MARKETS

Shareholder Activism: Declining or Morphing?

A Fundamental Shift is Underway Between Corporations and Shareholders

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After several years of unprecedented growth, both in the number of players and in assets under management, activists appear to be heading towards yet another down cycle. A number of factors are contributing to this including some high profile failures, an overall decline in performance and most importantly, the beginnings of a fundamental shift in the relationship between corporations and their shareholders. Is this a temporary phenomenon or should investors begin to look elsewhere for outsized returns?

Why is there Shareholder Activism?

In order to fully understand the current predicament of the modern day shareholder activist, one needs to look back at what caused them to exist in the first place.

Alpha, that nebulous thing that hedge fund managers are always talking about, is the root cause. Alpha is basically the return above the benchmark market return. Most people use the S&P index to define the market so if the S&P is up 10% and your hedge fund is up 15% then that fund generated 5% of alpha. If a fund has an "event-driven" strategy, it generates alpha by being able to pick stocks that will experience some type of event, like being acquired, that will cause the share price to increase disproportionately to the market. Funds with an activism focus are a variation of an event-driven fund because these funds look to actively cause the event rather than just hope

for one to occur. Many activists will claim that they are advocating for shareholders by pushing for actions that will "maximize long-term value" but more often than not, this is not really the case.*

***THE VALUE CREATION MYTH (IN 300 WORDS OR LESS):**

The value of a company is the sum of the cash it generates each year in the future, discounted to the present. To maximize value, the company must do things that maximize those future cash flows. A company's management decides each year how much of the cash it generates needs to be reinvested in the business (in the form of capex, R&D, acquisitions, etc.) in order to maximize those future cash flows and how much of that cash is truly excess and can therefore be paid to shareholders in the form of dividends or share repurchases. Some of the cash that is reinvested in the business is not invested immediately but is instead set aside for reinvestment at a future time. When an activist comes in and says that using that cash to instead buy back more shares will create value, a red flag should go up. The only way to create value is to do things that increase future cash flows. Buying back shares does not increase future cash flows. To simplify even further, here is an extreme example. Say you and your friend own a company. The company uses all of its cash to buy out your friend's shares and then retires them. The value of the company hasn't changed, but now you own the whole thing instead of only half of it. In the short term, you may think that your wealth just doubled but now the company has no cash to invest in order to grow future cash flows so the value of your shares will likely go down in the long term. Some activists admit to this:

"Simply calling for a company to buy back shares is not a plan… That does not create value." – Jeffrey Smith, Starboard Value

Others do not:
"We believe if [Goodyear] targets this magnitude of capital return, it would create significant shareholder value, and we would not be surprised to see the share price increase by as much as 50%-100% as a result," - Richard "Mick" McGuire, Marcato Capital Management, in a letter to Goodyear's Board suggesting among other things that the company repurchase significantly more shares than its current plan.

Now this isn't to say that repurchasing shares is a bad thing. When a company believes that the return it can generate on a portion of its cash from purchasing its own shares will exceed the return it would generate from deploying it elsewhere then it makes perfect sense to repurchase shares or pay dividends. The management team is in a better position than most to evaluate how much of its cash it should use for this purpose. They are certainly in a better position than someone who bought into the shares within the past three months.

In the past, activists created alpha by getting companies to do things to make the share price increase but how did the activist get the company to do what it was demanding? Why would major shareholders that have owned the stock forever support the agenda of someone that just bought into the stock? The answer is simple: the activist exploited the suboptimal relationship the company had with its shareholders.

