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Graduate School of Management
Master in Corporate Finance

HEDGE FUNDS AS ACTIVIST INVESTORS: IMPACT ON MARKET VALUE OF TARGET COMPANIES

Master's Thesis by the 2nd year student
Concentration — Corporate Finance
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ЗАЯВЛЕНИЕ О САМОСТОЯТЕЛЬНОМ ХАРАКТЕРЕ ВЫПОЛНЕНИЯ
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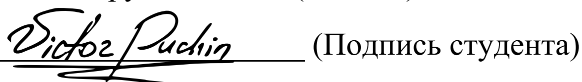

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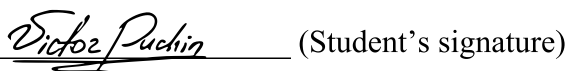

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АННОТАЦИЯ

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Описание цели, задач и основных результатов	Данная работа изучает, как рынок реагирует на вход активистов в компанию, и как он влияет на финансовое состояние других акционеров. Работа использует методологию финансового анализа событий, где за событие берется публикация формы 13D, запрашиваемая КЦББ в случае, если фонд приобретает от 5% компании и собирается оказывать давление на совет директоров. Исследование показывает, что данное событие сопровождается статистически значимой сверх-доходностью акций целевых компаний, таким образом приводя самые свежие результаты по теме. Также, работа оценивает рыночную реакцию на кампании по следующим критериям: 1) требования активистов, 2) рыночная капитализация целевых компаний и 3) дивизия индустрии, в которой компания осуществляет свою деятельность согласно SIC классификации
Ключевые слова	Активизм, Хедж-фонды, Доходность акций

ABSTRACT

Master Student's Name	Puchin Victor
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Description of the goal, tasks and main results	This paper addresses the question of current market perception of activist’s campaigns and how activist hedge funds’ entry in a company affects the wealth of other shareholders. The research goal of the research is to define whether an activist hedge fund’s intervention in a company increases the market value of the target company. The research methodology is event-study where an event is a filing of Schedule 13D required by US SEC if a fund acquires at least 5% stake in a company and has intention to engage with the board. The result of event-study demonstrates significant positive abnormal returns around mailing Schedule 13D, thus, providing the most recent evidence on market perception and impact on shareholders’ wealth. Also, the paper makes an attempt to explore market reaction on activists’ campaigns depending on the following criterions: 1) activist demand, 2) market capitalization of a target and 3) its division of operations according to Standard Industrial Classification system.
Keywords	Activism, Hedge Funds, Stock Performance

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Introduction

The last two decades have cast a shadow over the public company. Returns keep diminishing and there was not a good sign of wealth creation in cases like Enron and Lehman Brothers. Huge increase in passive index funds as 92% of all U.S. based active managers lag performance of their respective benchmark (The Wall Street Journal, Apr.12, 2017); retail investor ownership stake has a declining trend, while institutional wealth is getting accumulated in the hands of the largest asset managers. The passivity of shareholders and shift towards index tracking means that shareholders prefer to get rid of their positions in a stock in a case of trouble rather than to manage the issue. Mutual and hedge funds well-being is largely dependent on their performance and as managers are compensated on quarterly results basis, this implies that executives are more concerned with quarterly results rather than long-term growth due to pressure from the funds. Meanwhile, corporations from Silicon Valley have turned outside investors in the second-class investors with one or none voting rights while keeping the most voting shares in the hands of business founders or managers, for example, in Snap IPO the Snapchat founders and app creators retain 70% of voting shares (The Wall Street Journal, Jan.16, 2017).

Accordingly, shareholder activism in on the rise as not everyone agrees with the new establishing order. Activists have been around for the long time, but their role, actions and market perception keeps evolving. For decades, they were despised and viewed as belligerent corporate raiders that are interested in short-term profits in the detriment of long-term growth and prosperity of approached companies. One of the most famous activist investors, Carl Icahn, made his fortune by acquiring a stake in a company and pushing executives to improve short-term profits, while leveraging the company and substantially increasing share repurchasing and dividend payout program that occasionally ended up in bankruptcies of targets (Forbes, March 30, 2016).

However, the perception of activists and their actions started to turn around after the crisis of 2008. Recently, Mr. Icahn and other activists' actions are applauded by such pillars of the establishment as Mary Jo White, then the head of US Securities and Exchange Commission, who said that shareholder activism has lost its "distinctly negative connotation" (The Economist, Feb.15,2014). Nowadays, activism becomes more frequent, and not just in USA, but it is gaining in popularity around the world, while recent regulations make activism easier.

Shareholder activism has different forms and levels of engagement and tools of persuasion used in campaigns as well. An investor dissatisfying with a CEO salary and makes an effort to change it is vied as activist and so is the hedge fund proposing selling the whole company. Hedge funds activism is the most aggressive type of activism engagement, while the most powerful and effective due to unique characteristics of such an entity. Activist hedge funds acquire a stake in a target company that they think has an unleashed value and act as campaigners trying to obtain

other shareholders support for their proposals: board seat, cost or business optimisation, spin-off or M&A, or returning cash to investors. Public companies' executives treat loathe activist investors for their opportunism and belligerence. Some claim activist hedge funds to be opportunistic and do not create a long-term value, but rather would strip cash and assets in conjunction with leveraging the firm. Others treat them as corporate upgraders. They state, that plenty of companies suffer from bad management: approximately each tenth of big US based firms and many more smaller ones still employ poison pills tactics in order to shelter incompetent executives (Stowell, 2012).

The controversial view on hedge fund activism keeps developing as the results of activism campaigns still occasionally leave much to be desired and are widely criticized. There are plenty of studies that make attempt to analyze consequences of activism intervention in corporate governance, operational and strategic decision making of a company, but results are not consistent. Some scholars found positive changes in operational and stock performance of companies approached by activists, but they are not statistically significant in many cases or other studies provide opposite results.

However, in order to explore market perception of activists and an influence of their propositions on shareholders' wealth, one should look at stock performance around an activism campaign announcement as stock price is the best proxy of the market expectation. Some researchers used event-study or dynamic portfolio methodology to analyze abnormal returns around an activist stake acquisition in an approached company and found that this acquisition is accompanied with abnormal returns, however, there is no recent research of the issue, while many of the previous demonstrate nonsignificant results at conventional levels.

This paper uses event-study methodology and analyzes campaigns run by the most frequent US-based activist hedge funds that filed Schedule 13D, mailing of which is required by US Securities and Exchange Commission if a fund acquires at least 5% stake in a company and is going to engage with the board. The research goal of this paper is to define whether activist hedge funds entry in a company increases the market value of target companies. The event analyzed is publishing of Schedule 13D.

Research objectives of the research are the following:

- Define shareholder activism, clarify different types of shareholder activists and their goals
- Examine the trends in activism investing
- Analyze pros and cons of activist shareholder intervention in a company corporate governance and decision making

- Analyze target companies stock performance prior to and after activist hedge fund investment
- Define the effect activist hedge funds make on shareholders' wealth of target companies

The paper goes as follows: the first chapter provides definition of shareholder activism, describes different types of activism engagement, pursued goals and methodology they use. Then the recent trends in investing are provided and the effects they make on activism investing are explained, that is followed by a review of trends in activism investing. Then the paper summarizes scholars' findings on effects that activism makes on operational performance, corporate governance and shareholders wealth. The second chapter describes the methodology used in this research, sample creation policy and obtained empirical results. That is followed by managerial implications of the research and discussion of associated limitations.

Chapter I. Shareholder activism

§1. Types of shareholder activism and pursued goals

Activism represents a wide spectrum of activities initiated by one or several shareholders of a publicly traded company. An activist is often views as a shareholder who is dissatisfied with an aspect of a firm's governance, management or operations and try to conduct a change within the company, but without changing control over it (Morgan Stanley report, 2007).

The activities fall along a range of significance of the desired changes, assertiveness of these activities and its frequency. On the more aggressive end of the spectrum are hedge fund activists that seek the most significant change to the board of directors, management or the company's strategy. On the other end are private engagements between shareholders and corporate insiders triggered by advisory votes.

The whole range of shareholder activism types can be split up into the following four categories: hedge fund activism, "vote no campaign", shareholder proposal and say on pay (PWC report, March 2015). Each of these groups has unique approach to activist as well as methods they employ for achieving desired goals.

The most aggressive type of activism is hedge fund activism, when an investor, usually a hedge fund or a wealthy person aligned with a hedge fund, strives to conduct significant changes in the company's strategy or corporate governance. Some of these activist shareholders have been in this game for decades, for example, a renowned investor Carl Icahn, who started his activist activity in 1980s. Since then, many new funds were established and this so-called focused type of activism became a distinguished asset class. Goals, methods of negotiation and targets of this type of investment significantly vary, however, the common characteristic of this asset class is to generate returns on investment by unlocking a company's value by proposing and conducting operational changes that result in improving financial performance and increasing share price at least in the short-term. These type of interference is caused by investment managers dissatisfaction with a portfolio company's management and lack of progress, and this engagement can be a useful tool to catalyze the changes required to deliver returns. These funds often believe that their role as fiduciaries for their investors requires them to occasionally pursue this strategy instead of simply disinvesting (Activist Insight, 2016).

