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Hedge Fund Activism, Corporate Governance, and Firm Performance

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Abstract

Using the first large-scale sample of hedge fund activism, from 2004-05, we show that activist hedge funds resemble value investors and that the announcement of hedge fund activism generates statistically significant abnormal returns, in the range of 5-7% for a 20-day window, with results that are robust for different buy-and-hold periods. Target firms have significantly lower market value relative to book value, and are profitable with strong operating cash flows. The highest abnormal returns occur when activism targets the sale of the company or changes in business strategy, and hostile events generate higher returns than friendly ones. In contrast, activism that targets capital structure or governance generates no significant abnormal return. Preliminary data suggest that roughly two-thirds of the activist events have been successful or partially successful for the hedge funds (in achieving their stated goals). We find no empirical support for the assertion that hedge fund activism destroys value or is short-term in focus.

JEL Classification:

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I. Introduction

This paper is a first attempt to fill the gap between the widespread focus on hedge fund activism and the dearth of large sample empirical evidence and analysis of this new phenomenon.¹ We construct a comprehensive database of 110 activist hedge funds, and then examine 374 events involving these funds during the period 2004 through 2005.²

We find that a large majority of activist hedge funds are value investors targeting companies they believe are undervalued based on financial statement statistics. In roughly two-thirds of the Schedule 13D filings in our sample, the fund states that the target company is undervalued. Our analysis of the targets' financial statements further shows that targets resemble companies typically sought by value investors. They have low market value relative to book value, are profitable with sound operating cash flows and tend not to be technology companies (as proxied by R&D expenditure). Targeted companies have more takeover defenses than average firms and enjoy higher trading liquidity than companies of comparable size and book-to-market ratio. Finally, relatively few targeted companies are in the top twenty percent of firms by market capitalization, which is not surprising given the much higher cost of amassing a 5% stake in a firm in the top size quintile (an average of \$760 million).

We observe considerable heterogeneity in the degree of fund activism and range of activist techniques. Approximately 40% of all cases are hostile: they involve a threatened or actual proxy contest, takeover, or lawsuit. More than a quarter of cases involve multiple hedge funds acting as a block. Hedge funds report derivative positions in 13% of cases.

¹ There have been a few attempts at studying hedge fund activism targeting general corporations based on limited samples. Bradley, Brav, Goldstein, and Jiang (2006) is the only large sample study on hedge fund activism, but the analysis is confined to hedge fund activism against discounted closed-end funds, and its impact on closed-end fund governance and discount dynamics. Becht, Franks, Mayer, and Rossi (2006) gather data on activism by Hermes U.K., the pension fund of British Telecom. They state that the Hermes Focus Fund has generated abnormal annual returns net of fees of 4.9%, and estimate that 90% of this outperformance is due to activism. They do not find positive market reaction to public notification of Hermes's stake, but there is a significant 3% market reaction to governance outcomes of Hermes's activism.

² Although hedge funds are largely unregulated, the Securities Exchange Act of 1934 requires anyone, including hedge funds, to file a Schedule 13D if they directly or indirectly acquire beneficial ownership of more than 5% of a company's shares. Our sample is based on these Schedule 13D filings with additional news-based searches for activist events that do not meet the above filing criteria. Our sample construction methodology is discussed in detail in Section III.

Target responses vary. Targets fight back in roughly half of cases involving aggressive attacks. In about one-third of the hostile cases, hedge funds reach their main stated goals. In another third of the cases, hedge funds achieve partial success by gaining concessions from the target.

We also find evidence that market participants, on average, believe hedge fund activism creates value. The announcement of hedge fund activism, which often occurs after the fund files a Schedule 13D, generates large cumulative abnormal returns that are robust for different buy-and-hold periods. The average abnormal returns are in the range of 5-7% for the 20-day window around the Schedule 13D filing date. Analysis of a longer post-event window suggests that targets see significant positive returns during the month in which the Schedule 13D was filed or when the activism was first commenced, but little abnormal return during the 12 months thereafter.

We then examine the cross-section of these market price reactions. Contrary to media reports that investors welcome changes in target capital structure and governance, we find that the market response to capital-structure related activism—including debt restructuring, recapitalization, dividends, and share repurchases – is insignificant. We find a similar lack of reaction for governance-related activism—including attempts to rescind take-over defenses, to oust CEOs, to enhance board independence, and to curtail CEO compensation. Instead, events that are associated with positive abnormal returns involve more dramatic events, such as changes in business strategy (for example, refocusing and spinning-off non-core assets), the sale of the company, and providing financing for business growth. The event-window abnormal returns for these three categories of events are 5.9%, 10%, and 17% respectively.

Our findings are consistent with the view that informed shareholder monitoring can reduce the agency costs of equity by focusing managers on creating shareholder value instead of pursuing other agendas. In theory, shareholders can pressure corporate directors to remove underperforming managers, stop value destroying mergers and acquisitions, encourage companies to disgorge excess cash and optimize their capital structure, or press for a sale of the company, all of which are designed to increase shareholder value. Indeed, control shareholders, or large block holders, have strong incentives to exercise these powers, and always have been able to do so.

Activist hedge funds have similar incentives and abilities. Thus, the effects of hedge fund activism are in sharp contrast with other institutional shareholder activism. Since the 1980s, public pension funds and other large institutional investors have engaged in various types of shareholder activism. These institutions collectively hold a large percentage of equity securities, but also face serious obstacles, mostly because individual institutions generally hold a small percentage of shares outstanding and face significant collective action problems (Kahan and Rock, 1992; Partnoy and Thomas, 2006).³

Hedge funds are different. They employ highly incentivized managers who manage unregulated large pools of capital and seek to improve corporate performance by removing weak CEO's and directors, pushing cash out of firms into shareholders' pockets, and even selling portfolio firms to the highest bidder, sometimes themselves. Hedge fund managers suffer few conflicts of interest because they are not beholden to the management of the firms whose shares they hold. In sum, hedge funds are better positioned to act as informed monitors than other institutional investors.

In general, we find that recent abnormal positive returns to hedge fund activism are consistent with the early arbitrage profits hedge funds previously have captured using other strategies. Several hedge funds now appear to have detected profit opportunities from agitating for corporate change, perhaps because of the failure of other institutional investors to monitor managers.

One open question is whether such profits can persist. The number of hedge fund activist events surged after 2003,⁴ and their activity continues to grow in 2006 as they attract substantial additional capital. Although it is too early in the cycle to predict the fate of hedge fund activism with any certainty, if activism can be viewed as another form of arbitrage,⁵ then it is likely that

³ In brief, institutions' costs of informing themselves about the micro-level problems of any particular portfolio company are high and free riding by other shareholders is widespread. In addition, some institutions face significant conflicts of interest, such as mutual funds that are reluctant to engage in activism at firms they might take on as future clients. Other institutions face substantial regulatory constraints, including prohibitions on accumulating large block positions. Funds run by political appointees are constrained by local and state politics from engaging in activism as well. Finally, institutions' managements might have weak financial incentives to engage in aggressive intervention, as they realize little or no personal gain from increasing portfolio firm value. (Rock, 1992).

⁴ We are still in the process of collecting data on events in the pre-2004 period. However, we do observe a steep drop in aggressive activism (where hedge funds resort to public shareholder proposal, launch proxy contest, or seek control of the company) in 2003 and earlier years.

⁵ In contrast to the conventional *pure trading arbitrage* where arbitrageurs take positions and passively wait for the convergence of the prices of mis-priced securities, *activist arbitrage* entails actions that change the value of the underlying securities through intervention aimed at improvement.

the abnormal returns associated with it will decline, or even disappear, as more funds chase after fewer attractive targets, and as the market incorporates the potential of investor intervention and improvement into security prices.⁶

The rest of the paper proceeds as follows. Section II provides the institutional background and literature review. Section III describes the sample. Section IV discusses the characteristics of target companies. Section V looks at stock price returns to hedge fund activism. We present our conclusions in the final section.

II. Institutional Background and Literature Review

Hedge fund activism is a controversial but little studied phenomenon. One barrier to research is that there is not even a generally agreed-upon definition of a hedge fund. For example, the term “hedge fund” does not even appear in the federal securities laws.⁷ Likewise, there is no clear definition of an activist hedge fund.

Hedge funds generally have four characteristics: (1) they are pooled, privately organized investment vehicles; (2) they are administered by professional investment managers; (3) they are not widely available to the public; and (4) they operate outside of securities regulation and registration requirements.⁸ Hedge funds avoid regulations imposed on mutual funds by having a relatively small number of sophisticated or wealthy individual and institutional investors. Most hedge funds are exempt from the Investment Company Act of 1940, either because (1) they have 100 or fewer beneficial owners and do not offer their securities to the public, or (2) all of their investors are “qualified” high net-worth individuals or institutions.⁹ Although many private equity or venture capital funds also have many of these characteristics, those funds are distinguished from hedge funds because of their focus on particular private markets.

⁶ Using a simultaneous estimation technique, Bradley, Brav, Goldstein, and Jiang (2006) find that close-end fund discount shrinks in anticipation of the open-ending attempts from the hedge funds. Such feedback effect weakens the profitability of the activist arbitrage.

