a result, the player's superior information about his own intention to intervene becomes valuable. Such information, in contrast to the conventional informed trading, is not proprietary about the firm. Though there is some recent theoretical work analyzing the intervention-related informed trading (Cornelli and Li (2002), Bond and Eraslan (2007)), there is little empirical evidence on the sources of superior returns in this setting.

A. The Alpha Generated by Activism

We explore two sources of data to analyze the returns to our sample of activist hedge funds. We begin by merging two major hedge fund databases. The first is the CISDM, a hedge fund database (covering 8,589 funds) maintained by the University of Massachusetts and available through WRDS to accredited universities. The second is purchased from HedgeFund.net, owned by Channel Capital Group Inc., which is a leading source for hedge fund news and performance data. This database covers 11,530 funds, which is among the largest of all hedge fund data vendors. At the moment this paper is written, the CISDM data has been updated through the end of 2005 and the HedgeFund.net has been updated to June 2007. In order to maximize data coverage, we first match our sample hedge funds to HedgeFund.net. For all remaining unmatched funds after this first round, we then match to CISDM. Altogether we are able to match 103 unique funds that have at least 12 months of return data, 95 of which are covered by the HedgeFund.net. We retrieve hedge fund returns from January 1995 (or the earliest available date) through June 2007 (or the latest reporting date). Both databases keep a separate file for funds that stopped reporting (including defunct funds and funds that voluntarily stop reporting). The reported portion of these funds is included in our sample whenever possible.

To analyze the performance of activist hedge funds, we measure their CAPM and four-factor alphas using both all-sample factor loadings and 36-month rolling window factor loadings. Specifically, the first method uses the full-sample return data of a fund to estimate the loadings on the factors and the intercept (alpha). The second method allows time-varying factor loadings on the factors by the hedge funds. For each month we compute the residuals of a fund's monthly returns net of the risk-free rate and returns attributed to the factors, where the estimates of the loadings on the factors are obtained from the previous 36 months of data (or as many months as possible, subject to having at least 12 months of data). The resulting time-series average of this residual is interpreted as the alpha of the fund.

Since our performance measures condition on coverage by the data providers, we seek to benchmark activist performance against that of other self-reported, non-activist, hedge funds. We therefore repeat the measurement of fund alphas for two additional hedge fund samples: the first includes all hedge funds covered by HedgeFund.net; and the second includes all equity-oriented

hedge funds in HedgeFund.net.¹⁰ The latter group includes the following three categories of hedge funds: Equity long-only; equity long-short; and equity market neutral. About 70 percent of our sample activist hedge funds fall into these categories. Other categories that include some of our sample funds include “Event driven”, “Special situation,” etc. To allow flexibility, we keep the comparison with all hedge funds.

Table 4 Panels A to C show the alphas at the 5th, 25th, 50th (median), 75th, and 95th percentiles of activist hedge funds, all hedge funds and all equity-oriented hedge funds covered by HedgeFund.net. Examining the data, activist hedge funds on average perform better than the full sample of self-reported hedge funds (and the subset of equity-oriented hedge funds) by both the one-factor and four-factor alpha measures. The results are qualitatively similar whether we use all-sample factor loadings, or 36-month rolling window factor loadings. Specifically, the average (median) of one- and four-factor monthly alpha of the sample activist hedge funds is 0.82 percent (0.71 percent) and 0.70 percent (0.56 percent), as compared to 0.49 percent (0.37 percent) and 0.39 percent (0.28 percent). The average loadings on the market, size, value, and momentum factors are 0.33 (t-statistic = 8.71), 0.27 (t-statistic = 6.86), 0.17 (t-statistic = 3.74), and 0.04 (t-statistic = 1.38), respectively, indicating that most activist hedge funds over-weight small and value firms, but are not momentum players. Further, the relatively low loading on the market factor indicates that activists probably hold positions beyond purely long-positions in common stocks. The size and value tilt is consistent with the characteristics of the target companies described in Section II. We also conduct the seven-factor analysis as proposed by Fung and Hsieh (2004), and find that our sample funds have virtually zero loadings on the non-equity factors.