Hedge funds differ from pension and mutual funds by their unique organizational structure. Unlike other types of funds that have legal restrictions on investments in different asset classes and stakes of asset in a specific security, a hedge fund has an ability to use leverage, options and other mechanism of gaining an exposure to a specific stock. Hedge funds' managers earn performance-based compensation and due to higher exposure to a stock they are more willing to

monitor and effect strategy of portfolio firms. Consequently, their proposals are more likely to result in a more convincing threat to a target firm that results in significant effect on other shareholders' wealth as the result of their campaigns (Morgan Stanley report, 2007).

However, some claim that activist funds enhance the company's stock price volatility and its leverage, thus, obtaining returns in short-term, but fail to make measurable improvements in the long-term. This type of activist investors is the main focus of this paper; the methods these funds use to address their proposals to the board as well as trends in the field of such investments and their targets' characteristics will be described below with the following discussion of the short- and long-term effects on fundamental value.

The next class of activism is "vote no" campaigns where an investor or coalition of shareholders urges other investors to withhold their votes from one or more of the board-nominated director candidates (PWC report, March 2015). These campaigns are usually initiated by mutual or labor pension funds. This strategy can influence a candidate to voluntary withdraw from the election, or a director can be replaced during a subsequent term in the case of a high level of negative votes. However, this campaign is rarely successful, because at most companies this would require support from a majority of outstanding shares.

Further down the spectrum of activism engagement is shareholder proposal or the threat of a shareholder proposal. This strategy is usually used to address corporate governance issues, that could be divided into the following groups:

- Changes to the board's governance policies or practices, including:
  - Adopt majority voting
  - Provide proxy access
  - Change the board composition
  - Declassify the board
- Changes to the company's executive compensations
- Changes to oversight of functions, such as audit, risk management and etc.
- Changes towards corporate social responsibility
  - Climate change preparedness
  - Political spending and lobbying
  - Environmental practices

This kind of proposals is usually initiated by institutional investors, such as mutual funds, labour pension funds and occasionally by big individual investors. These changes are assumed to improve governance procedures and transparency and create broader social value that is beneficial for the long-term prosperity of the company and increases its value for all shareholders.

The last and the most passive type of activism of the spectrum are investor initiatives caused by "say on pay" advisory proxy item. This interference is limited to letters or occasional meetings/phone calls directed to the compensation committee of the board. The purpose of these interactions is to make an effect on change to the compensation plan or alter the way it is described in communications with shareholders. Usually, almost all investors participate in this type of activism. As "say on pay" is a proxy item presented to all investors for an advisory vote, all stockholders with voting rights have to form a view about executive compensation plans. A subset of these investors can decide to convey their view to the company; doing so generally does not require a substantial amount of resources. These votes are particularly likely to occur if investors believe that the most recent plan does not align directors' remuneration with long-term performance and value creation, or utilizes inappropriate performance metrics.

In spite of the particular class, all activists address the agency problem and expect to have capital gains by diminishing the information asymmetry or pressuring executives to act in the best interest of shareholders not of executives' that differ in the most cases (Jensen, Meckling, 1976). The general issue is that all recent trends in investing cultivate an environment where executives are able serve themselves more than previously could, while owners shift towards passive investing and acting more just like stock pickers, not actual owners.

The following section describes trends in investing and the reasons behind them and how they affect what activists do, how and why.

§2. Recent trends in activism investing

§2.1. Trends in institutional ownership

Before turning to a discussion of activist campaigns, we should highlight trends at the institutional investors that make huge impact on activist shareholders playing field. In spite of the significant growth of activist investing during the last decade, activism as an asset class in aggregate holds a small percentage of public funds and public company stocks as the result. Even in companies where activist campaigns were launched, these funds typically hold not enough stock to play a determinant role in voting outcomes – for example, for campaigns initiated and completed during 2015, the median percentage ownership of funds was less than 7% of outstanding stocks, while less than 3% of targets had market capitalization of over $20 billion.

In order to be successful in proxy fights or other campaigns, activist depend on the support of the large institutional investors that have become more dominant in the share ownership structure. These large investors are usually mutual funds and, particularly, index funds are not able to "vote with their feet" when it comes to corporate performance, management and governance structure, and they are aware of their critical role that is reflected in their responses to and

engagement with a company's executives and activist shareholders (Sullivan & Cromwell, 2016). That is why it is important to consider trends in institutional investing.

The first issue is associated with ownership structure of shares. Nowadays, more stocks of publicly traded companies are in the hands of institutions than it is of retail investors. This overweight is not new, in fact, this trend of shifting more ownership from retail investors to institutional one has continued in recent years.

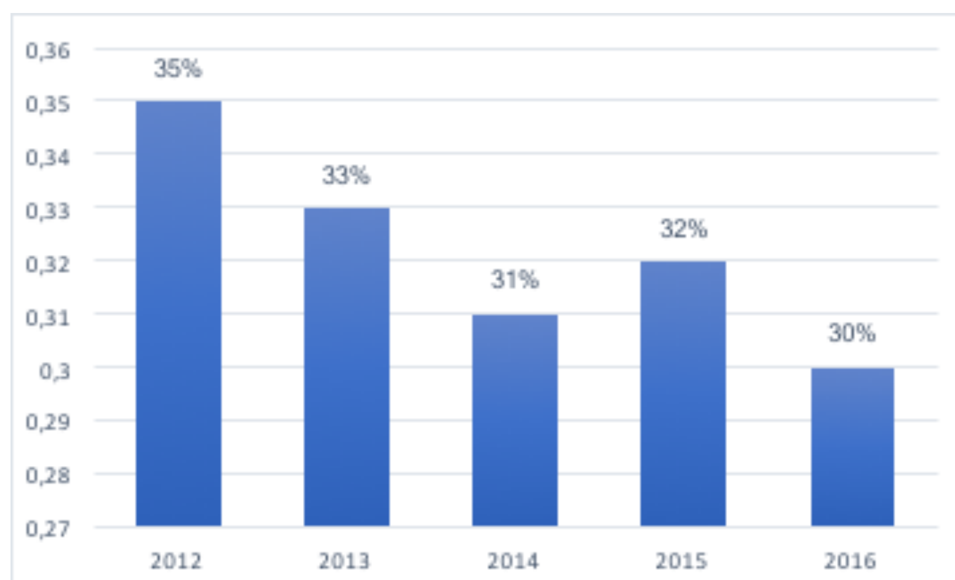

Figure 1. Retail ownership of public company shares.

Source: Sullivan & Cromwell, 2016

This decline actually understates the increase in voting power held by institutional investors. From activist shareholder standpoint, this difference within ownership structure is critical as these groups have different voting participation level. In 2016, only 28% of retail-held shares were voted, compared to 91% of shares held by institutional investors (Sullivan & Cromwell, 2016). This declining voting power of retail investors is caused by the elimination of broker discretionary voting of uninstructed shares in uncontested director elections. "While discretionary broker voting was prohibited in contested elections even before these changes, these new rules increased the influence of institutional investors on director "vote no" campaigns and on the types of governance changes that removed traditional antitakeover structures from companies, such as staggered boards and supermajority voting requirements. The use of notice-and-access for delivery of proxy materials to shareholders has also contributed to the declining voter participation of retail investors" (Sullivan & Cromwell, 2016).

The relative reason of shift towards passive voting is associated high costs. The costs of voting include costs of gathering information, making decision and procedural costs. Some argue that given the law that requires institutional investors to make a research and conduct a thorough analysis of all information available to make investment decisions, all information costs are

negligible for institutional investors. On contrary, others argue that the technical process of voting itself constitutes the bulk of all costs associated with voting and that these costs lead some institutional investors to passively participate in the voting process (Zetzsche, 2008). Moreover, it is not surprising that retail investors are even more willing to avoid such costs, therefore, their voting participation is even lower that it is of institutional investors.

The second issue related to trends in institutional investing is the shift towards index investments. In recent years, here has been a notable shift of investments away from funds with active management towards passive investing philosophies and index funds in particular. The Wall Street Journal noted that as of mid-2016, U.S.-based mutual funds and ETFs that track indexes owned 11,6% of the S&P 500, in comparison to 4,6% in 2006. This type of funds now accounts approximately 30% of all ETFs and mutual funds (The Wall Street Journal, Oct.25, 2016). The main reason for this is that active managers underperform their benchmarks. Over the last 15 years ending December 2016, on average, 92% of all US based funds trailed their benchmarks (The Wall Street Journal, Apr.12, 2017). Moreover, an additional pressure is made by robots and associated high-frequency trading and stock picking. Recently, Blackrock, the largest asset management, announced that it relies more on robots than humans in investing decision making. Its stock-picking unit lagged other funds' performance and started losing clients, that is why the firm fires dozens of personnel and offers clients lower-cost computer systems to make predictions (The Wall Street Journal, March 29, 2017).