⁷ Indeed, when the Securities and Exchange Commission held a roundtable discussion on hedge funds in 2003, one participant cited fourteen different definitions found in government and industry publications. See SEC Roundtable on Hedge Funds (May 13, 2003) (comments of David A. Vaughan), available at <http://www.sec.gov/spotlight/hedgefunds/hedge-vaughn.htm>.

⁸ Partnoy and Thomas (2006). See 15 U.S.C. § 77d(2) (Securities Act of 1933 registration requirements); 15 U.S.C. § 80a-2(a)(51)(A) (Investment Company Act of 1940 registration requirements); 15 U.S.C. § 80a-3(c)(7) (Securities Exchange Act of 1934 reporting obligations); 15 U.S.C. § 80b-3(b) (Investment Advisers Act of 1940 registration requirements).

⁹ See 15 U.S.C. § 80a-3c(1), (7).

Caldwell (1995) attributes the development of the first hedge fund to Alfred Winslow Jones, a sociologist and journalist who in 1949 established a private investment partnership that reduced risk by buying one stock while shorting another in the same industry. The President's Working Group (1999) estimates that there were 140 hedge funds operating in the late 1960s, and roughly 3,000 by 1998. There is no definitive count of hedge funds, although recent estimates are in the range of 8,000 funds with more than \$1 trillion under management.¹⁰ Established hedge funds tend to charge both incentive fees and fixed fees, typically in the range of 2 percent of assets under management.

The evidence on hedge fund performance is mixed, for two reasons. First, hedge fund databases are incomplete and subject to selection bias. Because hedge funds are unregistered, there is no objective and centralized source of information about them. Second, hedge funds engage in non-conventional trading strategies that make standard factor-model based performance metrics inappropriate.¹¹ Moreover, there are no large-scale studies of the performance of hedge fund activism.

Instead, research on investor activism has focused on investors other than hedge funds. Studies on non-hedge fund institutional investor activism show overall positive but insignificant effects.¹² Wahal (1996), Smith (1996), and Del Guercio and Hawkins (1999) all analyze a small number of firms targeted by CalPERS in the 1987 to 1993 period and document short-run returns that are not reliably different from zero. Gillan and Starks (2000) reach similar findings from corporate governance proposals by institutional investors. Barber (2006) finds a stronger market adjusted announcement day return of 23 basis points for a later and larger sample of CalPERS activism. Carleton, Nelson, and Weisbach (1998) find that the mutual fund family TIAA-CREF enjoyed great success in inducing proposed changes from target firms through private negotiations, but the market reaction is not statistically different from zero.

Institutional shareholder monitoring has had some successes, but never had the kind of impact its supporters sought (Partnoy and Thomas, 2006). Institutions faced collective action problems in organization remaining shareholders, as well as agency costs within their own

¹⁰ As of July 2006, the Securities and Exchange Commission estimated that there were 8,800 hedge funds, with approximately \$1.2 trillion of assets. See SEC Chairman Christopher Cox, Testimony Concerning Hedge Funds (July 25, 2006), available at <http://www.sec.gov/news/testimony/2006/ts072506cc.htm>.

¹¹ See, for example, Fung and Hsieh (1997), Brown, Goetzmann and Ibbotson (1999) for an overview of hedge fund performance evaluation.

¹² See a survey by Gillan and Starks (1998) for a complete list of studies on institutional shareholder activism till 1998.

institutions. Davis and Kim (2005) show that some institutions, such as mutual funds, faced significant conflicts of interest, and were reluctant to engage in activism at firms that they might take on as future clients. Other institutions faced regulatory constraints, including prohibitions on accumulating large block positions in any single firm, or the necessity to maintain liquidity of the portfolios that prevents them from intervening actions that might compromise trading flexibility because of insider trading regulations (Black, 1990). Del Guercio, Wallis, and Woidtke (2006) show that although institutions have sponsored shareholder proposals, organized “Vote No” campaigns, and pushed for majority vote bylaws, and thereby indirectly brought about change in the boardroom, but they have never been able to use their voting power directly to replace boards and CEOs. Some institutions have appeared as lead plaintiffs in securities fraud litigation, and had a positive impact on settlement size in those actions (Cox and Thomas (2006)), yet they have not used litigation on a widespread basis as a means of changing corporate governance structures. Finally, these large investors have been willing to sell their stock in change of control transactions initiated by other investors, but have not shown any interest in being the acquirers themselves. Due to these limitations, the “Wall Street Walk” often becomes the default form of institutional shareholder activism (Admati and Pfleiderer, 2005).

However, none of prior studies mentions hedge fund activism. Indeed, until recently, hedge funds did not play a significant role in shareholder monitoring. Instead, that role was played by control shareholders and other institutions, such as public pension funds and mutual funds, which held a large percentage of equity securities overall.

The unique structure and status of hedge funds suggest they have the potential to fill some of the gaps left by pension funds and mutual funds. Hedge funds are not subject to the same costly regulation as other institutions.¹³ Whereas mutual funds must have independent boards and permit shareholders to approve certain actions, hedge funds can, if they choose, more completely separate ownership and control. The typical hedge fund is a partnership entity managed by a general partner; the investors are limited partners who are passive and have little or no say in the hedge fund’s business. Because hedge funds do not fall under Investment

¹³ Hedge funds are exempt from rules requiring registration with the Securities and Exchange Commission. Although in late 2004 the SEC responded to criticism about the unregulated status of hedge funds by adopting new rules limiting the exemptions for hedge funds, effectively requiring that most hedge funds register with the agency, an appeals court struck down these new rules in 2006. See *Registration Under the Advisers Act of Certain Hedge Fund Advisers*, 69 Fed. Reg. 72,054 (Dec. 10, 2004); *Goldstein v. SEC*, 451 F.3d 873 (2006).

Company Act regulation, they are permitted to trade on margin and engage in short sales, strategies that are not available to other institutions, such as mutual and pension funds.¹⁴

Another distinction is that hedge funds typically require that investors “lock in” their investments for a fixed period of time, ranging from six months to several years. By comparison, other institutional investors, particularly mutual funds, are subject to more rapid investor redemptions. Because of these differences, hedge fund managers typically are more independent of their investors than are managers of other institutions. Perhaps most importantly, hedge fund managers are compensated based on their fund’s performance.

III. Data and Overview

III.1. The Activism Sample

There is no central database of activist hedge funds. For purposes of studying activism, the few publicly available hedge fund databases (such as TASS, CISDM) do not include a large number of funds engaged in activism.¹⁵ Moreover, as noted above, there is widespread criticism of available data regarding hedge funds in general as data vendors rely mostly on voluntary reporting by hedge funds. As a result, we decided to construct an independent sample.

We used a two-step procedure. We first focused on assembling a comprehensive list of hedge funds engaged in activism. To this end, we performed searches in both the Factiva and Lexis-Nexis news databases for stories during 2004 and 2005 mentioning both the terms “activism” and “hedge fund.” From those stories, we are able to gather the names of approximately 100 hedge funds. We then performed searches in the SEC Edgar database for securities filings by institutions with those names (or under other affiliated names). As a result of these searches, we were able to add additional funds to our initial list. Our second step was to collect information on the companies targeted by these funds. Again, we took a two-pronged approach. For each fund, we performed searches in the SEC Edgar database for all Schedule 13D filings by that fund during 2004 and 2005. We supplemented the information culled from these filings with Factiva-based news searches.

¹⁴ See 15 U.S.C. § 80a-12(a)(1), (3).

¹⁵ Using our activist hedge fund list we were found that only 20-25% of our sample funds are listed on the TASS or CISDM databases.

Section 13D of the Exchange Act of 1934¹⁶ is one of the key provisions of the Williams Act, passed by Congress in 1968 to regulate the method and timing of tender offers. This statute requires anyone who directly, or indirectly, acquires beneficial ownership of more than 5% of a public company's shares to file a disclosure document, the Schedule 13D, with the SEC within 10 days of crossing over this ownership threshold. Item 4 of Schedule 13D requires the filer to declare the 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 or a change in its capitalization or dividend policy, as well as a host of other types of corporate changes. Congress intended that the filing of a Schedule 13D would notify the market that the filer may seek to force corporate changes.¹⁷

Schedule 13D filings (and amendments thereto) are publicly available through the SEC's EDGAR filing system and the various private data bases that also disclose these filings. It is the best source of publicly available data concerning the holdings of hedge funds, although it does not require disclosure of certain types of derivative transactions in an issuer's securities.¹⁸ While institutional money managers may also have filing obligations for less than 5% positions under Form 13F, these obligations are much more limited in their scope and the 13F filings are done only on a quarterly basis with an additional 45 day delay permitted after the end of the quarter.¹⁹ Therefore, for our purposes, Schedule 13D filings are the best indicator of hedge fund shareholder activism.²⁰

We compile a list of hedge funds, the size of their positions, and their intentions, as well as their targets, from these 13D filings. We exclude targets that were closed-end funds. Finally,

¹⁶ 17 C.F.R. §240.13d-1 (2005).

¹⁷ In contrast, passive institutional investors that acquire more than 5% of the company's stock and do not intend to seek to influence control at the target company, but are just investing ordinary course of business, file the Schedule 13G within 45 days of crossing this ownership threshold. Typically, the filing of a Schedule 13G does not foreshadow an activist event. However, if an institutional investor did change its initial passive purpose and decide to become active, they would need to file a Schedule 13D to announce this shift to the market.