According to information gathered from Standard & Poor's Capital IQ, institutional investors own 76% of the market cap of all companies in the S&P 500. Furthermore, the top ten of these investors alone own nearly 30% of the S&P 500's market cap. Actually, it is important to note that they don't really own anything; they are acting as agents for all the people in the world that put their money into pension funds, retirement plans, 401K's, and other investment vehicles. Since these institutions are often structuring funds to mirror certain indexes (Exchange Traded Funds, or ETFs), they need to invest in nearly every stock and have little leeway to decide to exit or reduce their holding

in any specific stock. Because of the limited amount of active management necessary, these institutions are paid an extremely thin margin (a few basis points) to fund their operating costs and make a profit. This is in contrast to hedge funds which typically take larger, more concentrated bets within their portfolio and are paid the standard (or at least was standard) "two and twenty"* to fund their costs, which include very large houses and private planes.

Given the sheer number of companies in which these institutional investors must invest and the thin margin they receive for managing this money, it is nearly impossible for these firms to closely monitor each and every company in terms of governance, capital allocation decisions and management performance. In earlier days, these large investors would only get involved if a company was noticeably deficient in how it was managing and governing itself. And the management and boards of these companies were not proactively engaging with these investors to give them comfort that their investments were sound and returns were being maximized. This disconnect created the opening for activism. How could large shareholders resist when a very well-spoken and erudite Bill Ackman gets up on stage and walks the audience through an extremely thorough 200 page corporate dissection based on months of research that provides more insight about the company (both positive and negative, but mostly negative) than these shareholders have ever heard before? It is easy to see how in that environment, someone like this could earn the respect of these large managers of funds and convince them to defer to his agenda given the appearance that he is more on top of the issues of the company than are its management team and board members. Since the large institutions control such a significant percentage of most companies, an activist that has their respect can make a difference without having to buy a significant ownership percentage (e.g. ValueAct gained a seat on the board of Microsoft with only a 0.8% ownership stake).

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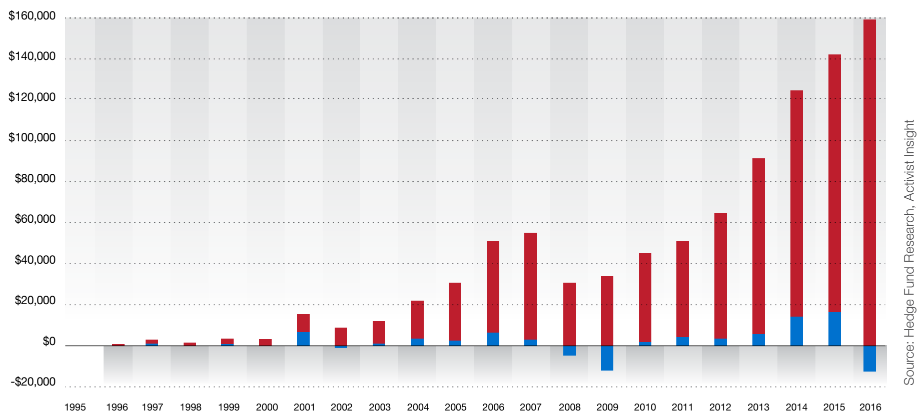
*Two percent of assets under management (regardless\ with no clawback if what went up in value goes down in value).

In What Environment do Activists Thrive?

In order to drive events and generate alpha from them, the right environment must exist. For example, in 2000, hedge funds engaging in activism were managing only $2.7 billion in assets worldwide but following the dotcom crash and subsequent scandals at companies like Enron, Tyco and WorldCom, an abundance of companies were trading at prices well below peak levels.