The key point of this, is that index funds are not able to react on financial performance, management decisions and corporate governance concerns by disinvesting and allocating their capital in other companies. In fact, they depend on interaction with companies to propose desirable changes and encourage these changes either on their own voting power, activist campaigns or other shareholder proposals.

Moreover, institutional investors influence on proxy voting is enhanced by further concentration of capital in hands of the largest institutions and increase in their percentage of share ownership. This shift has been for a long-term and it has continued in recent years. The graph below demonstrates the average ownership of companies forming S&P 500 by the top four largest asset managers: Blackrock, Vanguard, Fidelity and State Street during the last 5 years.

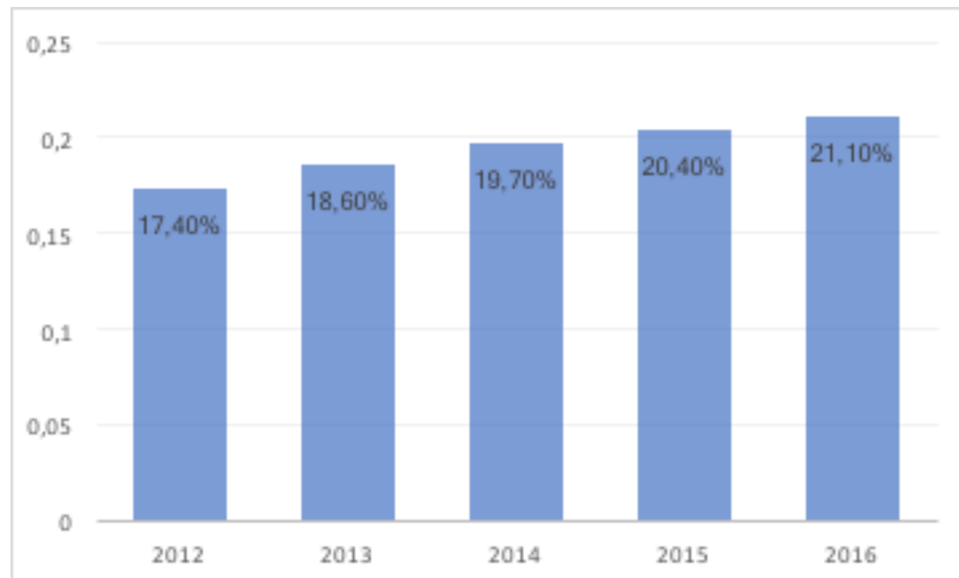

Figure 2. Average total stake in S&P 500 companies by four largest asset managers. Source: Sullivan & Cromwell, 2016.

The recent SEC's proposal of allowing dissident stockholders to list company nominees on the dissident proxy card can make the described narrow ownership more impactful. "If a dissident shareholder can solicit proxies for a majority of shares, thereby triggering the use of a universal proxy card, by reaching out to a small number of large shareholders, it would be much less costly for them to run a proxy contest" (Sullivan & Cromwell, 2016).

§2.2. Trends in activism investing

As institutional' ownership level has increased, their role as investors and owners has also changed. Some institutional owners began to shift from their conventional passive role towards more active participants in the corporate governance processes and policies in their holdings. The Investor Responsibility Research Centre reported that 464 proxy proposals demanding changes in governance were initiated by public pension plans in the period from 1987 to 1994 (Gillan, Starks, 2000).

During the recent years, numerous activist campaigns were launched and proposal were made. The data shows an increase in both proxy contests and other types of shareholder campaigns, which include public campaigns by activist investors seeking changes at a company with the goals of increasing shareholder value and/or enhancing corporate governance practices. Full scale proxy contests have developed, on average, in approximately one quarter of all activist campaigns announced in each year since 2013.

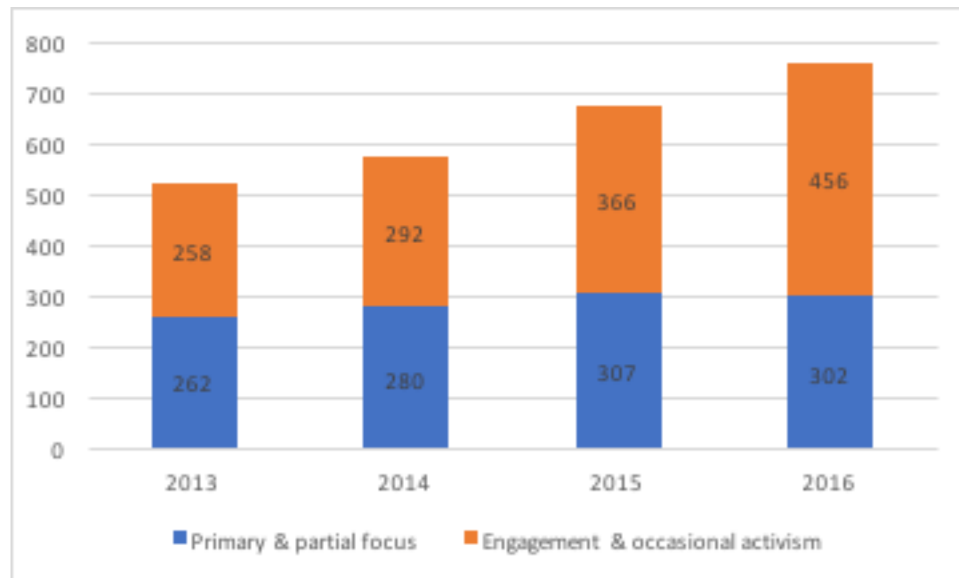

Figure 3. Trend in activist campaigns and engagements. Source: Activist Insight, 2016

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The formation of activist hedge funds has in large been linked with the performance of these type of funds over time, with periods of better performance resulted in foundation of more hedge funds. The graph below demonstrates this trend: the foundation numbers increased in general, but with a decline during the years following the financial crisis. In the period from 2012 through 2015, activist formation almost recovered to hit the pre-crisis levels, however, the foundation numbers slacked in 2015 and 2016, perhaps, that reflects the more limited opportunities for activism that led the performance downturn within the period.

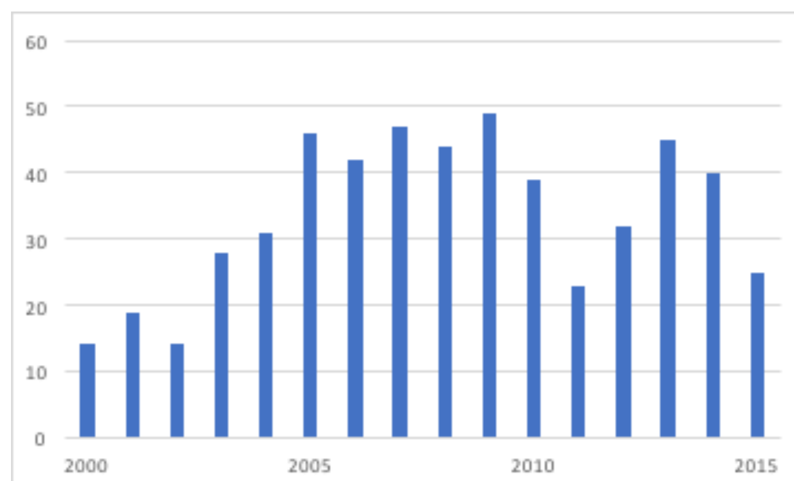

Figure 4. The number of activist hedge funds established through 2000 - 2015. Source: PWC report, March 2015

The key thing to understand how the activist hedge funds operate could be represented via the analysis of target companies and activists' ownership level in these companies that enabled them to conduct changes to the boards. In general, the scheme of approaching to a target company is the following: a fund buys 3% of a company and approaches the board with a proposal. In the case of the board's reluctance to implement prosed actions, the fund starts to acquire at least 5% of the company and makes public statements via interviews, publications to mass media or issues note on its website. It is very important to solicit other institutional investors to support activists and secure victory in the upcoming proxy fights. This is where the above-mentioned trends in investing play their roles (Gillan, Starks, 2000). The hugest share of voting power is concentrated in the hands of a few huge mutual funds, that implies the following: a) activists have only few big stockholders to convince in the necessity and expediency of the proposed changes; b) convincing a few is already procures significant voting power; c) these huge shareholders a more likely to be mutual funds that are either unable to sell their position while being an index followers or they are interested in better performance but are not eager to participate in shareholder engagement on their own. All these factors are beneficial for activists' performance (Clifford, 2008).

The necessity to acquire a significant portion of a company is a serious boundary for the range of potential targets. The table below shows the distribution of hedge fund activists deals done within the period of 2013-2016 by market capitalization of targets.

Table 1. Distribution of target companies' market cap during 2013-2016.

	\$100-\$500m	\$500m-\$1b	\$1-\$10b	\$10-\$50b	>\$50b
% of total campaigns	28%	16%	43%	10%	3%
2013 campaigns	38%	14%	35%	7%	3%
2014 campaigns	42%	14%	33%	6%	5%
2015 campaigns	45%	15%	29%	8%	3%
2016 YTD campaigns	42%	18%	31%	7%	2%

Source: PWC report, March 2016

The following graphs depicts the minimum ownership levels in settlement agreements within the same period. As it can clearly be seen, in the most successful agreements, hedge funds had to acquire at least 3% of total shares outstanding.