¹⁸ Hu and Black (2006) contains an extensive discussion of these limitations.

¹⁹ Form 13F is limited to the publicly traded U.S. equity securities that are listed in the SEC's official list of Section 13F securities; it does not cover privately traded securities. For further discussion of these limitations, see Hu and Black (2006). Despite these problems, we have been diligently searching for 13F filings for our hedge funds and hope to be able to supplement our existing data base using the results of that process.

²⁰ Since we are unable to detect positions below the 5% level using the Schedule 13D data and Schedule 13F data is difficult to find (see note 18 above), we are currently in the process of supplementing our 13D data with public searches of the news service databases, such as Factiva and Lexis-Nexis, to find other reported instances of hedge fund activism. For further discussion, see note 21 below.

we supplement the sample with additional events that we identified while processing the 13D filings, including new hedge funds and/or new targets by the same hedge funds.

We performed additional extensive news searches in Factiva and Lexis-Nexis with respect to each hedge fund-target pair. During these searches, we were able to find additional hedge funds that had participated in the activism event but were not found during our first search of media stories.²¹ We added these names to our list, and performed the same SEC Edgar database searches described above with respect to those names. To further increase the inclusiveness of our sample, at various stages during this process, we have shown our list of hedge funds to participants in the hedge fund industry and obtained comments and suggestions for additions or deletions. Although mutual funds are not technically hedge funds because they are required to register under the Investment Company Act of 1940, we made one exception, Franklin Mutual Advisers, because it behaves exactly like the other activist funds in our sample.

Ultimately, we generate a list of 110 activist hedge funds and 374 hedge fund-target pairs for 2004-2005, involving 339 unique target companies. Though this sample may not be exhaustive of all potential hedge fund activist events that occurred in the 2004-2005 time period, we believe it includes the great majority of the important events because the missed-events must have failed both in catch the attention of the news media and are unlikely to be economically meaningful.²² The target companies span 122 (respectively, 54) three-digit SIC code (respectively, two-digit) industries. By compiling our own database, we avoid some problems associated with survivorship bias, selection bias, and backfill, which are prevalent among other databases, such as those provided by Hedge Fund Research, Inc., TASS/Tremont, Managed Accounts Reports, and Zurich Capital Markets.²³

²¹ The fact that several activist hedge funds were not uncovered in the initial search reveals some of the limitations of computational linguistics.

²² We are in the process of a larger scale data gathering expanding the sample in the following directions: (1) An expanded search of 13Ds filed by our sample funds for the 2001-2005 period; (2) A search of 13F files by our sample funds for the 2001-2005 periods (that have less than 5% stake) that lead to activist events; (3) An addition of new hedge funds that engage in activism in 2001-2003 (but stopped after 2003). Our goal is to have a relatively complete sample of hedge funds' activist events for the 2001-2005 period, including those that have ownership levels than less 5%.

²³ See Malkiel and Saha (2006). Survivorship bias occurs because unsuccessful hedge funds – and their unsuccessful performance history – are removed from the databases. Backfill bias occurs because hedge funds start reporting performance only after a period of positive returns. Selection bias also is a problem, although there are dual incentives and it is unclear whether the firms that opt to be included in private databases under-perform or over-perform the mean.

III.2. Two Examples of activist events:

To give the reader a flavor of the boundaries of the activism that we focus on in this paper, we provide a detailed description of two such cases. The first event illustrates an initially hostile approach that was ultimately accommodated by target company management, while the second event stayed hostile to the bitter end.

A. Pirate Capital and James River Coal

On November 17, 2005, Pirate Capital filed a 13D file with the SEC indicating a 7.9% stake in James River Coal Co. Pirate purchased its stake at an average price of about \$33.45. On February 10, 2006, Pirate Capital sent a letter to the target stating that:

“We have become increasingly concerned that James River's valuation is being discounted relative to its peers - a discrepancy we attribute to management's failure to articulate to the investment community a cohesive operational and financial strategy, together with its demonstrated inability to meet earnings consensus...We attribute these missteps to CEO Peter Socha's lack of operating experience within the coal industry and to the Company's lack of a CFO...We are now convinced that the Company's senior management team is simply not up to the task of achieving such goals. As a result, we demand that (i) the Board immediately retain an investment banking firm to pursue strategic alternatives, including the potential sale of the Company and (ii) immediately redeem the shareholder rights plan effective no later than March 15, 2006.”

On March 10, 2006, management announced that they had hired Morgan Stanley to “look at alternatives and potential bidders.” James River Coal’s stock price rose more than 10% to \$39.77 on that day. From late April to July, Pirate demanded that its representatives be placed on James River’s board and the repeal of several anti-takeover by-laws passed by the board. On August 22, 2006, Pirate and James River Coal announced that they entered into settlement agreement whereby three representatives from Pirate were elected to James River

Coal's board, and in turn, Pirate dropped the proposals it had submitted to shareholders for the upcoming annual shareholder meeting.

B. Newcastle Partners and Pizza Inn

Not all activism is settled by negotiations as in the Pirate Capital-James River case. In some cases, hedge funds persist in using hostile tactics while target management continues to resist their actions. Newcastle Partners, L.P.'s acquisition of Pizza Inn is one such case. It began when Newcastle acquired an option to purchase 32.5% of the shares of Pizza Inn on December 11, 2002 from the CEO of Pizza Inn, who had resigned from the company several months earlier. The new management at Pizza Inn responded by adopting a broad variety of defensive measures, including golden parachutes for its top executives and restrictive bylaw provisions, in addition to its earlier enacted classified board. Newcastle subsequently exercised its option and negotiated with Pizza Inn to obtain two seats on the Pizza Inn board of directors in late 2002.

One year later, Newcastle was dissatisfied with management's progress in turning around the company. It lambasted the top managements' performance and then a few months before the 2003 annual meeting launched a full scale proxy solicitation seeking to elect three of its nominees to the Pizza Inn board and to remove certain of Pizza Inn's anti-takeover defenses. Pizza Inn management resisted these initiatives and a full blown proxy contest for corporate control developed. Eventually, Newcastle prevailed as the company's shareholders overwhelmingly voted for their slate of candidates to be elected to the board and to reimburse Newcastle's expenses for the proxy contest. Ultimately, the new board of directors fired the CEO that had been in place at the time that Newcastle came on the scene and rescinded all of the company's newly enacted takeover defenses.

III.3. Summary of Events

We sort the different approaches to activism into seven categories by combining the information found in the "Purpose of Transaction" section of the initial Schedule 13D with what we learned from our news searches. These categories are ordered from the least to most aggressive:

Category 1: The hedge fund states that it intends to communicate with the board/management on a regular basis with the goal of enhancing shareholder value (51.9% of the sample).

Category 2: The hedge fund seeks board representation without a proxy contest or confrontation with the existing management/board (16.6% of the sample).

Category 3: The hedge fund makes formal shareholder proposals, or publicly criticizes the company and demands change (26.2% of the sample).

Category 4: The hedge fund threatens to wage a proxy fight in order to gain board representation, or to sue the company for breach of duty, etc. (7.5% of the sample).

Category 5: The hedge fund launches a proxy contest in order to replace the board (16.0% of the sample).

Category 6: The hedge fund sues the company (7.5% of the sample).

Category 7: The hedge fund intends to take full control of the company, e.g., with a take-over bid (5.9% of the sample).

An activist event can fall within more than one category of activism so that the percentages of categories (2) to (7) sum to more than 48.1% (the remaining 51.9% fall into category (1) solely). For example, if a fund launches a proxy contest to replace the board, and files suit against them as well, we would place the event within both categories 5 and 6.

To refine our classifications, we say that if a case involves activism in the form of (3) to (7), we consider it to be “aggressive” activism. In this sample, 41.7% of all cases (156 events) involve aggressive activism. The rest are conducted through friendly communications with boards and managers, or involve invited board representation.

Finally, we note that hedge funds frequently work together. In approximately 27% of the events, we see multiple hedge funds reported as one group in their 13D filing.

In the 156 aggressive cases, target companies choose to accommodate the activists 29.5% of the time, to negotiate 16.7% of the time, to fight 49.4% of the time, and to ignore the hedge fund about 4.5% of the time. As for outcomes, in 32.1% of the cases hedge funds achieve complete or near complete success, which we define as achieving their main stated goals; in 32% of the cases, we observe a partial success where hedge funds gain major concessions from their targets; in 14.1% and 3.2% of the cases the fund failed its mission, or withdrew the case, respectively. The remainder 17.9% of the cases in our sample are either still ongoing at the time

of the sample collection, or are not reported by any news or filing.²⁴ Given that hedge funds achieve success, or partial success, in nearly two-thirds of the aggressive cases (and nearly all friendly cases), despite the targets' strong tendency to resist and to fight, the success rate is impressive.²⁵ Interestingly, ISS was reported in the press as having recommended a vote in favor of hedge funds in 13 of the 17 media reported cases.²⁶

Next we turn to the stated goals that the activist fund gives when it invests in the target. These motives behind hedge fund activism can be summarized into six major categories:

(1) The hedge fund believes that the company is undervalued and/or that the fund can help with improving the company's efficiency or maximizing shareholder value by communicating with the company's managers. No further activism (beyond communicating with the management) has been launched (up until the end of 2005) to achieve specific goals.