[Insert Table 4 here.]

Aggregating the returns of all activist funds into an “activism index” provides a simple overview of the time series of these funds’ returns. Figure 2 displays the equal-weighted activist

¹⁰ We compare our sample hedge funds to the HedgeFund.net, rather than the CISDM database, because the great majority of our sample funds are matched to HedgeFund.net. Further, HedgeFund.net also covers more hedge funds, and is updated to more recent period, than CISDM. However, the summary statistics from the two databases are very similar. Our conclusion does not change if we use CISDM for comparison.

funds monthly return index from January 1995 to June 2007.¹¹ The activism index tracks the S&P 500 index very closely up to mid-2000 (during which period open activist activities were much less common), and then departs significantly from the S&P afterwards. During the whole period, activist funds that reported to the two hedge fund databases significantly outperformed the S&P, and have also outperformed the average equity-oriented hedge funds in the databases since 2003.

[Insert Figure 2 here.]

B. Testing For Selection Bias

Return analyses based on self-reported hedge fund databases are often subject to criticism for potential selection bias issues, the most serious bias being the correlation between the propensity to report (to a hedge fund data vendor) and return performance (Baquero, ter Horst and Verbeek (2005)). To date there is no general agreement on the direction of the bias, or the sign of the correlation. To the extent that the self-reporting bias is no more favorable to activist hedge funds than to other equity hedge funds, Figure 2 and Table 4 indicate that activist hedge funds are among the better performers relative to the sample of self-reporting hedge funds.

We attempt to address the self-reporting issue using two additional data sources. First, as noted above, the market response to announced activism is an informative indicator for the perceived success of the activist fund. In a rational market, the abnormal return during the announcement window should be an unbiased estimate for the value creation brought about by the hedge fund (adjusted for the probability that the hedge fund will carry out the stated agenda and succeed). Among our 229 sample funds, the 103 reporting funds see a 3.90 percent average announcement window abnormal return, while the announcement return for the 126 non-reporting funds is 6.81 percent.¹² The difference is not statistically significant at the 5 percent level due to a high standard deviation of abnormal returns. However, there is no evidence that

¹¹ In unreported results we find that larger funds perform better than small funds, and therefore equal-weighting fund returns is conservative.

¹² Note that the abnormal return averaged at the fund level is lower than the returns averaged at the event level. This is because funds that are involved in more events generate higher announcement window returns.

reporting funds are disproportionately successful funds in terms of generating favorable market reactions upon intervention.

Second, the Thomson Financial 13F filings provide quarterly long equity positions of 147 of our sample funds. We construct the returns from the equity long-only position of our sample funds by assuming that they hold the most recently disclosed positions. This strategy is meant to capture the returns to the insider information possessed by the activist funds, and is not implementable for outside investors given the time lag between the quarter end and filing date (45 days). Table 5 (first column) shows that our sample funds on average outperform by 0.6 percent to 0.9 percent per month (significantly different from zero at the 1 percent level), a sizable premium given the lack of abnormal performance of 13F holding returns for hedge funds (see Griffin and Xu, (2007)). This is consistent with the previous evidence from the returns of self-reporting hedge funds that activist hedge funds are among the better performers.

[Insert Table 5 here.]

Interestingly, a tradable “copy cat” strategy that holds the most recent publicly available hedge funds’ 13F holdings yields positive but less impressive alphas. Given that institutions have 45 days after the quarter end to file their 13F forms, we define the most recent publicly available filings as the one with a filing date of at least two month earlier. The copy-cat strategy based on our sample funds would deliver average one- and four-factor alphas in the range of 0.3 percent to 0.6 percent (see the second column of Table 5). The difference between the returns of the copy-cat strategy and the hedge funds’ long positions indicates that some of the superior returns can be attributed to non-public information, and this advantage dissipates as the information is disseminated through the 13F filings.