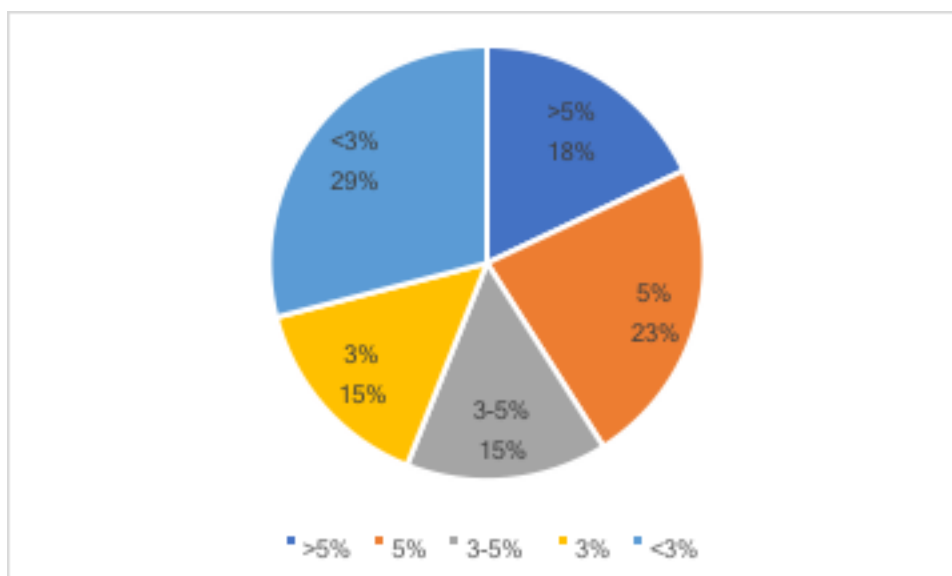

Figure 5. Minimum ownership levels in settlement agreements, 2013-2016.
Source: PWC report, March 2015

This implies that the most targets are micro to medium capitalization stocks. It is important to note, that acquiring small cap issuers is not only easier from invested capital perspective, but that these companies have weaker defensive mechanisms. Big companies have resources and well-developed PR departments to compete with and defend from activists' public statements. Meanwhile, micro-to-small cap companies' executives do not have this opportunity and it is common for them to take a poison pill in a threat of activism campaign.

Therefore, as in the most cases, activist hedge funds aim obtaining a board seat in a target companies, these factors play in favour of activists. The following table exhibits the portion of successful board seats taking.

Table 2. Boards obtained by activists.

	2013	2014	2015	2016 YTD
Total board seats obtained	128	169	173	63
Number of total completed campaigns	221	272	300	117
Average board seats per campaign	0,58	0,62	0,58	0,54

Source: Sullivan & Cromwell, 2016

As the table above demonstrates, activists are more often successful in obtaining the board than not. This implies that they are more likely to become able to pressure other members of a board and make their proposals come true. The following section discusses influence that activists make on corporate governance, operational performance and shareholder wealth and demonstrate why there is still so many controversial findings and opinions on the activism phenomenon.

§3. Activists' influence on operational performance and corporate governance

§3.1 Positive impact of activism

Supporters of the increased activism argue that activists' behavior causes a number of positive influences. For example, they argue that targeting a firm entails a close monitoring and analysis of management performance and strategic development, thus, this action is beneficial to all investors of the firm. Another argument is that activist investors have a long-term focus and this helps management improve long-run performance of a company. In contrast, the supporters of the institutional or conventional investing model argue, that fund managers lack expertise to advise corporate executives. Moreover, the opponents claim that the primary role of hedge funds is to manage money for beneficiaries and that activism is a side activity and engaging in it diverts managers from the main goal (Gillan, Starks, 2000). Further the paper provides arguments of each side of the discussion and demonstrates that there is still no consensus on the topic.

First of all, let's consider pros of activist interference and get back to the argument above regarding monitoring of management performance. Due to a free rider problem, scholars argue that only a large shareholder has an incentive to conduct monitoring or any other costly activity related to the agency problem. All shareholder benefit from such activities, especially if they do not bear any associated costs. And as the investor with a big stake in a company has the strongest incentive to do the monitoring, he expects a sufficient higher return to cover the monitoring costs (Gillan, Starks, 2000). This implies, that having an activist running a campaign is beneficial to shareholders in two ways. The first one is that when activists start a campaign they have already conducted a thorough research and monitoring and found some inefficiencies in management performance, corporate governance or a new opportunity to unleash the company's value. The second thing is that activists bear all the associated costs, not considering further proxy fights.

The second positive effect is related to a board of directors' performance. According to the theory, investors elect a board of directors to protect the owners' interests, including hiring and monitoring top management. In other words, control rests with the owners and flows to the board and managers. However, in practice it is often the opposite process. Management nominates directors (read elects) and then shareholders approve them almost always. That is exactly the place where the previously described trends in activism took action. Shareholders not just suffer from information asymmetry, but due to their passive behavior are heavily reliant on the management recommendations of the directors. And those directors are often executives and non-management candidates are not considered. Individual shareholders have weak incentives to make an attempt to force change due to high associated costs and the costs are borne disproportionally, but the benefits of this activity are dispersed evenly among all shareholders. This is another case, when

ordinary shareholders benefit from activists' actions and do not bear any costs (Angels Advisers, 2012).

Moreover, activists' action positively affect corporate information flow. The empirical results demonstrate that activism is associated with higher trading volumes and reduced information asymmetry that arises from differential information between investors. That resulted was obtained by examining 1362 activists' proposal during 1988 to 2010. It was found out that trading volume increased in the period following proxy filing and that bonds issued during the period had lower yield spreads compared to the bonds issued by non-approached companies. As for the stocks prices, they impound information through higher volumes of institutional trading and became more informative, at least in the short term (Prevost, Wongchoti, 2016). That positive effect also was observed in diminished spread between insiders' and outsiders' forecasts on stock performance after activist campaign announcements.

Other scholars made an attempt to analyze how activists' campaigns affect such things as tax avoidance and cost of debt. One study conducted on the sample of Korean companies found that bondholders view shareholder activism favorably, because it decreases the opportunism for the managerial rent diversion at an early stage in the emerging market. Moreover, as activists' presence strengthening the role of investors in the corporate governance system, it leads to lower cost of capital for the companies with poor governance (Lim, 2011).

The question of shareholder wealth creation caused by activist interference is also addressed in the literature. One study present evidence of investors wealth effect of activism using spillovers of non-target firms. Authors argue that spillovers are instructive as they constitute a response to an exogenous stock. In particular, researchers analyze how stock prices of non-target firms perform after the initial announce of one Korean hedge fund's activist campaign. The fund examined in the study invests in those companies whose stocks are traded at a significant discount due to governance problems while addressing those problems without control contests. The results of the research demonstrate that non-target companies that grant fewer rights to outside shareholders experience a more positive stock price reaction to the announcement. The result is consistent with the gains to outside investors from activism campaigns, because poorly governed companies are more likely to come under this disciplinary pressure from shareholders in the future. The study also shows negative relationship between the abnormal returns of non-target firms and the quality of corporate governance and authors highlight that this negative relationship is extremely rare during non-event time periods (Lee, Park, 2009).

Analyzing stock returns or abnormal returns around announcement date may be challenged by argument that the market reacts not on activists' campaigns, but rather on the big stake of a company acquired. In fact, when a fund makes a 13G filling that is required to be done if a fund

acquires at least 5% of a target company and not going to engage in discussion with the board (passive investing, in other words), the target's stock experience some significant abnormal returns. However, this abnormal return is less than that of activists 13D Schedule filing (Clifford, 2008). This study reveals that difference in means and medians of cumulative average abnormal returns around 13D and 13G filings demonstrate that the market reacts more favorably to companies approached by activists that those targeted by passive investors. Activists' targets earn a mean of 3,39%, while CAR of firms targeted by passive investors has a mean of 1,64% and the difference in returns is significant at all conventional levels.

Taking in to account that targets of activist campaigns experience significant excess returns around the announcement date a reasonable question may arise regarding whether these returns are the result of expectations about improved governance or it has something to do with operating performance. Many researchers found limited evidence of operating performance improvements (Smith, 1996; Karpoff et al 1996). Some, on contrary, find that firms targeted by activist funds experience a median increase in ROA of 1,17% the year following the announcement date. Similar result is observed for the two-year period after the announcement (Clifford, 2008). The author also reveals the positive shift in industry-adjusted ROE and as the obtained result is contradicts other researchers' findings (Klein, Zur, 2008), Clifford brakes down the ROA into simple elements and examined whether the improvement in operational efficiency is driven by reduction in assets, progress in cash flow, or both. The result demonstrates that firms targeted by passive and activist investors experience reduction in EBITDA in the consecutive year after stake acquisition, but the difference in means and medians of the two groups are not statistically significant. But targets of activist hedge funds demonstrate larger decrease in total assets that targets of passive investors do. Therefore, improvement in ROA value is mainly caused by reduction in assets rather than in improvement in cash flows. These results are consistent with the research outcome of Bethel el al (1998).