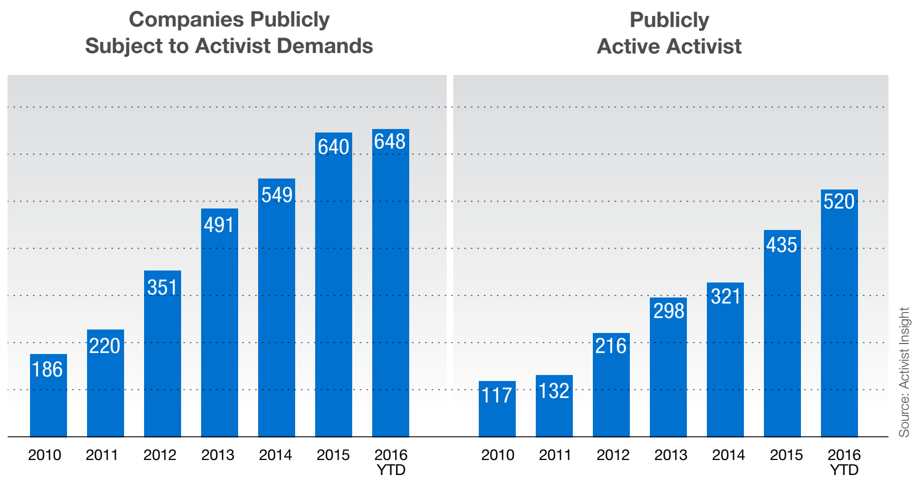


Even as prices rebounded, activists were increasingly able to identify undervalued companies. As corporate earnings grew, cautious executives accumulated cash rather than investing it back in their businesses or returning it to shareholders. Meanwhile, interest rates remained low into the mid 2000's making debt very cheap. The combination of high cash balances and cheap debt created an opening for activists to push for cash payouts and/or M&A.

The corporate scandals also brought attention to corporate governance and management accountability, which gave rise to government legislation in the form of Sarbanes-Oxley and the UK Corporate Governance Code. This marked the beginning of the period when the interests of activists, particularly on governance-related matters, increasingly aligned with the interests of institutional shareholders. Additionally, influential proxy services in the US such as Institutional Shareholder Services (ISS) began to show growing sup-

port for activist proposals. The combination of conservative capital management by executives, favorable debt markets and heightened focus on corporate governance resulted in a spike in activist AUM to over $60 billion by 2007 as activist returns outpaced other hedge fund strategies and market indices.

Then came the financial crisis. This time, activist funds outpaced their hedge fund buddies in a different category: losses and liquidations. Investors withdrew more from activist funds during 2008 and 2009 than they had invested during the previous four years[1]. Activist fund investments fared worse than other funds for several reasons but mainly because: 1) activists take large bets in a few companies and therefore lack diversification, 2) during this period, activists primarily invested in small and mid-cap companies which are more severely impacted in troubled times, and 3) their returns depended heavily on events like share repurchases, asset sales or spin-offs that relied on cooperation from the capital markets. Additionally, during this period when all companies had fallen victim to the macro-economy and had questionable growth prospects, it was difficult for an activist to make a case to shareholders that its ideas were better than those of current management.



[1]Source: Hedge Fund Research

The recovery following 2009 and continuing today, however, resulted in a resurgence in activist investment far exceeding the previous boom and activist returns far exceeding the market and other hedge fund strategies.

The same attributes that led to opportunities in 2001 resurfaced again but at a heightened level – disproportionate levels of cash, low leverage and reduced shareholder payouts, severe lowering of interest rates, reopening of the M&A markets, etc. And like the first time, the crisis resulted in a renewed wave of corporate governance agendas and the introduction of legislative and policy changes that encouraged shareholder engagement, including “Say on Pay” in the US and the UK Stewardship Code. As the economy surged upwards and all boats (companies) began to rise, it became elementary to spot those companies that were not rising as quickly as the others.

The institutional credibility garnered by the top activists, together with the post crisis factors mentioned earlier (high cash balances, cheap debt, M&A appetite, governance gaps, etc.), has led to an extremely high success rate for activists. Over 60% of activist demands which have been resolved (many still ongoing) have at least partially been satisfied in 2016, which is slightly up from the 59.8% of demands that were at least partially successful in 2015*. A total of 640 companies worldwide were subjected to activist demands in 2015, up 16.5% from the prior year. So far in 2016 we have already seen 542 companies subjected to at least one activist demand, on pace to surpass the 2015 total by 27%[2]. Not captured is the claim by many activist investors that less than half of activist campaigns ever become public knowledge.

Has Alpha Left the Building?