Among the 147 13F-filing funds, 64 also report to at least one of the two hedge fund databases mentioned earlier. We find that reporting funds on average have somewhat lower returns: their average return in excess of the market is 0.70 percent lower (t-stat = -1.91), their one-factor alpha is 0.63 percent lower (t-stat = -1.78), and their four-factor alpha is 0.73 percent lower (t-stat = -1.40). Again, the differences between the two groups of funds (self-reporting

ones and non-reporting ones) are not statistically significant. What we can conclude, however, is that the more successful funds (in terms of returns from the long positions in common stocks) are *no more* likely to report to hedge fund databases.

Finally, we analyze the cross-sectional variations in the returns of activist hedge funds, and results are reported in Table 6. The dependent variables are four- and one-factor alphas, as well as the average announcement window excess returns (the average of which is plotted in Figure 1). All variables are constructed at the fund level. The first two variables are highly correlated (with a correlation coefficient of 0.86), and are weakly positively correlated with the third (about 0.06). There are two sets of independent variables: those capturing the style of launching activism, and those describing the characteristics of the funds. Variables in the first group include: the number of companies that the fund targeted during the 2001-2006 period (in logarithm); the proportion of events launched by the fund that are hostile; and the proportion of events launched by the fund that aim at the sales of the target companies. The last two variables are included because we find that that hostile tactics and sales-motivated activism are particularly well-received by the market. Fund characteristics variables include fund age (in number of years as of 2006); average assets under management (in logarithm); management fees (in percentage points); incentive fees (in percentage points); minimum investment (in logarithm); and the adoption of a high watermark.

[Insert Table 6 here.]

Table 6 indicates that fund performance is very difficult to predict from observed characteristics. Most of the independent variables are insignificant except that high-fee firms tend to deliver better performance (after fees). Such a pattern is predicted in theoretical work (Berk and Green (2004)) and confirmed by empirical evidence (Liang (2001)).

IV. Conclusions

This paper examines hedge fund activism using a large-scale sample over the time period 2001 through 2006. We document the heterogeneity in hedge fund objectives and identify common features of targeted firms. We find positive market reactions to announced hedge fund intervention. Moreover, although critics of hedge fund activism have argued that activists are overly short-term in focus, the median holding period of hedge fund activists has been in the range of one-year.

When we compare the returns to hedge fund activism with those to the S&P 500 index, we find our activism index tracks the S&P 500 index very closely up to mid-2000, and then departs significantly upward from the S&P afterwards. Overall, activist funds generate a large abnormal return, once we control for standard risk factors. Activist funds outperformed the S&P, and have also outperformed the average equity-oriented hedge funds in the databases since 2003.

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Table 1. Summary of Hedge Fund Activism: 2001-2006

	(1)	(2)	(3)	(4)	(5)
Objective categories:	All Events				Num. of Hostile Events
	Num. of Events	% of Sample	% Success	% Partial Success	
1. General undervaluation/maximize shareholder value	511	48.3%	--	--	--
2. Capital Structure					
-- Excess Cash, under-leverage, dividends/repurchases	134	12.7%	32.0%	32.0%	65
-- Equity issuance, restructure debt, recapitalization	65	6.1%	37.3%	35.6%	38
3. Business Strategy					
-- Operational efficiency	131	12.4%	35.6%	27.6%	63
-- Lack of focus, business restructuring and spinning off	96	9.1%	27.8%	38.9%	62
-- M&A: as target (against the deal/for better terms)	79	7.5%	36.7%	19.0%	42
-- M&A: as acquirer (against the deal/for better terms)	25	2.4%	20.0%	52.0%	22
-- Pursue growth strategies	12	1.1%	44.4%	0.0%	0
4. Sale of Target Company					
-- Sell company or main assets to a third party	148	14.0%	37.0%	26.7%	93
-- Take control/Buyout company and/or take it private	44	4.2%	43.2%	25.0%	34
5. Governance					
-- Rescind takeover defenses	60	5.7%	21.7%	43.3%	43
-- Oust CEO, chairman	59	5.6%	39.7%	29.3%	59
-- Board independence and fair representation	159	15.0%	34.4%	35.7%	114
-- More information disclosure/potential fraud	58	5.5%	42.1%	26.3%	42
-- Excess executive compensation/pay for performance	50	4.7%	20.4%	44.9%	38
Sum of categories (2) through (5):	548	51.7%	40.6%	25.8%	286