In fact, many activists' campaigns end up with some asset divestitures, but it should not be treated negatively. Looking at activists' demands and intentions reveals that spin-off and improving operational performance are ones of the most frequent demands. Activists bear costs of monitoring, analyzing and defining businesses the sale of each would be beneficial for a company and its investors in the long-run. There are plenty of examples of a such divestments: Motorola, Volvo and etc. In each of these examples there were a clear extractable flaw – a division that caused negative operating result, or while bottom line was positive, profitability was low that dragged the whole company performance down.

Taking into account activists' demands is crucial in analyzing the impact of their actions on such things as operational performance and total asset values. While some demand spin-offs or

assets sale, others, on contrary, offer conducting acquisitions and expansions. Therefore, creating a sample of all activist campaigns during a period of time and calculate average ROA, ROE and so on may be incorrect, as some effects of one demand is getting offset by effects of the opposite demand, thus, a researcher obtains average low and/or not significant results in improvement of operating performance. That means, that there is still a research gap in analyzing activists' influence on operating performance, and that the stock price is still the best measure of activists' proposals and subsequent actions.

Next, a popular argument against activist campaigns is that these hedge funds focus only on short-term profits rather on long-term value of a target company. Therefore, in order to define is this argument is fair, the long-term returns of the targeted firms by activists should be examined. One study used calendar-time portfolio approach with Fama-French 3 – factor model to estimate the long-run excess returns. The hypothesis of this research was that average monthly access return on the calendar-time portfolio is zero. However, the empirical result demonstrates that average monthly excess return of activists' targets is not just positive, but statistically significant in each of 1 to 3 – year periods following entry in a company. This positive effect is also demonstrated by passive entries of 13G fillers, however, in the case of activists' entry the annualized excess return was 22,32% in the first year following the stake acquisition, but passive investors generated only 7,80% of excess returns. However, there is no evidence that activism generates long-run abnormal returns. For the one year period following the entry, activists' targets yielded an annual excess return of 4,68% over the passive investors portfolio, but the result is not statistically significant at conventional levels (Clifford, 2008). On contrary, another author found that his sample experienced a favorable valuation effect over each of one to three-year interval after activists' interventions. The cumulative result over the three-year period exceed market performance by 23% and additionally the researcher found that valuation effect is more modest when an activist campaign is initiated by individual shareholders (Akhigbe, Madura, 1997).

Many of the previously stated studies use abnormal returns as a measure of market reaction on activists' performance and make conclusions based on these information, but they do not address the issue of where the announcement premium comes from. Later in the section of analyzing empirical results of this research, a problem of identifying concrete purposes of activism will be discussed, but it is reasonable to assume that market expects and thus creates value from some improvements in firms as going concern, either by changing board composition, turning down CEO or other operational and financial reforms. One study made a hypothesis that returns to investors are driven by activists' success at getting target firms taken over. This hypothesis is aligned with the proposition made earlier that shareholder returns should be examined by activists demands rather than all together. Under this hypothesis, stock prices increase around 13D filing

date reflects market's expectation that the firm will be acquired with a premium to the current price. From activists' perspective, this outcome is doubly beneficial – not just they generate stock premium from following acquisition, but also avoid price pressure associated with exiting their position. The main result of the study is that high returns occur primarily when a takeover takes place, however, as the majority of activists' targets are not eventually getting acquired, those firms' abnormal returns around that date of announcement are not statistically significant. Moreover, the result is also demonstrated by the drift in long-term returns following the initial acquisition of stake in a company. This implies that the returns associated with activists' campaigns are largely explained by the activists' ability to force target firms into a takeover and collecting an acquisition premium (Greenwood, Schor, 2009).

This result has an important managerial implication related to this research paper. Basically, Greenwood et al says that abnormal returns around a campaign announcement date is explained by activists' ability to win proxy fights and conduct the proposed changes or actions. That implies, that activists' experience is the key factor and that is why this paper focuses on hedge funds that has activism as a primary focus of their activities.

§3.2. Negative impact of activism

The main argument against activists' interference in the corporate governance system or operational and strategic decisions of target companies is that these hedge funds are oriented on short-term results. Supporters of this statement argue that some shareholders demonstrate their penchant for rapid returns on investments, placing pressure on executives to favor short-run results even at the expense of long-run performance. Although short-termism is not limited to a particular class of shareholders, this effect is mostly attributable to hedge funds as their investment strategy naturally consists of buying and holding stocks for short periods of time, including speculation strategies (Correia, 2014). Some argue that short-termism presents the potentially most important, most controversial, most ambiguous, and most complex problem associated with hedge fund activism (Kahan, Rock, 2007). However, hedge funds are not the only investment vehicles that are suspected in this practice. Many high-turnover funds' portfolio managers use speculation, because many of these institutions engage in quarterly evaluation of their performance that is vital in the industry, therefore, the managers are interested in have to focus on delivering short-term results.

Another issue associated with activism investing is earnings management. While many researchers focus on and investigate its impact in firm performance, ownership monitoring and organizational performance, only a few made an attempt to define the impact activist hedge funds make on earning management – an accounting phenomenon of manipulating financial results. The study conducted by Hadani et al (2011) explored the impact of shareholder proposal and monitoring on earnings management. They argue that due the public threat to executives'

legitimacy and reputation that is usually posed by activists, and the challenges that shareholder proposal present to executives, management is more likely to engage in earning management just in order to signal their managerial capabilities and hold their current positions in company structure. The research found positive correlation between shareholder proposals and earning management. This effect is especially in nano- and micro-capitalization stocks as these companies do not have developed public relationship departments and money for proxy fights and thus are more prone to use aggressive defensive mechanisms such as earnings management and other forms of poison pills.

The other argument on negative activism influence is related to firm disclosure. Some firms that are subject of potential approach by activist hedge funds are advised by law firms and investment banks to regularly monitor changes in activists' stakes in company and to prepare confrontational campaigns by reviewing external communication processes and policies (Christopher, Sheng, 2007; Gelles, 2013). This implies that when a firm detects a small increase in ownership by activist or group of activist hedge funds it may diminish the guidance information in order to avoid further attention from activists. Moreover, once a company is approached by activist and the demands are announced, a company's operating and financing environment is in flux, it is not surprising that current management suddenly loses ability to make accurate forecasts on future sales, expenses and other accounting measure that directly affect the bottom line and cash flows. Thus, even if activists' demands include some kind of corporate governance reform and enhanced disclosure and guidance in general, it unintendedly can cause reduction in guidance information provided to the market participants (Chen, Jung, 2016).

Moreover, as it was discussed earlier in this paper, stock returns serve as a proxy of market reaction activists' proposals and subsequent changes in corporate governance and operating performance. Some made an attempt to analyze long-term returns, however, scholars' definition of long-term returns varies from one to five-year period. These studies found some positive drift in stock returns within this period, but there is a problem associated with uncertainty about the linkage between cause and effect that is exacerbated by long-term stock returns measure. In some cases, activists' efforts indeed lead to a notable improvement in operational performance and stock price appreciation, however, it is challenging to state with confidence that activism per se caused the changes (Morgan Stanley report, 2007). In fact, many studies made an effort to evaluate long-term performance, but most of them failed to provide significant results (Guercio, Hawkins, 1999).

Also, analyzing activists' influence on corporate governance procedures, strategic and operational decisions, some may raise a question regarding a board of directors' view on the issue. NYSE Governance Service made a survey that included responses of more than 300 directors of public US companies. The results are clearly not in the favor of activists: 84% of directors claim

that most of activists do not represent the interests of other shareholders of a company, while 85% think that activists are focused on short-term results; 63% of directors believe that activists had not make an effect on boards' ability to attract quality members, while 47% think that activists nominated directors remain independent of the origins of their nomination (NYSE Governance System report, 2016).

To sum up, activism is a widely-discussed research topic that still has no consensus. While some provide evidence, that targets of activists' campaigns experience such benefits as improved corporate governance policies and procedures, enhanced transparency and executives and board of directors' performance with associated wealth creation for all of the shareholders, others provide counterarguments such as short-termism of hedge funds investing nature and earnings management caused by activists' interventions. In general, activism is viewed as an additional monitoring mechanism that diminish information asymmetry between shareholders and executives that not only addresses agency problem, but bears all of the costs associated with the monitoring. However, the real debate arises in evaluation of activists' effect on target companies. Many studies provide contradictory results to others regarding topics on operational performance improvement and stock performance in the long run. While positive shift in operational metrics such as ROA or ROE do occur and stocks experience abnormal returns in the long run, these results fail to pass significance tests in the most cases or there is uncertainly that activists' proposals and changes were the catalyst of these improvements.