The funny thing about alpha is that it has a limited life. Any hedge fund manager will tell you that market forces eventually attack and diminish the outsized returns generated by any particular strategy (and activism is a strategy,

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*It’s important to note that “success” here means the activist got its way; it does not mean that the activist succeeded in generating alpha from it.

[2]Source: Activist Insight

not an "asset class"; a common misnomer). In the case of activist funds, that alpha is being attacked from many angles as we speak and it is beginning to show in their results and in the money flowing in and out of them.

Hedge Fund Research's Activist Index has underperformed the S&P 500 each year since the start of 2013. Since a five year peak return performance of 20.9% in 2013 (the S&P 500 returned 15.9%), the index's absolute return has further decreased each year including a 1.6% year-to-date return in 2016 (compared to a positive 7.2% return by the S&P 500). Similarly, Activist Insight's index of activist funds has trailed the S&P 500 in five of the last eight years.

And if it begins to look like the alpha is gone (or even worse, negative), investors in these funds will vote with their feet. We have already begun to see signs of this. In the first quarter of 2016, investors pulled $4.3 billion from activist funds[3], a shift from the record $14 billion they added in the full year of 2015. Similarly, the total amount invested in the broader hedge fund market fell to $2.86 trillion (from just over $3 trillion) in the first quarter, marking the first time since 2009 that the sector has faced two consecutive quarters of net outflows, according to Hedge Fund Research.

What's Behind the Numbers?

Companies are No Longer as Flat-Footed

Management teams and boards are becoming aware of the risk of activism and many are taking steps to preempt possible areas of attack. With the proper guidance and initiative, management teams can predict where their companies may be vulnerable to activist attack (peer comparisons of total shareholder return, valuation multiples and operating metrics, board composition, etc.). With such preparation, management teams are either taking strategic steps to address them (like repurchasing shares, selling or spinning off undervalued businesses, cutting costs, refreshing the board, etc.) or creating cogent arguments as to why such activist

[3]Source: Hedge Fund Research

suggested actions are not value-enhancing in the long-term. In fact, companies in the S&P 500 spent $166.3 billion on share buybacks during the first quarter of 2016[4], which marked a new post-recession high. They are also becoming more proactive in explaining and justifying their strategy to shareholders so that when or if an activist buys a stake and pushes an agenda, large shareholders will be less inclined to side with the activist because of the dialogue and trust they have established with management and/or directors.

The Low Hanging Fruit has Been Picked

With the proliferation of share repurchases, that demand is no longer a quick hit for activists like it was in the past. As seen below, so far in 2016, balance sheet demands (primarily repurchasing shares and paying one-time dividends) have declined significantly as a percentage of overall activist demands. A notable increase in demands for changes in business strategy (including cutting costs and achieving operational efficiencies) has replaced the reduction in balance sheet demands. This is an important fact because business strategy improvements take an extended period of time to fully realize, unlike an asset sale or a share repurchase, and the resulting impact on the share price is not a given. The feasibility of such business strategy improvements requires a higher level of knowledge of the inner workings of the company to measure than the activist likely possesses, which adds to the risk of a misinformed and ineffective attack (which is PR the activist does not need).

Additionally, M&A requests (mostly for business separations) continue to remain a significant portion of overall attacks which also adds to the uncertainty of returns. Without insider knowledge of the tax basis on the targeted business, along with other friction costs that are unknown to the activist, there is risk that the upside the activist is chasing from such a transaction is not possible to obtain.