Notes: The sample includes 1,059 events, sorted by hedge funds' stated objective. Columns (1) and (2) report the number of events, and the percentage among all events, in each category. Columns (3) and (4) list the rate of success (including partial success) and number of hostile events within each category. Column (5) reports the number of hostile events. Percentages sum up to more than 100% since one event can have multiple objectives (The first category and the other four categories are mutually exclusive).

Table 2. Characteristics of Target Companies

Firm Characteristic	(1)	(2)	(3)	(4)	(5)	(6)
	Summary Statistics			Difference with matched firms		
	Mean	Median	Std Dev	Avg. Diff.	t-stat of Diff.	Wilcoxon
<i>Market Cap (\$Mil)</i>	726.56	160.07	1669.17	-63.54	-1.52	-2.05
<i>Book-to-Market</i>	0.773	0.615	0.914	0.081	4.28	3.93
<i>Sales Growth</i>	0.084	0.041	0.357	-0.057	-4.44	-7.72
<i>ROA (Ebitda/Assets)</i>	0.054	0.085	0.201	0.020	3.12	4.18
<i>Stock Return</i>	0.195	-0.010	1.200	-0.073	-3.11	-5.15
<i>Debt-to-Capital</i>	0.348	0.327	0.297	0.028	2.91	1.70
<i>Dividend Yield</i>	0.007	0.000	0.016	-0.001	-2.13	-5.48
<i>R&D/Assets</i>	0.079	0.029	0.114	-0.010	-2.21	-4.51
<i>HHI(Business Segment)</i>	0.800	1.000	0.251	-0.034	-3.64	-1.93
<i>#Takeover Defense</i>	9.005	9.000	2.702	0.353	2.27	2.33
<i>#Analyst</i>	4.387	2.000	5.959	0.547	3.01	0.99
<i>%Institutional Ownership</i>	0.447	0.447	0.274	0.083	9.57	8.82
<i>Trading Illiquidity</i>	0.466	0.193	0.699	-0.075	-3.99	-7.65

Notes: This table reports the characteristics of target companies and a comparison to a set of matched companies. The first three columns report the mean, median, and standard deviation of the characteristic for the target companies. Columns (4) through (6) report the average difference between the sample firms and the industry/size/book-to-market matched firms, the t-statistic for the average difference, and the Wilcoxon signed rank statistic, which is asymptotically normal, for the median difference. Size matching is dropped for *Market Cap* comparison, and book-to-market matching is dropped for *Book-to-Market* analysis. Most variables are self-explanatory. *HHI* is the Herfindahl-Hirschman index of sales in different business segments as reported by Compustat. Trading illiquidity is proxied by a measure developed in Amihud (2002), defined as the yearly average (using daily data) of $1000\sqrt{|\text{Return}|/(\text{Dollar Trading Volume})}$.

Table 3. Long-Term Returns of Target Company Portfolios

Panel A: Equal-weight four-factor model													
Window (months)	Alpha		Beta(-1)		Beta		SMB		HML		MOM		R2
	Estimate	t-statistic	Estimate	t-statistic	Estimate	t-statistic	Estimate	t-statistic	Estimate	t-statistic	Estimate	t-statistic	
(-12,-10)	-1.023	-1.82	0.123	1.04	0.976**	6.81	0.663**	4.40	0.421**	2.41	-0.278**	-3.14	0.578
(-9,-7)	0.283	0.54	0.078	0.67	0.671**	4.94	0.913**	6.69	0.17	1.01	-0.493**	-5.88	0.657
(-6,-4)	-0.513	-1.02	0.252	2.27	0.805**	6.22	0.851**	6.15	0.322*	1.91	-0.243**	-2.84	0.648
(-3,-1)	-0.664	-1.30	-0.057	-0.50	0.57**	4.44	0.906**	5.20	0.333*	1.88	-0.164*	-1.79	0.516
Event	5.095**	6.72	0.371**	2.00	0.401*	1.90	0.644**	2.45	0.205	0.72	-0.274*	-1.77	0.302
(1,3)	1.093**	2.01	0.157	1.23	0.339**	2.26	0.611**	3.26	0.400*	1.74	-0.609**	-4.85	0.540
(4,6)	0.237	0.52	0.195*	1.71	0.727**	5.24	0.989**	5.99	0.428**	2.34	-0.092	-0.84	0.651
(7,9)	-0.093	-0.19	0.118	0.77	0.902**	5.45	0.655**	3.41	0.387	1.48	-0.163	-1.10	0.599
(10,12)	1.124	1.84	0.008	0.04	0.776**	3.65	0.602**	2.41	0.009	0.03	-0.019	-0.10	0.395