(2) Activism targeting capital structure issues. The hedge fund proposes changes geared towards the reduction of excess cash; increase in firm leverage; or higher payouts to shareholders (using either dividends or stock repurchase). A subcategory of capital-structure related activism involves suggested equity issuance (the hedge fund suggests stopping or reducing seasoned equity offerings by the target company) and proposed debt restructuring.

(3) Activism targeting business strategies. There are two subcategories that fall within this group. First, hedge funds target companies they believe lack business focus or have excess diversification, and propose spinning-offs of some divisions or refocusing the business strategy. Second, the hedge fund attempts to play a role in a pending merger or acquisition, by asking for a better price where the firm is the target of the acquisition or by trying to stop the pending acquisition.

(4) Activism targeting the sale of the target. In this category, hedge funds attempt to force a sale of the target company, either to a third party, or they attempt to takeover the company themselves.

(5) Activism targeting governance issues. There are multiple subcategories here, including efforts: to rescind takeover defenses (most often to declassify the boards or to

²⁴ We continue to update these filings and will report completed events in future versions of this paper.

²⁵ By way of comparison, Ikenberry and Lakonishok (1993) examine proxy contests for corporate control from 1968 to 1988 and find dissidents acquire majority control of the board in about 28.4% of the contests, a minority of the seats in another 23.2% of the contests and a favorable settlement not involving board representation in 26.3% of the contests.

²⁶ We found press references to ISS' recommendations in only 17 (out of 60) proxy contests in our sample.

revoke poison pills); to oust the CEO or chairman; to challenge board independence and fair representation; to demand more information disclosure and question potential fraud; and to challenge the level or the pay-for-performance sensitivity of executive compensation.

(6) Activism in the form of providing finance. In this category, the hedge funds are financing either business growth or restructuring due to bankruptcy/financial distress. In most of these cases, hedge funds would seek board representation in a friendly way.

Table 1 summarizes the distribution of all cases along the above discussed classification scheme. Columns (1) and (2) report the percentage of cases in each category among the types of intervention, “Non Aggressive” or “Aggressive.”²⁷ It is clear from the two columns that hedge funds more frequently resort to aggressive methods (public proposal, proxy contests, law suits, and take-over bids) when they are targeting a specific issue (other than providing finance). For example, activism targeting excess cash/under-leverage/low payouts accounts for 4.8% of all the non-aggressive cases and 21.2% of all the aggressive cases.

Columns (3) and (4) of Table 1 track the hedge funds’ full and partial success rates for activism in each category. If the main stated goal by a hedge fund is achieved (e.g., ousting a CEO), it is classified as “successful.” If the fund and company reached some settlement through negotiation that partially meets the hedge fund’s original goal, it is considered “partially successful.” The remaining events (not shown) are classified as either a “failure” or “ongoing.” The overall success rate varies widely by goal. At the high end, in 60% of all the cases where a hedge fund attempts to oust a CEO (or chairman), it succeeds in doing so. We could add to this an additional 5% of the time, where the CEO keeps stay on the job but agrees to make changes along the line proposed by the hedge fund. A second important category involves forcing a sale of the company. In 26.2% of the cases where the hedge fund wants the company to sell itself, the targets end up being sold, while in an additional 11.9% of these events the company remains as a stand-alone but agrees to undergo a major reform. Overall, hedge funds manage to impose economically meaningful changes and achieve, at the very least, part of their specifically stated goals at about two-thirds (64.1%) of targeted firms.

III.4. Hedge Funds’ Investment in Target Companies

²⁷ As mentioned before, percentages sum up to more than 100% since an event can have multiple missions.

How big are hedge fund investments in target companies? In Table 2, Panel A, we report the size of the activists' stakes in their target firms, both in dollar value, and as percentage of the outstanding shares of the target.²⁸ This information is gathered from the "Initial Filing" columns of the first 13D filing.²⁹ The "Max. Ownership" columns report the maximum stake that the funds accumulated in the targets.³⁰ The median stake is higher in aggressive cases (15 million dollars, 6.6% of the target) than in friendly cases (9 million dollars, 5.75% of the target). In 96.3% (respectively, 61.9%, 46.0%, and 16.7%) of all the cases, the hedge fund invests at least 1 (respectively, 10, 20, and 100) million dollars with the target company at the maximum. Such highly concentrated stakes in one company must be considered large.

In approximately 13% of the cases, hedge funds have reported derivative positions in the target companies. Panel B of Table 2 lists the breakdown. The most common are option/warrants, which appear in 3.1% of all the friendly cases and 9.4% of all the aggressive cases. There are a total of seven cases where the hedge funds report put option/short selling positions. We believe, however, that this information is likely incomplete given that the disclosure is not mandatory.

Finally, activist hedge funds' investment horizon has been an issue of contention. Critics accuse activist funds of aiming for short-term gains at the expense of long-term shareholder value (Kahan and Rock, 2006). Using information from Schedule 13D/A filing (amendments to Schedule 13D), we are able to look beyond the initial 13D filing to trace out the dates when the hedge fund's stake drops below 5%.³¹ If we treat divesting to below 5% as a proxy for exit, we can get conservative estimates of the investment duration after the filing of the Schedule 13D. Panel C of Table 2 lists the distribution. Because our sample period is so recent, we find that in 86.9% of the cases hedge funds maintain their significant (more than 5%) stakes in the target. For the sub sample where the fund has dropped below the 5% reporting level, the median

²⁸ We exclude from this analysis cases where the primary motive of the hedge funds is to provide financing to the company, mostly for reorganization after financial distress, because these investments are unlikely to be primarily used to exert pressure on target firm management.

²⁹ We are limited here to the holdings that are reported on the Schedule 13D. As Hu and Black (2006) note, not all investments in the target firms are reported on the Schedule 13D. As they discuss in some detail, certain types of derivative investments may not need to be reported publicly.

³⁰ After the initial Schedule 13D filing, the fund is required to file an amendment 13D/A if there is change in the position. The maximum investment is retrieved from one of the 13D/A files that reports the highest holdings by the filing party in the target.

³¹ If the hedge fund's stake falls below 5% after the first Schedule 13D filing, the last Schedule 13D/A would reveal the date, remaining stake, and sometimes sale prices of the transactions that free the hedge fund from future reporting obligations associated with the 5% or more investment.

duration from the first Schedule 13D filing to divestment is 299 days for Non Aggressive events, and 319 days for the sub sample with aggressive activism. These numbers indicate that the investment horizon is not as short as critics of hedge fund activism imply.

IV. Characteristics of Target Companies

The next natural question to ask is: what type of companies do activist hedge funds target? We compare the characteristics of the target firms (during the year before they are targeted) with a set of matching firms, defined as firms from the same SIC 2-digit industry and the same Fama-French 25 size and book-to-market matched portfolios.³²

Table 3 reports the comparison of targeted firms and the matched sample. In Panel A, we focus on the full sample (all 13D filings), while in Panel B we report results for the sub sample of aggressive activism events. The first two columns report the summary statistics of the target companies in terms of sample mean and standard deviation values. The third column reports the average difference between the sample firms and the matching firms. That is, for each firm i , we calculate:

$$Dif_i = X_i - \frac{1}{m} \sum_{j=1}^m X_j,$$

where X is a characteristic variable, and firms $j=1, \dots, m$ are from the same SIC 2-digit industry and the same Fama-French 25 size and book-to-market matched portfolios as firm i . Then reported in columns (3) of Table 3 is $\frac{1}{n} \sum_{i=1}^n Dif_i$, where $i=1, \dots, n$ is index for our sample target firms. Column (4) reports the t-statistics associated with the difference statistics.

Given that the distributions of many of the variables display non-normality and skewness, we supplement the difference statistic with a ranking (percentile) statistic. We first rank a sample firm among all matching firms along the dimension of a characteristics variable, obtain a rank between 0 and 1, and then average over all target firms. The null distribution of the ranking variable is a uniform distribution between 0 and 1, regardless of the distribution of the underlying variables. Therefore, the percentile statistic reported in column (5) of Table 3 should

³² When size (market cap) is concerned, the size matching criterion is dropped. When comparing book-to-market and Q, the book-to-market matching is dropped.

be robust to distributional irregularities. We state that target firms are significantly different from matching firms along the variables of interest if the following two criteria are satisfied: if the difference statistic is significantly different from zero at less than the 5% level; and if the average percentile is at least 5 percentage points away from the neutral value 0.5 (that is, below 0.45 or above 0.55).

Finally, the last five columns list the proportion of the target firms that fall into each of the quintile groups formed by the CRSP/Compustat firms. This sorting is unconditional and is meant to offer an overview of where the target firms populate in the universe of U.S. public firms. Our discussion will focus on Panel A since results from both panels are quite similar.