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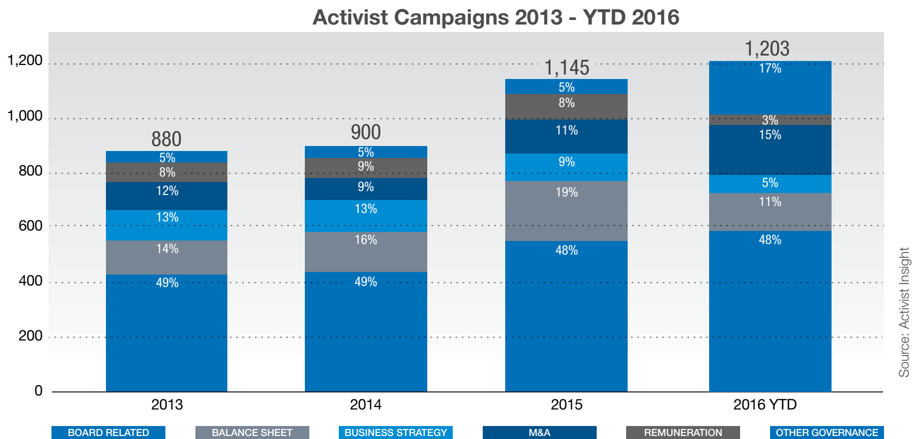
[4]Source: FactSet

Lastly, demanding board seats remains the favored strategy for activists, making up about 50% of all attacks so far this year and in prior years. Gaining board representation allows activists to show to their investors that they are in fact “actively involved” (See Check the Box Activism below) and also gives the activist a platform to demand other actions like increased share repurchases and M&A. There have been several research papers written by various Ivy League academics that attempt to prove whether having an activist on the board of a company is good or bad for the long term value of the company. However, none of them are conclusive either way. The problem is the fact that the data is far too squirrely. The most frequently mentioned study for example (The Long Term Effects of Hedge Fund Activism by Harvard professor Lucian Bebchuk) has been widely refuted for many reasons, including that: 1) the data used is from 1994-2007 even though 60% of all attacks have happened since then, 2) the data uses all 13-D filings which may or may not involve actual activist activity, 3) the results look at the companies over a 5 year period and begin with 1,584 companies and end with 694 companies (because of mergers, bankruptcies, etc.), so in essence it is drawing conclusions on the whole apple by looking at what happened to one-third of the apple, 4) both metrics used, ROA and Tobin’s Q score, use book value as the denominator, so if a company for example writes off goodwill at some point, the metric will shoot up even if performance did not change, and 5) the study claims that the findings are “statistically significant” (meaning greater than zero) even though they are infinitesimally small and should not be used from which to draw any conclusions.



Gravity

Like in 2001 and in 2008, there is an eventual end to every bull market run. As mentioned earlier, activists have tended to generate alpha as both the tides and boats were rising and tended to heavily underperform the market when those boats leveled off or started to sink. The bursting of bubbles triggered the end of the previous two bull runs and there has been endless debate as to whether we are currently in a bubble (perhaps a free money bubble) and if so, whether there are signs that it is ending. Regardless, the run-up this time looks to be twice the height of the previous two so a feeling of “something’s gotta give” may not be unwarranted. And as the S&P levels off, activist fund returns are showing signs of heading south as it becomes harder to pick winners, repeating the history of the past two cycles.

Sudden Extreme Fallibility

With so many new players in the activist space, it is unfair to use an activist index to measure the viability of the strategy because the great performance of the powerful marquee players gets diluted by a bunch of amateurs, right? Wrong. While it is true that there is plenty of second-string activism happening today, like demanding that a company sell itself when there are no willing buyers, even the most revered of activists are proving to be fallible, and in a

big way (think Valeant, Qualcomm and Hertz). In fact, if someone had set up a fund one year ago beginning on 6/30/15 with the sole strategy of picking the opposite side of the investments made by Pershing Square, ValueAct, and Icahn, the collective portfolio would have generated a return of nearly 37%*.

Armchair quarterbacking aside, what is clear is that the activist playbook is not a formula for success, especially in turbulent markets. And as increasing levels of capital flow into these funds, activists need to take larger bets in larger companies where it is more difficult to make change that has a significant impact on share price and where picking the wrong company can have a devastating impact on total returns.