Panel B: Value-weight four-factor model													
Window (months)	Alpha		Beta(-1)		Beta		SMB		HML		MOM		R2
	Estimate	t-statistic	Estimate	t-statistic	Estimate	t-statistic	Estimate	t-statistic	Estimate	t-statistic	Estimate	t-statistic	
(-12,-10)	-2.377**	-3.18	-0.06	-0.38	1.18**	6.17	0.413**	2.06	0.723**	3.10	-0.177	-1.50	0.383
(-9,-7)	-0.261	-0.42	0.161	1.17	1.025**	6.46	0.482**	3.03	0.145	0.74	-0.193**	-1.97	0.54
(-6,-4)	-2.122**	-3.34	0.054	0.39	1.032**	6.34	0.834**	4.79	1.054**	4.98	0.025	0.23	0.46
(-3,-1)	-1.663**	-2.33	0.159	0.99	0.731**	4.07	0.235	0.96	0.486*	1.96	-0.301**	-2.35	0.323
Event	1.616	1.18	0.820**	2.44	0.663*	1.74	0.678	1.43	0.112	0.22	-0.021	-0.07	0.173
(1,3)	0.141	0.28	0.211*	1.78	0.522**	3.75	0.450**	2.60	0.604**	2.84	-0.419**	-3.61	0.508
(4,6)	-0.683	-1.24	0.033	0.24	1.005**	6.04	0.959**	4.84	0.99**	4.52	-0.268**	-2.05	0.625
(7,9)	-0.005	-0.01	0.089	0.60	0.742**	4.57	0.587**	3.12	1.03**	4.03	-0.692**	-4.74	0.685
(10,12)	-0.041	-0.08	-0.132	-0.82	0.985**	5.50	0.778**	3.69	0.666**	2.181	-0.165	-1.05	0.61

Notes: The table reports regression estimates and t-statistics from equal- and value-weighted calendar-time portfolio regressions. “Window” indicates the buying time relative to the event (hedge fund activism targeting) and the holding period in months. “Alpha” is the estimate of the regression intercept from the factor models. “Beta(-1)” and “Beta” are the factor loading on the lagged and concurrent market excess return (the Fama and French RMRF). “SMB,” “HML,” and “MOM” are the estimates of factor loading on the Fama-French size and book-to-market factors, and the Carhart momentum factor. “R2” is the R-squared from the regressions. * and ** indicate statistical significance at the 10% and 5% levels.

Table 4. Excess Returns to Activist Equity Hedge Funds, Equity Hedge Funds, and All Hedge FundsPanel A: All Activist Equity Hedge Funds

Percentile	All sample		36-month rolling window	
	One-Factor Alpha	Four-Factor Alpha	One-Factor Alpha	Four-Factor Alpha
5%	-0.05	-0.28	-0.57	-0.58
25%	0.38	0.33	0.38	0.26
50%	0.71	0.56	0.65	0.57
75%	1.19	0.94	0.99	0.96
95%	1.79	1.86	1.82	2.00
Average	0.82	0.70	0.67	0.63
Standard Dev.	0.62	0.70	0.66	0.75
Number of Funds	102		102	