The summary statistics on market value (MV) indicate that the target firms are under-represented in the top size quintile, but are otherwise roughly equally distributed among the other four quintiles. The biggest firms are less likely to be targeted, perhaps because of the amount of capital needed to amass a meaningful stake. Acquiring 5% of a top size-quintile firm might introduce too much idiosyncratic risk to these hedge funds. We collect fund size information from news articles for about 60% of the sample activist funds. The median size of the hedge funds in our sample is 765 million dollars, and the 25th and 75th percentile values are 350 and 3,785 million dollars. The top quintile CRSP target firms have an average (median) market value of 15.2 (5.7) billion dollars. A 5% stake in the average (median) top quintile target firms implies an investment of 760 (285) million dollars, a considerable amount relative to the size of the typical sample funds.

The valuation variables, Q (defined as $(\text{book value of debt} + \text{market value of equity})/(\text{book value of debt} + \text{book value of equity})$) and book-to-market (BM, defined as $(\text{book value of equity}/\text{market value of equity})$), indicate that the activist hedge funds are “value investors.” The targeted firms are, on average, at the 39th percentile in terms of Q and the 59th in terms of BM among firms in the same industry and of similar market cap size. In fact, in about two-thirds of the cases, the hedge fund explicitly states that it believes the target is undervalued. To the extent that activist hedge funds profit from the improvement of the companies’ operations and strategies, it is also important that hedge funds target companies whose prices have yet to reflect the potential for improvement.

In terms of operational performance, measured by sales growth (Growth) and return on assets (ROA, defined as $\text{EBITDA}/\text{Assets}$), target firms fare no worse than their comparable

firms. In fact, target firms tend to be more profitable, both in terms of return on invested capital, and of the cash flows generated (CF, defined as (net income + depreciation and amortization)/assets). The stock performance of the target firms is roughly at par with that of the comparable firms.

The next group of variables are related to targets' capital structure. Target firms have slightly higher leverage: the average book value debt-to-capital ratio (LEVB) is 0.35, about 0.04 higher than that of the matching firms. And these firms have significantly lower new equity issuance. Target firms' dividend payout is slightly lower relative to peers, measured both by the dividend yield (DIVYLD, defined as (common dividend + preferred dividends)/(market value of common stocks + book value of preferred)) and payout ratio (PAYOUT, defined as the total dividend payments divided by net income before extraordinary items).

On the investment side, target firms spend significantly less than their peers on research and development (RND), but invest slightly more on capital expenditure (CAPX). Target firms also have slightly lower Herfindahl indices (HERF, measured as the Herfindahl index of sales in different business segments as reported by the Compustat); that is, they are more diversified.

Next, we turn to governance characteristics. Measured by the Gompers, Ishii, and Metric governance index (GINDEX), target firms tend to have more takeover defenses. The GINDEX tracks 24 takeover defenses (including state laws) that firms could adopt. In the GIM data set that covers 2,004 firms in 2004, 8.8% of the firms have 13 or more takeover defenses; in our sample of target firms, the same proportion is 14.9%. Targets also have significantly higher institutional ownership of shares: an average of 49.2%, 12.1% higher than comparable firms. The target firms also enjoy higher trading liquidity. The liquidity measure (Liquidity) used here is the square root of the inverse Amihud illiquidity measure, defined as $E\left(0.001\sqrt{p_t \text{vol}_t / |r_t|}\right)$, where p , vol , and r represent daily close price, trading volume, and stock returns, the average is taken over the year. Target firms are on average at the 60th percentile of liquidity among similar size and book-to-market firms in the same industry. Finally, target firms have slightly lower idiosyncratic volatility (IV, measured as in Campbell, Lettau, Malkiel, and Xu (2001), as the monthly average square root of the squared deviations of daily returns from the target's industry daily return.)

In sum, two patterns emerge. First, activist hedge funds resemble value investors. The key characteristics of the target companies in our sample, including valuation, suggest that

activist hedge funds are seeking to identify undervalued companies where the potential for improvement is high. The hedge funds' stated goals, as reflected in their Schedule 13D filings also are consistent with this conclusion. Indeed, even the names of activist hedge funds also suggest that the funds and their investors believe they are value investors. A large fraction of the hedge fund names in our sample include words or phrases that connote value investing, such as "value," "contrarian," "distress," etc.

Second, the potential problems that targeted firms have are general issues (such as governance, payout), rather than firm-specific operational problems. Targeted firms do not seem to suffer from serious operational difficulties. They are actually profitable and enjoy handsome cash flows. The potential problem that these companies face is likely related to the agency problem of free cash flows, such as relatively low payouts, and diversifying investments that may not be in the best interest of shareholders. As shown in Table 1, in 21.2% of the aggressive cases, hedge funds demand higher payouts; 13.5% demand the target assume more debt; 12.2% ask for refocusing of business and attempt to stop diversifying endeavors by management; in 9.0% of the cases funds attempt to stop the target firm from acquisitions. Governance issues, including rescinding takeover defenses, ousting CEOs, promoting board independence and curtailing executive compensation, are also commonly cited as reasons for activism.

These targeting patterns seem sensible given that hedge funds are, in general, not experts in the specific business of their target firms, and that focusing on common issues (such as payouts and governance) helps lower the marginal cost of launching activism on a new company (Black, 1991). The fact that hedge funds tend to avoid high-tech firms (as proxied by *RND*, the ratio of R&D to assets) provides additional support for the pattern discussed above. Kahn and Winton's (1998) theory predicts that investors are more likely to intervene in well-understood firms or industries so that the market can appreciate the effects of intervention. And they should avoid "opaque" and complicated business, such as those involved with high R&D, in order to avoid delays in the resolution (in the market price) of intervention's impact. This prediction is strongly supported by our data.

Finally, an alternative method to analyze the characteristics of the target companies is to run probit-like regressions. Univariate probit analysis (not shown) mostly confirms the results in Table 3. In multivariate analysis where all major variables are included, only *BM* (or *Q*) and *GINDEX* turn out to be significant. The main reason for the low power is the missing values.

Less than a quarter of the target firms have all variables available,³³ which renders the multivariate analysis of low statistical power.

V. Stock Return and Hedge Fund Activism

We analyze abnormal stock returns and hedge fund activism to answer two related questions: First, how profitable is the activist investment strategy for hedge funds (and their investors)? Second, how does the market perceive the effect of hedge fund activism on shareholder value? This is particularly useful given the limitation on ex post performance analysis due to current sample constraints.³⁴

In the return analysis, we adopt both a long window and a short window. Figure 1 plots the average cumulative buy-and-hold return, in excess of the buy-and-hold return on the market, from 25 days before the Schedule 13D file date to 25 days after. The market index that we use is the value weight NYSE/AMEX/NASDAQ index from CRSP. We observe a run-up of about 1.8% abnormal return from 10 days prior to the filing up to the date of the initial Schedule 13D³⁵ and a 2.2% jump in the two following days. The cumulative abnormal buy-and-hold return rises to about 6.5% twenty-five days after the filing.

Figure 2 plots the same return graphs for the sub sample of aggressive activist events where the event date is the first public activism statement by the hedge fund. About 47.7% of all the first activism dates occur within 5 days of the 13D filing, and 63.3% within 25 days. We see that the total abnormal buy-and-hold return is slightly higher at about 7%. Here the run-up before the event date is quite important because in more than half of the cases, the market has already been alerted by the filing of a Schedule 13D to the activist hedge fund's presence and the size of its stake before the first activist event occurs.

Figure 3 shows the cumulative abnormal return on a monthly frequency from 24 months before the event month to 12 months after. The abnormal returns are calculated as the difference between the stock returns of the target company and that of the matching Fama-French 5 x 5 size

³³ Missing values are particularly serious issues for variables from sources other than CRSP/Compustat. For example, only about a quarter of the CRSP/Compustat firms have GINDEX information.

³⁴ At the time of this draft, there is no complete data on operating performance for the year of 2006, one year after our sample period.

³⁵ Note that investors are required to file Schedule 13D no later than 10 days after the transaction that triggers the 5% level.

and book-to-market portfolios. Two patterns are notable. First, there is significant positive return during the event month, 5.3% for the Schedule 13D filing month, and 5.0% for the month of activism. This is consistent with the daily return analysis. Second, the average run-up return is slightly negative for all 13D events, and more so for the activism sub-sample. The companies see, on average, a -6.1% abnormal return (industry, and size and book-to-market adjusted) during the two-year period before they are targeted. Note also that all three figures indicate no reversal of the market response, which rules out the possibility that the positive abnormal return in the event window is driven by the price impact of buying by the hedge funds.

To assess the statistical significance and the distribution of the abnormal returns, Table 4 lists the average abnormal returns of various windows, the associated t-statistics, and the values at different percentiles. The returns are right-skewed, but the positive average abnormal returns are not driven by extreme values. The median abnormal return for the (-20, 20) window is 4.7% around the 13D file date, and 5.7% around the first activism date.

Next, we explore the cross-sectional variation of market responses to shareholder activism. Table 5 reports how the abnormal return in the (-20, 20) window correlates with various characteristics of the events. All regressions control for the size of the target firm (using market cap in logarithm). In all the regressions in Table 5, the independent variables are all dummy variables except firm size. In order to make the interpretation of the coefficients on the dummy variables easier, the size covariate is expressed as deviation from the median, and the intercept of the regression is suppressed. As a result, all the coefficients could be interpreted as the average abnormal return of one particular group of events (as captured by all event observations that assume value one for one dummy variable), assuming that the target firms are of typical size (close to the median size of the sample).