Taking a look at fourteen of the top activist funds (below), whose activist investments combined make up 38% of all activist investments outstanding[5], one can see that losers outweigh winners on a 3 to 2 basis. And in some cases, like Icahn, nearly all investments are lagging the S&P. When institutional investors are considering supporting a well-known activist's agenda, they should think long and hard about what they are signing up for.

Top 14 Activist Funds Performance Against the S&P

	OUTPERFORMING S&P	UNDERPERFORMING S&P
JANA Partners	4	4
ValueAct	7	7
Trian	4	3
Third Point	20	22
Starboard Value	9	9
Pershing Square	6	5
Greenlight Capital	2	6
Carl Icahn	3	16
Marcato Capital	4	3
Glenview Capital	0	1
Elliott Management	16	18
Corvex Management	3	3
Cevian Capital	6	7
Blue Harbour Group	3	8

Total Investments **Outperforming S&P** 87

Total Investments **Underperforming S&P** 112

Source: Activist Insight

*Assumes all stocks were bought on the last day of one quarter and sold on the last day of the following quarter, with a time horizon of 6/30/15 through 6/30/16. The investment capital was weighted across the combined Pershing Square, ValueAct, and Icahn portfolio and was reinvested in a re-weighted combined portfolio at the end of each quarter.

[5]Source: Activist Insight

The People are Rising Up

Corporations and institutional investors understand that change is needed in the ways companies interact with their shareholders and that a shift is needed in focus away from short term results and towards long term growth. Since activists thrive by exploiting the deficiencies in the relationships between companies and their shareholders and tend to generate better returns when pushing short term agendas, both of these developments have negative implications for activists.

- In early 2016, Larry Fink, CEO of BlackRock, sent a letter to each CEO of the S&P 500 condemning the growing focus on short term results and encouraging long term strategy. He said capital allocation decisions should be left to management provided that the company lay out for shareholders each year a strategic framework for long-term value creation.

- In mid-2016, thirteen leaders of the largest corporations and institutional investors and ValueAct, widely considered to be one of the few truly constructive, long-term-focused activists, joined together to publish the Commonsense Corporate Governance Principles. The goal of the principles is to set a framework for strong corporate governance and active shareholder engagement: "Effective governance requires constructive engagement between a company and its shareholders. So the company's institutional investors making decisions on proxy issues important to long-term value creation should have access to the company, its management and, in some circumstances, the board; similarly, a company, its management and board should have access to institutional investors' ultimate decision makers on those issues."

Check the Box Activism

With the amount of investor capital that activism-specific funds must put to work and the diminishing number of easy targets, a disturbing trend is emerging in the activism space. If a fund manager raises capital for an ac-

tivism-specific fund, those investors will expect the manager to be actively-influencing each company in which the fund invests, including pushing for events that will boost the stock price. Therefore, the fund managers will likely need to show concrete proof to their investors that they are actively involved. Given the sheer dollar amount committed to this strategy, it is not feasible for the portfolio managers of the largest funds to be on the board of every investment in their portfolio. Additionally, since most activist situations are settled privately between the activist and the company's management and board, there is rarely a public fight that makes it obvious that the activist is actively influencing the company's decisions.

So what is the path of least resistance in order for the activist to prove to its investors that it is actively involved, while at the same time avoiding having to gain shareholder support for its agenda or having a proxy fight? The below is an amalgamation of real scenarios that have occurred across corporate America within the past year:

- ABC Company is a solid player in its industry with a competent, proactive management team
- Total Shareholder Return (stock appreciation plus dividends) is in line with the peer average across most timeframes (1,3,5 years) or at least does not stand out as an issue
- Valuation multiples, however, could be considered below peer averages using most measurements (price to earnings, Enterprise Value to EBITDA, etc.)
- Management is privately well into the process of pursuing options to improve valuation
- The activist buys a large stake in ABC and demands that ABC take value-enhancing actions very similar to those already being pursued by the company and threatens a proxy fight if the company does not openly take these actions