Panel B: All Hedge Funds

Percentile	All sample		36-month rolling window	
	One-Factor Alpha	Four-Factor Alpha	One-Factor Alpha	Four-Factor Alpha
5%	-0.54	-0.69	-0.94	-1.04
25%	0.09	0.01	0.02	-0.02
50%	0.37	0.28	0.32	0.29
75%	0.74	0.65	0.69	0.67
95%	1.98	1.84	1.88	2.10
Average	0.49	0.39	0.38	0.39
Standard Dev.	0.95	1.00	1.36	1.63
Number of Funds	10,530		10,384	

Panel C: All Equity Hedge Funds

Percentile	All sample		36-month rolling window	
	One-Factor Alpha	Four-Factor Alpha	One-Factor Alpha	Four-Factor Alpha
5%	-0.77	-0.97	-1.28	-1.24
25%	0.09	-0.01	-0.03	-0.07
50%	0.46	0.38	0.40	0.38
75%	0.92	0.82	0.84	0.87
95%	2.34	2.16	2.25	2.65
Average	0.58	0.47	0.42	0.48
Standard Dev.	1.17	1.36	1.71	2.07
Number of Funds	3,986		3,563	

Notes: The table reports the summary statistics of alpha estimates from the CAPM and the four-factor (defined in Table 3) models for the sample of self-reported activist hedge funds, all hedge funds, and equity-oriented hedge funds. In the “All-sample” column, alpha and beta loadings on the factors are estimated using the full sample. In the “36-month rolling window” column, the same beta loadings are estimated using the 36 months prior to the current month. Monthly alphas are calculated using the time-varying beta loadings, and then averaged at the fund level.

Table 5. Returns Based on 13F-Filed Holdings

Percentile	Most recently filed holdings			Holdings filed at least 2 months ago		
	Excess of Market	One-Factor Alpha	Four-Factor Alpha	Excess of Market	One-Factor Alpha	Four-Factor Alpha
5%	-0.53	-0.41	-0.59	-0.54	-1.12	-1.56
25%	0.55	0.49	0.27	0.24	0.13	-0.01
50%	0.99	0.88	0.66	0.65	0.54	0.26
75%	1.49	1.35	1.23	0.96	0.88	0.71
95%	2.82	2.98	2.22	2.13	2.13	1.58
Average	0.96	0.90	0.62	0.65	0.58	0.36
Standard Dev.	2.06	1.85	2.67	1.07	0.93	1.02
Num. of Funds	147			147		