Column (1) shows how event-window abnormal returns vary with the stated goals of the hedge funds. Remember that there are six categories that are not mutually exclusive. The “General” category includes all events where the hedge funds do not specify any specific goal or motive; rather, they state a general goal of improving shareholder value or a general motive that the stock is undervalued. The capital structure category includes activism targeting excess cash, leverage (equity issuance, debt restructuring, and recapitalization) and payouts (dividends and repurchases). The business strategy category includes activism related to diversification, spin-off of assets, and pending merger and acquisition deals. The sale category includes events where

hedge funds request the sales of the target companies, either to the hedge funds, or (in most cases) to a third party. The governance category include events related to rescinding takeover defenses (staggered board and poison pill are the two most common ones), firing CEOs or curtailing executive compensation, changing board composition, and requesting more information disclosure. Finally, the financing category takes all events where the main motive of the hedge funds is to provide financing to the firm, either for business growth or for reorganization of financial distress.

We find that activism that aims to provide finance, or the sale of the target, generates the highest abnormal return, with average abnormal return of 16.8% and 10.4%, respectively. Business strategy related activism also generates a significant abnormal return of 5.9%. A revelation of a hedge fund's intention to intervene without any specific goals generates a return of 5.5%. Surprisingly, activism targeting at capital structure issues and governance issues exhibits near zero abnormal return.

Columns (2) to (4) of Table 5 separate events by the timing strategy that hedge funds adopt. One strategy is for a hedge fund to accumulate stakes and file a Schedule 13D when it explicitly intends to intervene, while the alternative is to accumulate the stake and keep open the option to intervene later. We classify the two strategies by whether the first activist event happens within 20 days of the 13D filings. The file-and-intervene strategy sees slightly higher market response than the file-and-wait-to-interview strategy (7.9% vs. 6.8%). Similarly, we track down the 1st quarter-end holding date of the hedge funds in the target companies using 13F filings of the funds from Thomson Financial, and separate the sample by whether the hedge fund had disclosed holdings in the company at least six months before the 13D filings. Not surprisingly, activism by funds that have already invested in the target companies for a while generate lower returns, presumably because the information of potential hedge fund intervention was already partially disseminated through the 13F filings.

Finally, column (4) shows that *ex post* confrontational events generate higher return than relatively friendly ones. We define an event as being "hostile" if the hedge funds use at least one of the following: proxy contest, law suits, hostile takeover bid, threat to launch proxy fight or to sue, or public campaign to replace the management. The market responds more strongly to hostile events than to friendly ones. Given that hostile activism is more costly, hedge funds

should only resort to it when the perceived benefits (improvement of the firms) are higher. It is consistent with the perception of the market as manifest in the return responses.

VI. Conclusion

This paper is the first to examine hedge fund activism using a large-scale sample based on a reliably complete database. Although hedge funds are largely unregulated and generally do not make public filings with the Securities and Exchange Commission, those activist hedge funds that accumulate 5% equity ownership stakes in U.S. companies must file Schedule 13Ds describing their ownership interests. By hand collecting data from these filings and other public reports, we generate a database that is free of many of the biases present in other hedge fund sources.

Analysis of these Schedule 13Ds, and other public information, show that activist hedge funds resemble value investors and that hedge fund activism generates positive abnormal returns. The funds in our sample identify undervalued targets, and the market reacts positively to the announcement of their activism. Even as of this early date, the funds have achieved their announced objectives in roughly half of the cases in our sample. In addition, preliminary data suggest the funds have not exhibited a short-term bias.

Finally, the abnormal returns generated by activist hedge funds are not due to changes in capital structure or governance, as some media reports and commentators have suggested. Instead, the highest abnormal returns occur when activism targets the sale of the company or changes in business strategy.

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Table 1. Summary of Activist Events by Stated Goals of the Hedge Funds

Columns (1) and (2) report the percentage of cases in each category among all “Non Aggressive” or “Aggressive” types of intervention (percentages sum up to more than 100% since one event can have multiple missions). Columns (3) and (4) track the success rate (from the perspective of the hedge funds) of activism in each category.

	(1) % of all Non Aggressive Events	(2) % of all Aggressive Events	(3) % Successful	(4) % Partially Successful
General statement of undervaluation/maximize shareholder value/inefficient management	60.1%	33.3%	--	--
<u>Capital Structure</u>				
Excess Cash, under-leverage, more dividends, more repurchases	4.8%	21.2%	28.57%	7.14%
Equity issuance; restructure debt	1.2%	13.5%	30.43%	13.04%
<u>Business Strategy</u>				
Investment: lack of business focus/excess diversification/business restructuring including spinning off	1.2%	12.2%	28.57%	9.52%
M&A: as target	3.0%	16.0%	43.33%	23.33%
M&A: as acquirer	0.0%	9.0%	35.71%	7.14%
Tax: tax efficient transaction	0.6%	1.9%	25.00%	0.00%
<u>Sale of the Target Company</u>				
Sell company or main assets to a third party	3.6%	23.1%	26.19%	11.90%
Take control/Buyout company and/or take it private	1.2%	16.7%	35.71%	17.86%
<u>Governance</u>				
Rescind takeover defenses	2.4%	14.7%	22.22%	11.11%
Oust CEO, chairman	0.0%	12.8%	60.00%	5.00%
Board independence and Fair Representation	3.6%	17.3%	27.27%	6.06%
More information disclosure/potential fraud	1.8%	6.4%	53.85%	7.69%
Excess executive compensation/pay for performance	1.8%	11.5%	19.05%	19.05%
<u>Financing/Turnaround</u>				
Provide financing for business growth	10.7%	2.6%	60.00%	4.00%
Bankruptcy reorganization	11.3%	1.9%	81.82%	0.00%
Total # Events	218	156	--	--

Table 2. Patterns of Activist Investment by Hedge Funds

Panel A provides the size of the stakes (both in terms of dollar values, and as percentage of the outstanding shares of the targets) that hedge funds have in the targets. In the “Initial Filing” columns, we report the stakes that hedge funds take at their initial 13D filings. The “Max. Ownership” columns report the maximum reported stakes that the funds accumulated in the targets. Panel B provides derivatives positions by the hedge funds in the target companies. Panel C provides the length of time between the first 13D filing and the launch of activism (applies only to “Aggressive” events) or the date when the ownership falls below 5%.

Panel A:

Percentile	Non-Aggressive				Aggressive			
	Initial Filing		Max. Ownership		Initial Filing		Max. Ownership	
	% Own	\$ Mil.	% Own	\$ Mil.	% Own	\$ Mil.	% Own	\$ Mil.
5%	5.00%	0.6	5.10%	0.672	5.00%	1.471	5.18%	2.271
25%	5.30%	3.093	6.28%	3.801	5.60%	6.478	7.70%	9.244
50%	5.75%	9.05	9.05%	13.821	6.60%	15.098	9.90%	23.882
75%	7.70%	29.801	12.43%	40.709	8.80%	52.352	14.90%	84.037
95%	15.87%	174.306	28.70%	222.29	20.22%	315.892	39.60%	391.678

Panel B:

	None	Convertible Debt	Equity Swap	Option/Warrants	Convert. Preferred
Non-Aggressive	90.07%	1.53%	0%	3.05%	0.76%
Aggressive	81.20%	2.68%	2.01%	9.40%	2.68%

Panel C:

Percentile	Non-Aggressive		Aggressive	
	Days from 13D to Below 5%	Days from 13D to Action	Days from 13D to Below 5%	Days from 13D to Below 5%
Not yet happened	86.90%	--	83.30%	
5%	17	-12	8	
25%	136	0	133	
50%	299	0	319	
75%	831	55	501	
95%	1234	413	1142	

Table 3. Characteristics of Target Companies

The first two columns report the mean and standard deviation values of the target companies. The third column reports the average difference between the sample firms and the matching firms (from the same SIC two-digit industry and the same Fama-French 5x5 size and book-to-market portfolio). Column (4) reports the t-statistics associated with the difference statistics. Column (5) reports the average percentile ranking of the sample firms among the matching firms (from 0 to 1). The last five columns list the proportion of the target firms that fall into each of the quintile groups formed by the CRSP/Compustat firms. All variables are retrieved from the year before the event year. MV is market capitalization in millions of dollars; SALES is annual sales in millions of dollars; Q is defined as (book value of debt + market value of equity)/(book value of debt + book value of equity); BM is the market to book ratio defined as (book value of equity/market value of equity); GROWTH is the growth rate of sales over the previous year; ROA is return on assets, defined as EBITDA/assets (lag); CF is cash flow, defined as (net income + depreciation and amortization)/assets (lag); STKRET is the stock return during the year; LEVB is the book leverage ratio defined as debt/(debt + book value of equity); LEVM is the market leverage ratio defined as debt/(debt + market value of equity); Cash is defined as (cash + cash equivalent)/assets; NEWEQ is the amount of new equity issuance during the year scaled by lag assets; DIVYLD is dividend yield, defined as (common dividend + preferred dividends)/(market value of common stocks + book value of preferred); PAYOUT is the payout ratio, defined as the total dividend payments divided by net income before extraordinary items; RND and CAPX are R&D and capital expenditure scaled by lag assets; HERF, is the Herfindahl index of sales in different business segments as reported by the Compustat; GINDEX is the Gompers, Ishii, and Metric (2003) governance index where high index values represent less shareholder rights and more management entrenchment; INST is the proportion of shares held by institutions; LIQUIDITY is the square root of the inverse Amihud illiquidity measure, defined as $E\left(0.001\sqrt{p_t \text{vol}_t / |r_t|}\right)$, where p , vol , and r represent daily close price, trading volume, and stock returns, the average is taken over the year; finally IV is idiosyncratic volatility as defined in Campbell, Lettau, Malkiel, and Xu (2001). Panel A provides summary statistics based on all Schedule 13D target firms while in Panel B we report on the sub-sample of firms target by aggressive activism.