- In order to avoid a costly and drawn out public battle and potentially disrupt its internal process, ABC settles with the activist by allowing the activist to assist in filling the next open board seat
- As part of settlement, the activist agrees to "cease-and-desist" for a certain period of time (no involvement in decision-making, no public criticism, no increasing ownership, etc.)
- The activist and ABC negotiate the wording of a press release which describes the activist's involvement with the company

Why should this scenario bother anyone? For starters, the above events typically consume the attention of the CEO and management team for a one to six month period. Management teams and boards though usually agree that it is their fiduciary responsibility to settle with the activist rather than risk more costs and distraction that would result from a proxy fight (a perfectly reasonable and increasingly common decision).

Secondly, activism is supposed to "unlock value." The actions taken by the activist in this example at best had and will have no incremental impact on the company's strategy; and at worst, distract the company from executing on its value-creating plan. So it can be argued that the involvement of this activist actually harmed long term value instead of created it. It is true that the activist will assist in choosing a board member but the price for doing so requires the activist to be a "lame-duck" shareholder for an extended period. The benefit received (assistance in finding a director) could be accomplished with much less disruption by hiring a good executive recruiter.

Finally, and this is for the investors in the activist's fund, there is no alpha being generated here. The hedge fund that is supposedly creating an outsized return via activism is actually potentially harming the value of the company by distracting its management from carrying out its strategy. It all seems like an exercise in extortion but instead of the payoff being in cash, it is in the form

of a press release that gives undeserved credit to the activist for actions that they did not influence.

If such "check-the-box" activism, which really is in essence disruptive stock-picking, continues at its current pace, it is logical to expect eventual push-back from both institutional shareholders and the investors in activist funds.

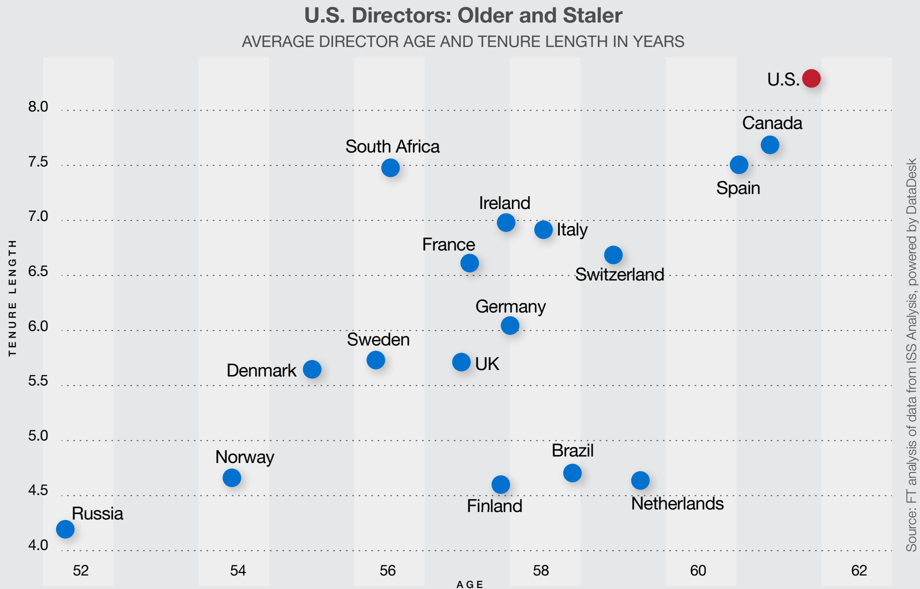
CALLING ALL BOARD CANDIDATES

One thing that is certain in this new age of better governance: being a board member of a corporation ain't what it used to be. There are so many forces at work that have put new pressure on the role, including: activists and their deep-rooted desire to shake up boards and jump onto them, the rising influence of governance rating services like ISS and Glass Lewis that penalize companies for having long-tenured, non-diverse, over-boarded or aging board members, and the push for board members to get out and press the flesh with shareholders rather than just showing up for the quarterly meetings.