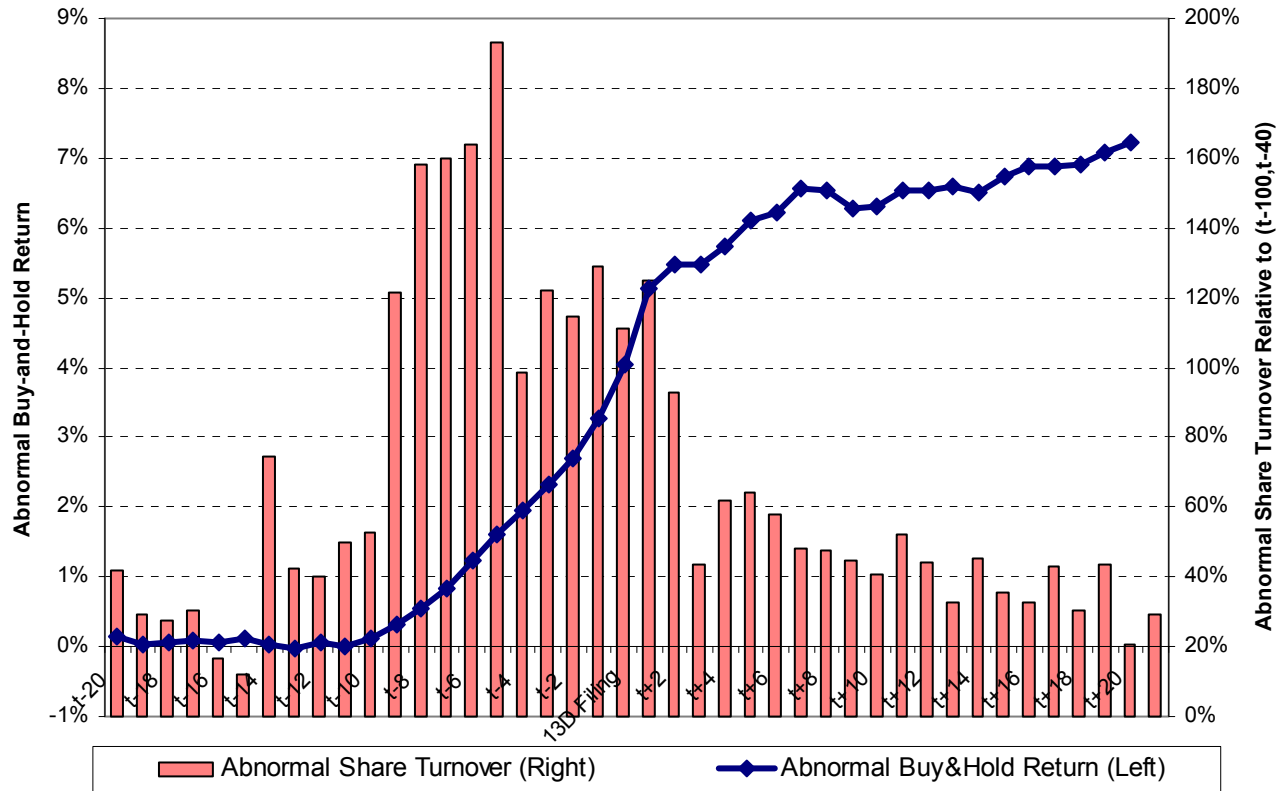
Notes: This table reports the summary statistics of abnormal returns (in terms of excess return over the market, one-factor alpha, and four-factor alpha) of the long-equity positions of sample hedge funds that report quarterly holdings to the Thomson Financial Spectrum database. In the first column, we construct the returns from the equity long-only position by assuming that the hedge funds hold their most recently disclosed positions. In the second column, the returns are imputed on the filings that are at least two months old.

Table 6. Cross-Sections of Activist Hedge Fund Returns

	Four-Factor Alpha		One-Factor Alpha		Avg. Announcement Ex. Return	
	COEF	t-stat	COEF	t-stat	COEF	t-stat
Log(#Targets)	0.049	0.93	0.021	0.37	2.496**	2.50
Hostile Tactics	0.060	0.41	0.087	0.5	-0.348	-0.10
Objective: Sale	0.089	0.46	0.063	0.28	9.085**	2.83
Fund Age	0.002	-1.45	0.002	-1.41	-0.005**	-1.99
Log(AUM)	0.05	0.95	0.076	1.33	1.002	1.02
Management Fee (%)	0.179*	1.78	0.034	0.28	-5.444	-1.62
Incentive Fee (%)	0.052**	3.90	0.062**	3.98	0.364	0.91
Log(Min Invest)	-0.11	-1.21	-0.208*	-1.73	-1.293	-0.31
Watermark	0.042	0.15	-0.012	-0.04	4.687	1.07
Constant	-0.33	-1.09	-0.056	-0.16	0.993	0.11
R-sqr and # of Obs	0.20	103	0.19	103	0.17	103