That is why the author of these research argues that stock return is the best measure of the market's treatment to activists and their proposals. And as the market view on activism evolves, this paper contributes by conducting the most recent analysis of the issue.

Chapter II. Empirical study

§1. Research methodology

The literature review above shows that researchers are not solidary regarding activists' proposals and actions. However, the market opinion is identifiable by looking at stock prices' performance when news about proposals come up. The methodology of the research is event study as the stock prices and returns around the event serve as the best proxy for market view on the event. In general, event-study methodology uses financial market data to measure the impact of event on the market value of a firm or security.

An event study examines the behavior of a company's stock prices around a corporate or another important event. In a corporate context, event study is useful in determining the magnitude of the unanticipated impact of the event on the company's shareholders' wealth. As researchers argue, the market is rational and the effects of the event are will be reflected immediately in a security price (McKinley, 1997). Therefore, event study methodology focuses on announcement effects in a short- or long-term horizon around an event and provides relevant evidence for understanding corporate policy decisions (Kothari, 2004).

Moreover, event study methodology plays an important role in researching and testing capital market efficiency. Systematically nonzero abnormal returns of a security around a particular event are inconsistent with the theory of market efficiency. Accordingly, event studies that focus on long-term horizons following a corporate event can provide significant evidence on market efficiency (Fama, 1991).

The following section describes the methodology in details.

§2. Empirical model

This paper analyzes how the market views hedge funds activists' proposals and how it reacts on the activist campaign launch. Therefore, the event is filling 13D Schedule that is required by U.S. Securities and Exchange Commission if a fund acquires at least 5% of a public company and is going to engage with the board of the target. The 13D Schedule is available at SEC website and its filing is a public information that causes specific market reaction.

As for the methodology, event studies use daily (occasionally intraday and weekly/monthly) security return data that allows precise measurement of abnormal returns and more useful studies of announcement effects. Scholars use different time horizons in the analysis of activist campaigns impact on market value of target firms. Some use 2- or 5-day period, while some studies use bigger time-frame in the attempt to analyze long-term effect of such intervention in the corporate governance of a firm. This study uses two time frames – seven days and 127 days that represent six calendar month. The purpose of this is to demonstrate and analyze the

significance of obtained results both in short-term and long-term range. Moreover, it is important to check that the sample is not biased and does not include other significant events. Obviously, checking each company in the sample for this time frame is challenging task and defining a hurdle rate of return to exclude a company from the sample is very subjective, however, the sample was skimmed for other significant returns and stocks having a daily return over 50% were excluded from the sample.

In general, the process of conducting an event-study looks as follows:

1. Identify sequence of securities that are eligible for the event-study
2. Obtain and match time series of a security returns and their reference index
3. Using regression analysis on the time-period prior to the event, calculate the models' coefficients that explains the relationship between security and index
4. Using the regression model, calculate expected or normal returns for the whole period concerned
5. Deduct calculated expected returns from the actual market returns, calculate cumulative abnormal returns
6. Check the significance of results

There are several alternatives in the methodology of conducting an event-study analysis. The model used in this research paper is based on the work dedicated to event-study analysis by Kothari, 2011. Let t = 0 represents the date of 13D Schedule filling by an activist. For each security i in the sample, the return of the security is for time period t relative to the event, R_{it}, is:

$$R_{it} = K_{it} + e_{it} \quad (1)$$

where K_{it} is the expected return given a particular model, and e_{it} is the component of abnormal or unexpected return.

The abnormal return represents the difference between the return conditional on the event and the expected return unconditional to the event, therefore, the abnormal return is a direct measure of the change in investors' wealth associated with the event (Kothari, 2011). In this paper, S&P500 index was used as a measure of market return in the described single factor model.

An event study aims to define whether the cross-sectional distribution of returns at the t =0 is abnormal, and that could be done in different ways. In this paper, the focus is on the mean of the distribution of abnormal return. The null hypothesis to be tested is that the mean abnormal return equals zero at time t. For a sample of N securities, the cross-sectional mean abnormal return for any date t is:

$$AAR_t = \frac{1}{N}\sum_{i=1}^{N} e_{it} \quad (2)$$

Also, this paper analyzed whether mean abnormal returns for 127-day period around the date of 13D Filling equal zero. This test demonstrates whether an activist entry was expected and how efficient the market was and what are the short-term reflections on the event. The cumulative average abnormal return (CAAR) uses as the abnormal performance measure the sum of each day's average abnormal return and is defined as follows:

$$CAAR(t_1, t_2) = \sum_{t=t_1}^{t=t_2} AAR_t \quad (3)$$

For CAAR performance measure a test statistic was compared to its assumed distribution under the null hypothesis and computed as:

$$t - statistic = \frac{CAAR(t_1, t_2)}{[\sigma^2(t_1, t_2)]^{0,5}} \quad (4)$$

where:

$$\sigma^2(t_1, t_2) = L\sigma^2(AR_t) \quad (5)$$

§3. Sample description

The data was collected by going through SEC EDGAR searching engine and Thomson Reuters DataStream report on activists' campaigns. In the sample were included activist funds that run at least 10 campaigns during 2011 – first half of 2016 and filled 13D Schedule. Filling this schedule is required if a fund purchased at least 5% stake in a company within previous 10 days and managers of the fund are going to engage in discussion with the board of the target. The reason for picking the most active activists is that they have a superior ability to select target firms and have a record of successful deals that gained them reputation and clout and expertise (Krishnan, Partnoy, 2016). Thus, they are able to target large firms and launch successful proxy fights and pressuring target firms' boards and overcoming executives defense mechanisms. By drawing the line between active and occasional hedge funds activists, two issues are solved. One of them is that market does not guess on outcomes of future proxy fights as previous record of deals facilitate the process of forecasting. The second is that the sample is clean from uncertainty around occasional investors' effort that could make harm while having good intentions just due to the lack of expertise in the field. Therefore, the sample includes activists with quite forecastable outcomes and the market reaction purely reflects the market's view on activists 'proposals.

The date of filling the schedule is the event date that is analyzed with the stock returns examined in the range of 180 days prior to and after the event that resulted in +/-127 business days. This period of time is appropriate as it allows to see market reaction not just within a week or so, but also demonstrates how the market reacts on further ongoing proxy fight and activists'

engagement with the board. At the same time, the period is not long enough to be significantly influenced by other possible market events that could bias an observation.

This criterion generated 15 funds and 312 campaigns. However, the decision was made to completely exclude Bulldog Investors PLC and its 26 campaigns from the sample as the fund invested in other funds or REITs which shares traded at a significant discount to net assets value of funds. The purpose of this exclusion is that stock price of a fund reflects changes in its portfolio companies and distinguishing between market reaction on activist proposals and price changes of the portfolio is a challenging task that lies beyond the purpose of this research paper. Moreover, due to absence of trading data some campaigns had to be excluded, thus, the sample consists of 14 top active hedge funds with 259 campaigns or company entries in total. The table below provide data on the sample.

Table 3. Sample data

N	Fund	# Campaigns total	# Campaigns in sample
1	Bulldog Investors LLC	26	0
2	Cannell Capital Management	10	8
3	Carlson Capital LP	10	10
4	Clinton Group Inc.	12	11
5	Corvex Management LP	10	8
6	Elliott Associates LP	22	20
7	GAMCO Investors Inc.	43	44
8	Icahn Partners LP	34	31
9	JANA Partners LLC	15	12
10	Lone Star Value Management LLC	10	9
11	PL Capital LLC	16	16
12	Raging Capital Management LLC	13	12
13	Starboard Value LP	37	32
14	The Stilwell Group	40	33
15	ValueAct Capital Partners LP	14	13
Total		312	259

As for the purpose of starting activists' campaigns, this data was collected from Thomson Reuters report on activists' activity and presented in the chart below.

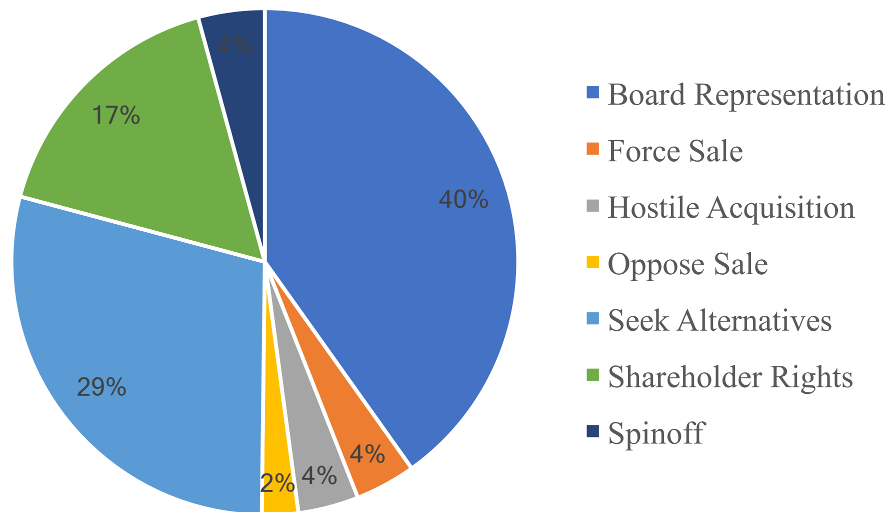

Figure 6. Sample activists' demands

Source: Thomson Reuters

The demands mentioned above should be clarified. "Board Representation" is the most common demand as obtained seat in board of directors allows an investor to make a real impact on decisions made in the company. The most recent examples of this demand are Sarissa Capital Management LLP targeting three board seats in Innovia (CNBC, 13.03.17), while Oasis Management acquired a seat in Premier Foods on March (The Telegraph, 1.03.17).