With these ever-narrowing requirements for board members (investor savvy, well-versed about the company, the right age and tenure), the field of candidates begins to narrow. And this comes at a time when board members are being replaced with more frequency than any time in history. The United States in particular stands out when it comes to long tenure and age of board members:

To put some numbers against this, approximately 20% of S&P 500 board members, estimated at 1,140 directors in total, have already reached or will reach the ISS recommended retirement age of 72 within the next 2 years, according to data provided by S&P's Capital IQ. Additionally, another estimated 1,280 board members, or 23% of the total S&P 500 Board members, are currently aged 65-69. And according to data provided separately by ISS Governance Analytics, 36.2% of S&P 500 Board members, or 1,977 direc-

tors in total, already exceed the ISS tenure limit of nine years. ISS believes the director is considered to be entrenched after nine years of serving on the Board, which penalizes the company's governance score*.



So in other words, executive recruiters will be extremely busy trying to find director candidates to replace this impending run-off and that thread the needle in meeting this ever-growing list of requirements. More than half (53%) of new independent directors are active senior executives and professionals. This compares with 47% of new directors in 2014[6]. Finding active CEO's to serve on boards is becoming a challenge, particularly given how serving on numerous boards is an infraction in the eyes of ISS. Making up for the decline in available active CEOs is a rise in the number of active corporate executives a level or two down from the CEO. Other corporate executives — including

*Note that there is overlap between directors reaching or exceeding retirement age and reaching or exceeding the tenure limits

[6] Source: 2015 Spencer Stuart Board Index

active division and subsidiary presidents and line and functional leaders — make up 14% of new independent directors, compared with 9% in 2014. Recruiting financially savvy directors is also on the rise with new active directors with financial backgrounds representing 12% of new independent directors in 2015, an increase from 9% last year.

Even activists are becoming stretched when it comes to filling board seats. Carl Icahn was criticized by large shareholders of Freeport McMoran for putting two of his junior employees on the board. With so many dollars to put to work, there are only so many boards on which activists can sit. Activists are therefore searching the same dwindling pool for external candidates.

"The alpha to be generated from activism is getting squeezed. It is getting squeezed by everyone: institutional investors, management teams, and board members."

What's the Outlook?

Predicting what happens to a $163 billion dollar strategy is no easy task. To say that activism is going away any time soon would be naive. There's just too much money committed to it across an extremely wide range of investors. Not only are nimble, wealthy individuals invested in the space, but so are slower moving, highly structured pension and sovereign funds. In a no yield environment, it is almost a requirement of these funds to park at least a small percentage of their assets in strategies that might in fact generate a market-beating return. And when you add up these small percentages, it comes to a big number.

But what is happening is that the alpha to be generated from activism is getting squeezed. It is getting squeezed by everyone: institutional investors, management teams, and board members. They have picked up on the imperfection that activists exploit and they are taking measures that take the

"need" for activists off the table. If management teams and directors are actively engaging with institutional investors and vice versa, what value does an activist add? If a company has a solid long term strategy, a clearly defined capital allocation plan, and is continually optimizing its board composition, while at the same time communicating these things to its investors and the market, what is an activist other than just another shareholder? As this new paradigm proliferates more broadly, there will be little to distinguish an activist from any other hedge fund, and that would be a bad thing for activists.

"The periods following the past two [economic] cycle downturns have generated anomalies that opened the door to activism. These anomalies occurred regardless of the governance measures undertaken by corporations and regardless of the regulations put in place by governing bodies."

That being said, the periods following the past two cycle downturns have generated anomalies that opened the door to activism. These anomalies occurred regardless of the governance measures undertaken by corporations and regardless of the regulations put in place by governing bodies. It is like any pendulum: the more it swings in one direction, the more it comes back in the opposite direction. Activism works the same way. The key though is to figure out where their alpha will come from when the pendulum starts its return.