Panel A:

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
	Sample Mean	Std Dev	Dif w/ Match Firm	t-stat of Dif	Avg Percentile	% in Q1	% in Q2	% in Q3	% in Q4	% in Q5
MV	918	2096	-628	-5.28	0.51	0.22	0.23	0.22	0.20	0.13
SALES	1008	2303	89	1.14	0.63	0.10	0.20	0.28	0.29	0.14
Q	1.629	1.128	-0.531	-8.30	0.39	0.31	0.24	0.17	0.18	0.10
BM	0.739	0.601	0.148	4.90	0.59	0.14	0.16	0.17	0.19	0.33
GROWTH	0.081	0.264	-0.018	-1.20	0.49	0.21	0.25	0.22	0.20	0.12
ROA	0.093	0.142	0.048	5.83	0.60	0.16	0.15	0.24	0.24	0.21
CF	0.040	0.151	0.035	3.89	0.55	0.18	0.16	0.24	0.22	0.20
STKRET	0.003	0.050	-0.003	-0.89	0.49	0.28	0.21	0.15	0.18	0.18
LEVB	0.353	0.301	0.039	2.47	0.53	0.20	0.17	0.19	0.23	0.20
LEVM	0.282	0.272	0.037	2.65	0.53	0.20	0.15	0.19	0.19	0.27

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
	Sample Mean	Std Dev	Dif w/ Match Firm	t-stat of Dif	Avg Percentile	% in Q1	% in Q2	% in Q3	% in Q4	% in Q5
CASH	0.168	0.195	-0.037	-3.65	0.48	0.17	0.21	0.23	0.24	0.15
NEWEQ	0.036	0.125	-0.060	-7.41	0.45	0.27	0.20	0.23	0.17	0.13
DIVYLD	0.007	0.015	-0.004	-4.46	0.46	0.65		0.05	0.17	0.14
PAYOUT	0.149	0.293	-0.079	-4.32	0.47	0.65		0.09	0.17	0.10
CAPX	0.049	0.057	0.006	1.70	0.55	0.14	0.25	0.24	0.16	0.21
RND	0.060	0.093	-0.029	-3.99	0.39	0.33	0.23	0.14	0.17	0.13
ACQUISITION	0.022	0.061	-0.001	-0.30	0.51		0.66		0.13	0.21
HERF	0.787	0.252	-0.033	-2.26	0.47	0.23	0.24		0.53	
GINDEX	9.365	2.558	0.707	3.38	0.57	0.25	0.16	0.24	0.12	0.23
INST	0.492	0.281	0.122	8.04	0.64	0.08	0.18	0.23	0.24	0.27
LIQUIDITY	17.790	22.582	2.189	4.32	0.60	0.17	0.20	0.25	0.22	0.16
IV	0.147	0.084	-0.014	-3.41	0.46	0.14	0.23	0.25	0.22	0.15

Panel B:

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
	Sample Mean	Std Dev	Dif w/ Match Firm	t-stat of Dif	Avg Percentile	% in Q1	% in Q2	% in Q3	% in Q4	% in Q5
MV	1189	2572	-353	-1.70	0.56	0.15	0.23	0.27	0.18	0.17
Sales	1260	2417	110	0.76	0.66	0.10	0.13	0.27	0.28	0.22
Growth	0.091	0.235	-0.007	-0.32	0.52	0.18	0.21	0.24	0.24	0.13
ROA	0.089	0.136	0.044	3.87	0.60	0.16	0.14	0.30	0.19	0.22
Q	1.574	0.942	-0.634	-7.29	0.38	0.29	0.26	0.27	0.07	0.11
BM	0.702	0.567	0.139	3.09	0.60	0.16	0.13	0.16	0.24	0.30
LEVB	0.360	0.293	0.040	1.70	0.54	0.17	0.19	0.21	0.28	0.17
LEVME	0.279	0.253	0.038	1.89	0.55	0.15	0.15	0.20	0.25	0.25
CASH	0.152	0.188	-0.056	-3.87	0.46	0.18	0.23	0.27	0.19	0.13
NEWEQ	0.038	0.149	-0.059	-4.44	0.45	0.28	0.21	0.23	0.18	0.10
DIVYLD	0.008	0.014	-0.003	-3.26	0.49	0.57		0.08	0.18	0.16
PAYOUT	0.202	0.326	-0.045	-1.43	0.51	0.55		0.10	0.21	0.14
CAPX	0.049	0.060	0.005	0.93	0.54	0.14	0.22	0.28	0.17	0.18
RND	0.056	0.098	-0.028	-2.59	0.36	0.36	0.26	0.14	0.10	0.14
ACQUISITION	0.022	0.055	-0.002	-0.34	0.51		0.62		0.15	0.23
CF	0.034	0.137	0.030	2.44	0.53	0.19	0.16	0.30	0.21	0.14
HERF	0.764	0.258	-0.054	-2.47	0.44	0.27	0.26		0.47	
GINDEX	9.740	2.609	0.948	3.20	0.60	0.22	0.10	0.29	0.14	0.26
LIQUIDITY	21.212	25.842	3.742	4.57	0.66	0.11	0.17	0.30	0.24	0.19
STKRET	0.001	0.044	-0.004	-1.18	0.46	0.33	0.19	0.16	0.17	0.16
INST	0.535	0.275	0.158	6.95	0.67	0.06	0.13	0.21	0.26	0.33
IV	0.128	0.063	-0.026	-5.16	0.43	0.18	0.21	0.29	0.24	0.08

Table 4. Distribution of Abnormal Returns

This table reports the average abnormal returns for various event windows, the t-statistics associated with the average values, and the abnormal returns at the 5th, 25th, 50th, 75th, and 95th percentiles. Panel A covers all Schedule 13D filing events; and Panel B covers the sub-sample of aggressive activism.

Panel A: All Schedule 13D Filing Sample Centered on the Filing Date

	Average Abnormal Return	t-stat	5%	25%	50%	75%	95%
(-20,20)	0.068	5.822	-0.199	-0.053	0.047	0.172	0.405
(-10,10)	0.060	6.238	-0.183	-0.019	0.048	0.132	0.362
(0,2)	0.023	5.663	-0.062	-0.006	0.012	0.041	0.148
(0,10)	0.042	6.577	-0.115	-0.009	0.036	0.085	0.223
(0,20)	0.048	5.509	-0.133	-0.027	0.038	0.101	0.290

Panel B: Aggressive Activism Sample Centered on the First Activism Date

	Average Abnormal Return	t-stat	5%	25%	50%	75%	95%
(-20,20)	0.068	3.772	-0.196	-0.037	0.057	0.165	0.398
(-10,10)	0.063	3.849	-0.164	-0.020	0.053	0.130	0.299
(0,2)	0.028	4.590	-0.047	-0.007	0.016	0.056	0.142
(0,10)	0.049	4.601	-0.112	-0.013	0.033	0.100	0.223
(0,20)	0.049	3.497	-0.116	-0.029	0.028	0.099	0.290

Table 5. Relation between Abnormal Return and Type of Activism

Column (1) shows how event-window abnormal returns vary with the stated goals of the hedge funds. Here there are six categories that are not mutually exclusive. The “General” category includes all events where the hedge funds do not specify any specific goal or motive. The capital structure category includes activism targeting excess cash, leverage (equity issuance, debt restructuring, and recapitalization), pay outs (dividends and repurchases). The business strategy category includes activism on diversification, spinning off of assets, and pending merger and acquisition deals. The sale category includes events where hedge funds request the sales of the target companies, either to the hedge funds, or (in most cases) to a third party. The governance category include events related to rescinding takeover defenses, firing CEOs or curtailing executive compensation, changing board composition, and requesting more information disclosure. Finally, the financing category takes all events where the main motive of the hedge funds is to provide financing to the firm, either for business growth or for reorganization due to financial distress. Column (2) classifies all events by whether aggressive activism was launched within 20 days of Schedule 13D filings; Column (3) classifies all events by whether the hedge fund had invested in the company for at least six months (using information from the 13F filings); Column (4) classifies all events by whether they are “hostile,” where the hedge funds use at least one of the following: proxy contest, law suits, hostile takeover bid, threat to launch proxy fight or to sue, and public campaign to replace the management. All regressions control for the size of the target firms (log market capitalization, expressed as the deviation from the median firm size in the sample).