The "Force Sale" demand stands for selling the whole company when its operations and financial performance struggle and selling the company is probably the only way to reduce shareholders' losses by associated stock appreciation before M&A deal. An example – Corvex Management urged Ralcorp Holdings to sell itself in 2012.

Next, "Hostile Acquisition" means an activist's intention to acquire the company. The most frequent demand is demonstrated by Carl Icahn as he approached six different companies during the period considered, for example, he made several attempts to acquire Greenbrier Inc, a rail-car manufacturer, but he did not succeed.

The "Oppose Sale" is the opposite move to the previous one. In this case activists make an attempt to prevent the sale of a company when thing that offered price for the company is too low or the deal is not necessary for the further growth of the company. An example is Lone Star Value letter to the board of SWS Group in order to turn down the acquisition offer made by Hilltop Holdings.

Further, "Seek Alternatives" stands for suggesting some strategic moves or changing the current strategic or operational decisions that would allow to unlock value for shareholders. This demand represents the second biggest portion of demands in the sample, falling behind board representation demand. However, unlocking the value is the ultimate goal of hedge fund activism.

"Shareholder rights" group of demands represents activist shareholders' intentions to make changes in governance, remuneration and other policies. For example, PL Capital sent three letters to Bank of California regarding their issues in negotiating with shareholders, CEO compensation and some other shareholders' concerns (Seeking Alfa, 07.01.17).

The "Spinoff" demand speaks for itself – activists demand a sale of spinoff of a company's division. There are some famous spinoffs, such as Xerox, Motorola, EBAY and many others. In this case, activists manage to find an extractable flaw – an underperforming division that is usually non-core business unit of a company that usually drags the whole company's performance down.

As for the market capitalization of targets, the sample is consistent with the research outcomes of other papers dedicated to activists: the majority of targets were from Nano – to Small capitalization stocks.

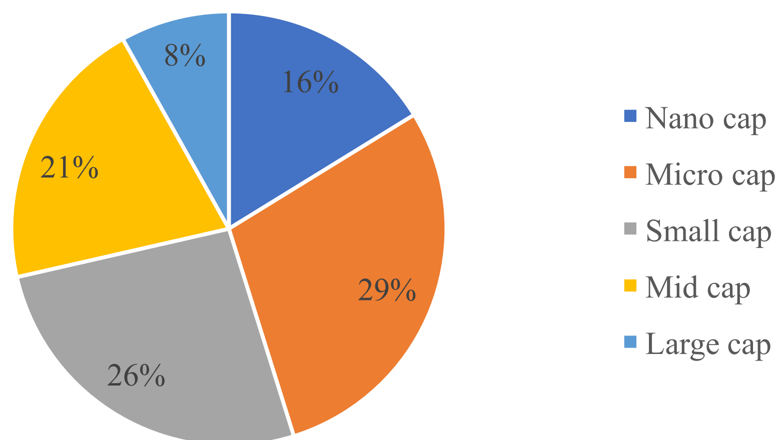

Figure 7. Capitalization of targets
Source: Thomson Reuters

It should be stated that there is no one set framework that defines different market caps, and the one used in the paper is the most widely used.

The sample covers companies from many industries, that is why for classification and further analysis purposes, this paper uses Standard Industrial Classification system.

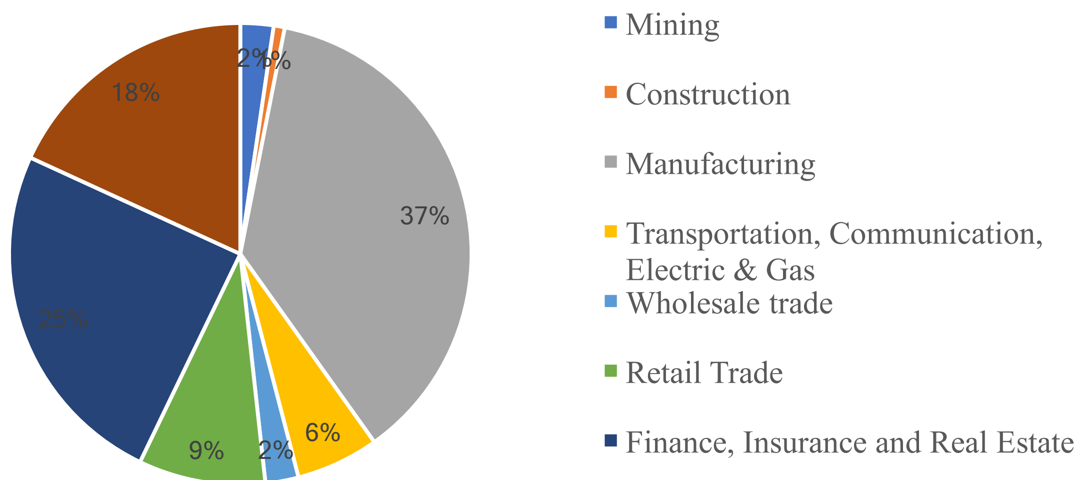

Figure 8. Industries presented in the sample

Source: Thomson Reuters

The distribution of number of campaigns run within 5-year period in sample is shown below.

Table 4. Number of campaigns per year

Year	# of campaigns
2011	50
2012	53
2013	36
2014	37
2015	54
2016	29
Total	259

To sum up, the sample of this research paper consists of 14 activist funds that run at least 10 campaigns during the period of Jan.2011-Sept.2016. The event of the study is the date of filling 13D Schedule by activist funds, and stock data was collected for +/-128 business days around the date or six calendar months. The total number of observations (campaigns) is 259, while distribution of activists' demands, targets' capitalization and industries were described above. The following part of research is aimed to present a model used in the event study.

§4. Empirical Results

The paper used the described model above and the following results were obtained. First of all, conducting the event-study for the whole sample of 259 companies within 127- and 7-day time range demonstrated significant positive results. In the day of filing 13D Schedule, the market

demonstrated huge abnormal returns with CAAR(-127;127) of 0,089 and t-test of 2,202, while CAAR(-7;7) was 0,073 and t-test equaled 3,089. The result is significant at 5 percent level. The chart below demonstrates the result.

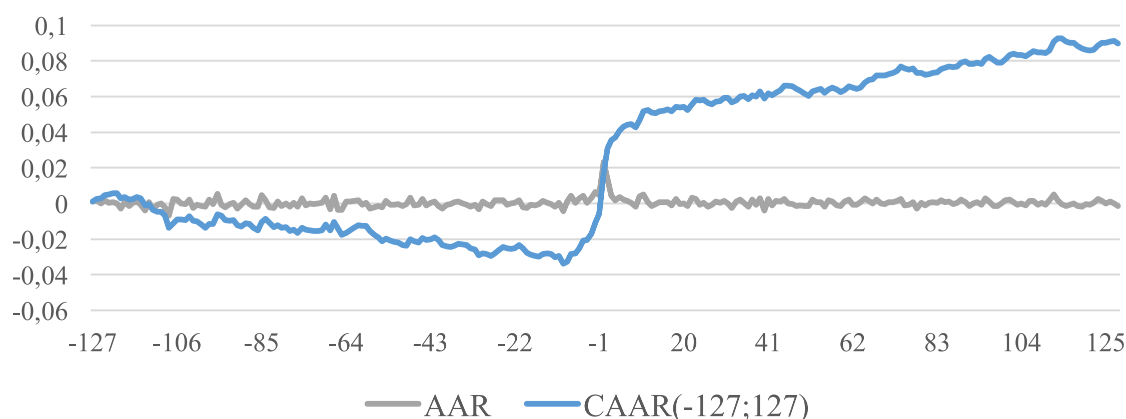

Figure 9. The event-study result

The chart clearly depicts the market reaction – an activist fund entry in a target company is viewed as positive intention that potentially increases wealth of shareholders. The additional observation is that the market is quite effective – the prices of targets are adjusted quickly, with the most price changes being done within first few days after the event.

Moreover, it is a point of interest to analyze market reactions on different activist proposals and how stock prices of targets reflect market reaction in dependence on a target market capitalization and industry. The information with results regarding activists' proposals is presented below.