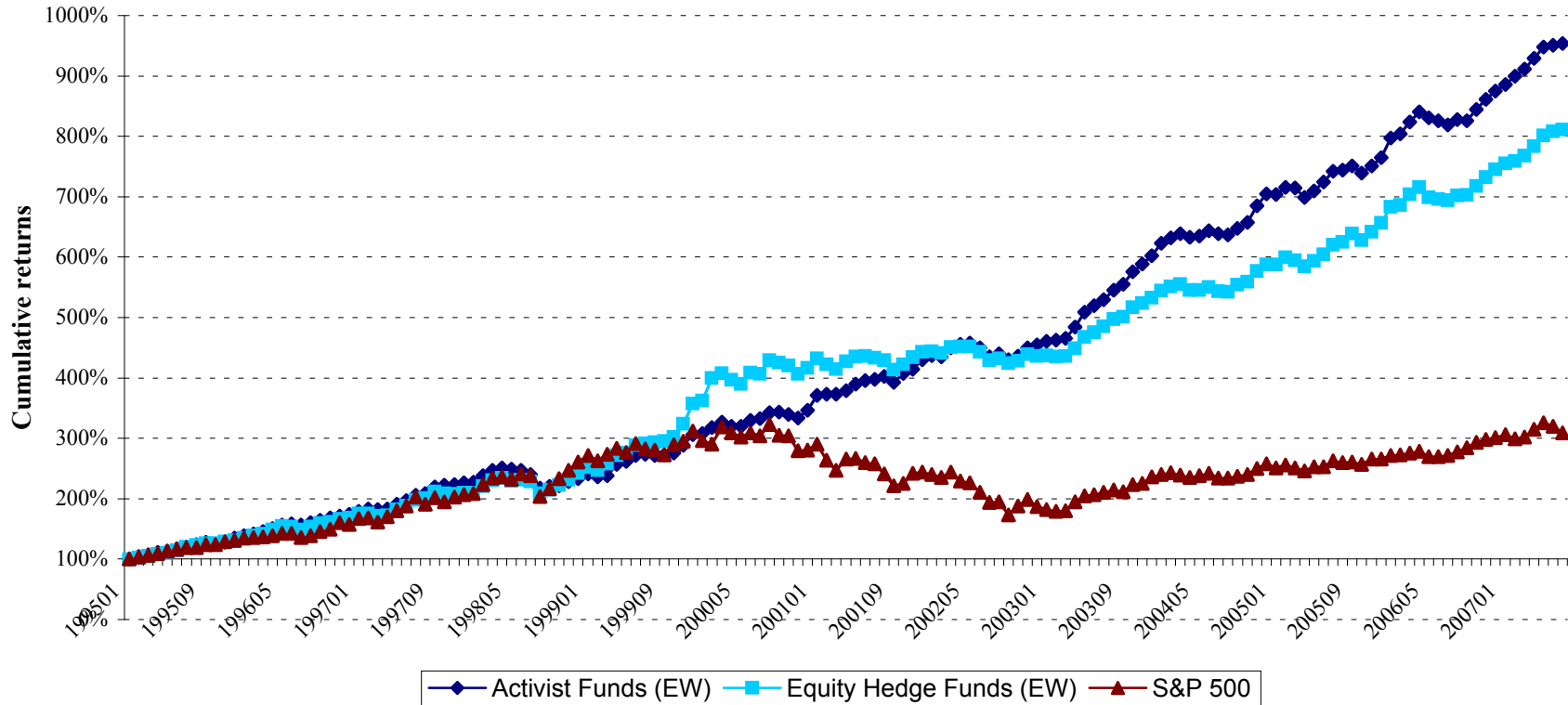
Notes: The dependent variables are four- and one-factor alphas, as well as the average announcement window excess returns (the average of which across all funds is plotted in Figure 1). All variables are constructed at the fund level. * and ** indicate statistical significance at the 10% and 5% levels.

Figure 1. Buy-and-Hold Abnormal Return Around The Filing of Schedule 13Ds



Note: The solid line (left axis) plots the average buy-and-hold return around the Schedule 13D filing, in excess of the buy-and-hold return of the value-weight market, from 20 days prior the 13D file date to 20 days afterwards. The bars (right axis) plot the increase (in percentage points) in the share trading turnover during the same time window compared to the average turnover rate during the preceding (-100, -40) event window.

Figure 2. Returns to Activism Indices, January 1995- June 2007 (Beginning from 100% in January 1995)



Notes: This figure plots the Activist Fund Index by aggregating the returns of all activist funds on an equal-weight basis. As a comparison, also plotted are the HedgeFund.Net all hedge fund equal-weight index and the S&P 500 index.

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