	(1)		(2)		(3)		(4)	
	coef	t-statistic	coef	t-statistic	coef	t-statistic	Coef	t-statistic
ln(MV)	-0.003	-0.230	-0.008	-0.740	-0.006	-0.583	-0.009	-0.780
General	0.055	3.764	--	--	--	--	--	--
CapStructure	0.000	0.001	--	--	--	--	--	--
BusStrategy	0.059	2.567	--	--	--	--	--	--
Exit	0.104	4.865	--	--	--	--	--	--
Gov	-0.005	-0.296	--	--	--	--	--	--
Financing	0.168	2.592	--	--	--	--	--	--
Act<20Days	--	--	0.079	3.083	--	--	--	--
Act>20days	--	--	0.068	5.615	--	--	--	--
Hlding > 6M	--	--	--	--	0.037	1.987	--	--
Hlding < 6M	--	--	--	--	0.077	6.066	--	--
Hostile	--	--	--	--	--	--	0.090	6.728
Friendly	--	--	--	--	--	--	0.056	4.264
R-squared	0.063		0.003		0.010		0.018	

Figure 1. Abnormal Buy-and-Hold Return around Schedule 13D Filing

This figure plots the average cumulative buy-and-hold return, in excess of the buy-and-hold return of the market, from 25 days prior the 13D file date to 25 days afterwards.

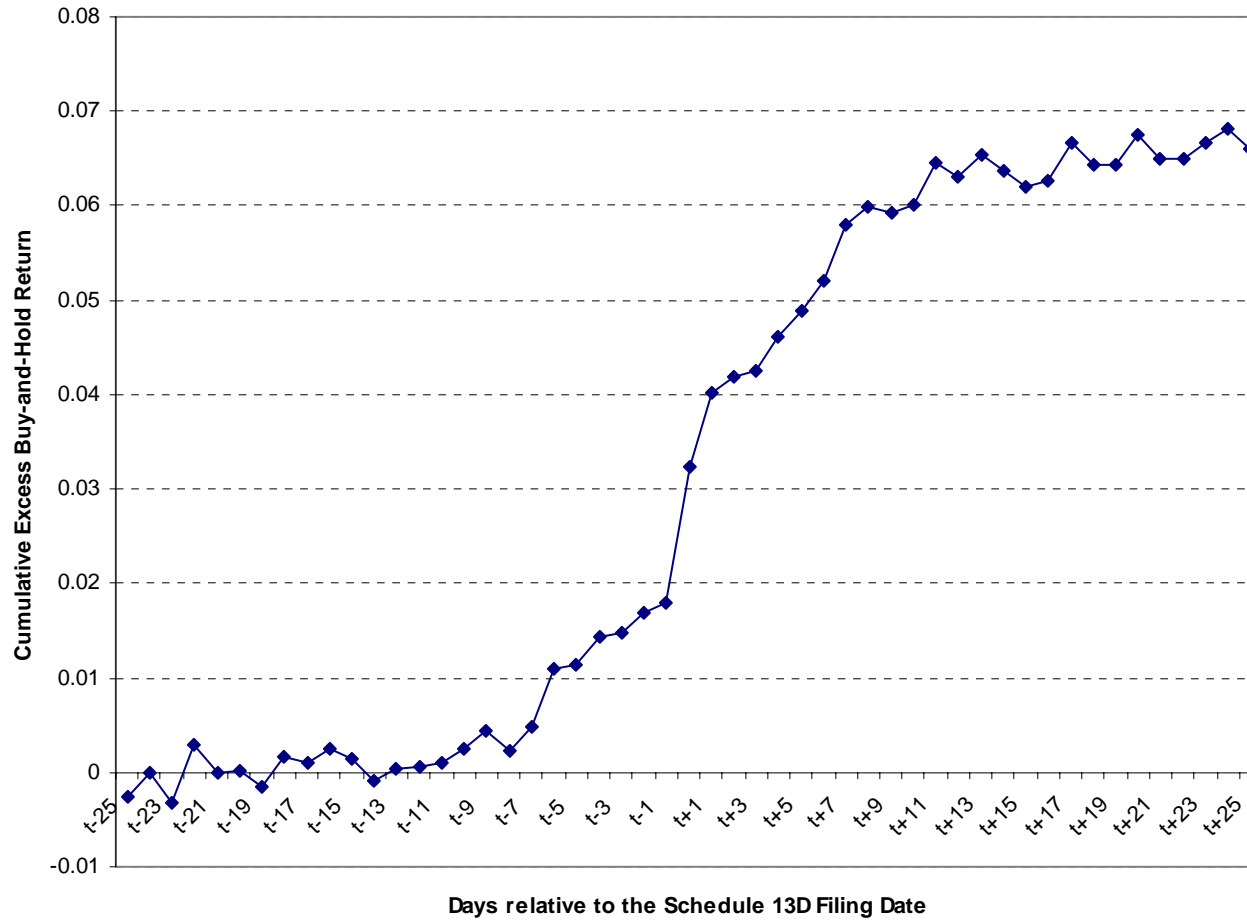


Figure 2. Abnormal Buy-and-Hold Return around the First Activism Date

This figure plots the average cumulative buy-and-hold return, in excess of the buy-and-hold return of the market, from 25 days prior the announcement date of aggressive activism to 25 days afterwards.

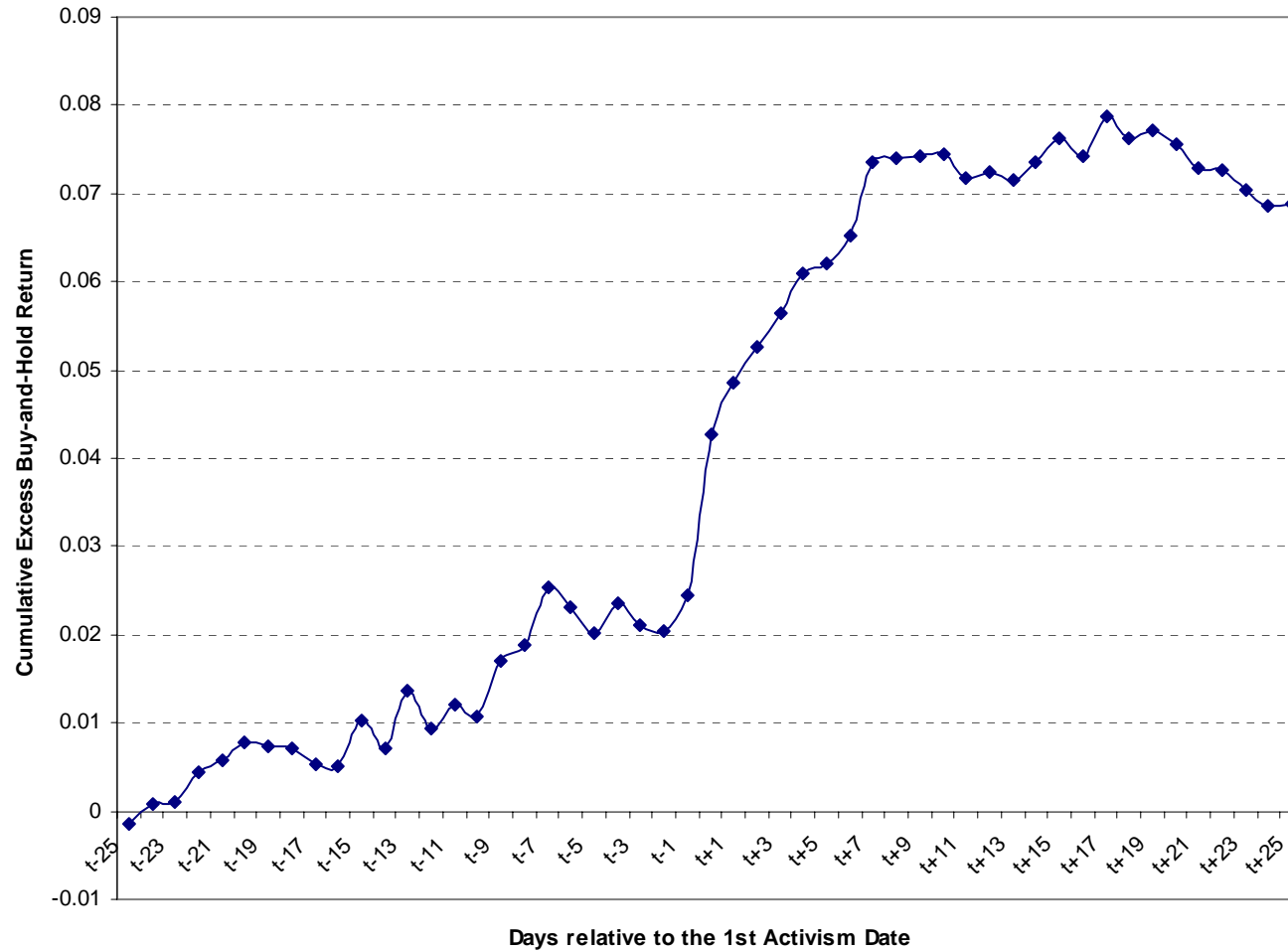


Figure 3. Monthly Cumulative Abnormal Returns

This figure plots the average cumulative abnormal returns, adjusted for returns of the matching Fama-French 5 x 5 size and book-to-market portfolios, from 24 months prior the event to 12 months afterwards.