Table 5. Event-study results by activist demands

Demand	# of campaigns	CAAR (-7;7)	t-test (-7;7)	CAAR (-127;127)	t-test (-127;127)
Board Representation	104	0,64	3,45	0,14	2,72
Force Sale	10	0,15	1,66	0,405	2,89
Hostile Acquisition	10	0,20	1,97	0,16	1,09
Oppose Sale	6	0,24	1,42	0,01	0,03
Seek Alternatives	75	0,07	2,81	0,076	1,35
Shareholder Rights	43	0,04	1,92	-0,08	-1,05
Spinoff	11	0,06	1,50	0,07	0,83
Total	259				

Before commenting obtained results, it is important to say that some outcomes either positive or negative ones may not be representative even if t-test denotes significance at 5 or 10 percent level. The reason of this the small amount of campaigns or observations within a category.

The chart below demonstrates cumulative average abnormal returns for 7-days period and depicts short-term market reaction.

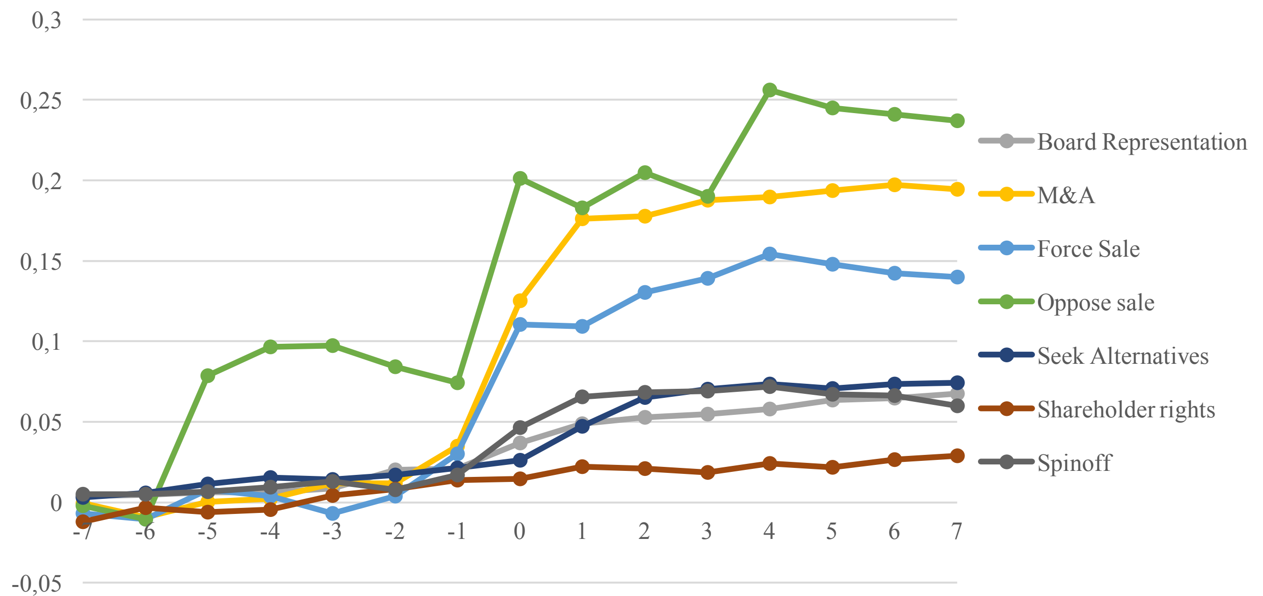

Figure 10. 7-days CAARs by different activist demands

As the figure above depicts, prior to Schedule 13D filing CAARs were around zero that proves that the econometric model used in predictions is a solid one, while all demands were viewed positively by the market that resulted in abnormal returns, but to the different extent. The highest return is demonstrated by oppose sale demand that cumulated 24% of return around the date, the second highest return was generated by hostile acquisition attempt that generated 20% of abnormal returns, while the significant result is only demonstrated by the second demand among the described ones.

The least CAARs were generated by shareholder rights and quite close results were obtained by other demands. Taking into account, that shareholder rights demand influences communication policies and addresses other corporate governance issues and possibly enhance premium for good governance, but does not directly mean significant changes in operations, strategy or financials, it is not surprisingly that associated abnormal return is lower than it is of proposed changes in items directly affecting shareholders' wealth.

However, the result changes when long-term time frame is being analysed.

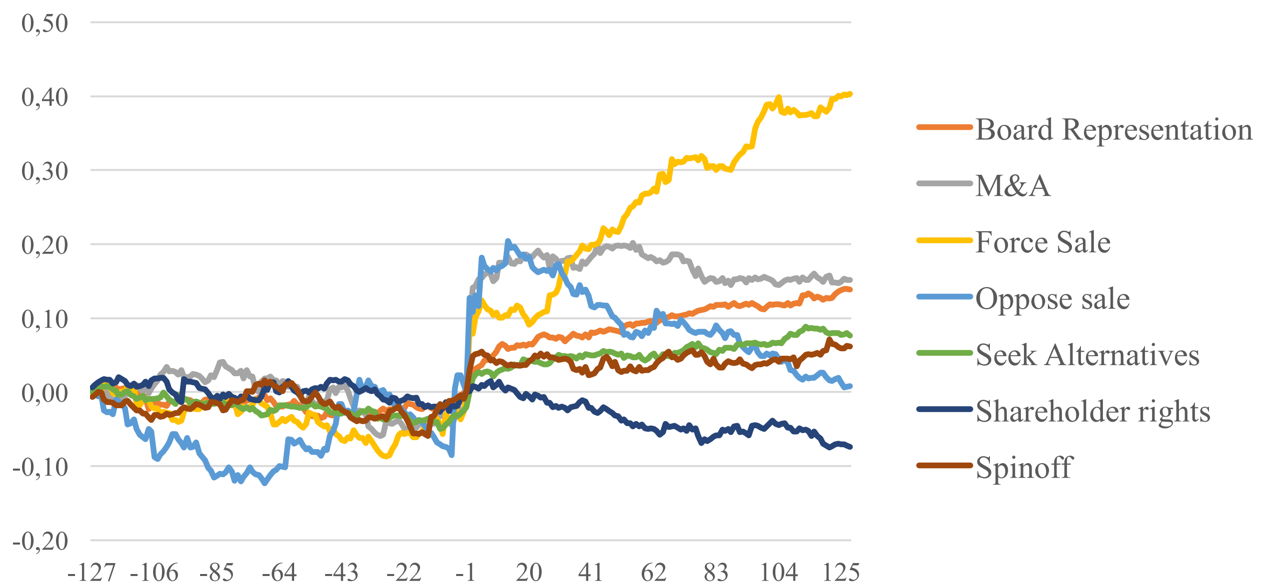

Figure 11. 127-days CAARs by different activist demands

Not surprisingly, activists' intervention in a company with an intention to sell the target company leads to the highest return as the stock price of a potential takeover company rises on rumours of possible deals and especially high returns are shown when the deal in fact takes place.

Usually, activist hedge funds propose selling a company when it performs extremely poorly and generates losses to shareholders. These big losses imply low valuation that makes a company a good target for a potential acquisition, while rumours and especially stated plan of future sale of a company significantly increase its share prices. That is why the news of a company sale is favourably viewed by shareholders in this case and sometimes as the only option to get some capital back from the falling knife stock.

The similar picture is shown by activists' intention to acquire a target company as the market follows the same logic regarding the possible acquisition. Shareholders' rights concern as the reason for entry in a company performs in the similar pattern in the long-run as it does in the short-term period.

Good positive results are shown by campaigns with board representation demands. The amount of observation is quite high, representing almost half of the sample, and t-test denoted significance of both 7 and 127 cumulative average abnormal returns. The board representation demand is the most frequent demand of activists as board seat enables them implement other changes or proposals. This demand together with force sale demand represent are most significant ones in terms of t-test and CAAR in both 7- and 127- day period. It has the following explanation.

As for the board representation demand, it is important to remind that other demands are also likely to be accompanied with board seat demand as it facilitates the process of conducting proposed changes. However, for the purpose of this research, campaigns with several stated

demands were marked in accordance with the first stated demand from Thomson Reuters data. Thus, it was expected that the whole sample performance picture looks similar to that of board seat demand and that hypothesis turned out to be true.

Also, this paper describes how the market reacts on activists' entry in target companies of different market capitalization. The outcomes are presented in the table below.

Table 6. Event-study results by targets' market capitalization

Market Cap	# Campaigns	Limit, $M	CAAR (-7;7)	t-test (-7;7)	CAAR (-127;127)	t-test (-127;127)
Nano	42	50	0,065	0,716	-0,020	-0,195
Micro	75	300	0,054	0,521	0,072	1,295
Small	68	2000	0,075	0,635	0,163	3,043
Middle	53	10000	0,088	0,611	0,143	2,231
Large	21	200000	0,084	0,678	-0,011	-0,140
Total	259					

In the case of market capitalization as the criteria for the analysis, number of campaigns per group are distributed more evenly. The column "Limit, $M" represents the upper bound of market capitalization within the group expressed in millions of dollars. As it was mentioned above, there is no universal set frame for differentiation market capitalizations and that the most frequent one is used, thus, this paper considers a company to be a middle cap stock if it lies within 2 – 10 billion. The chart below demonstrates obtained results for the 7-day period.

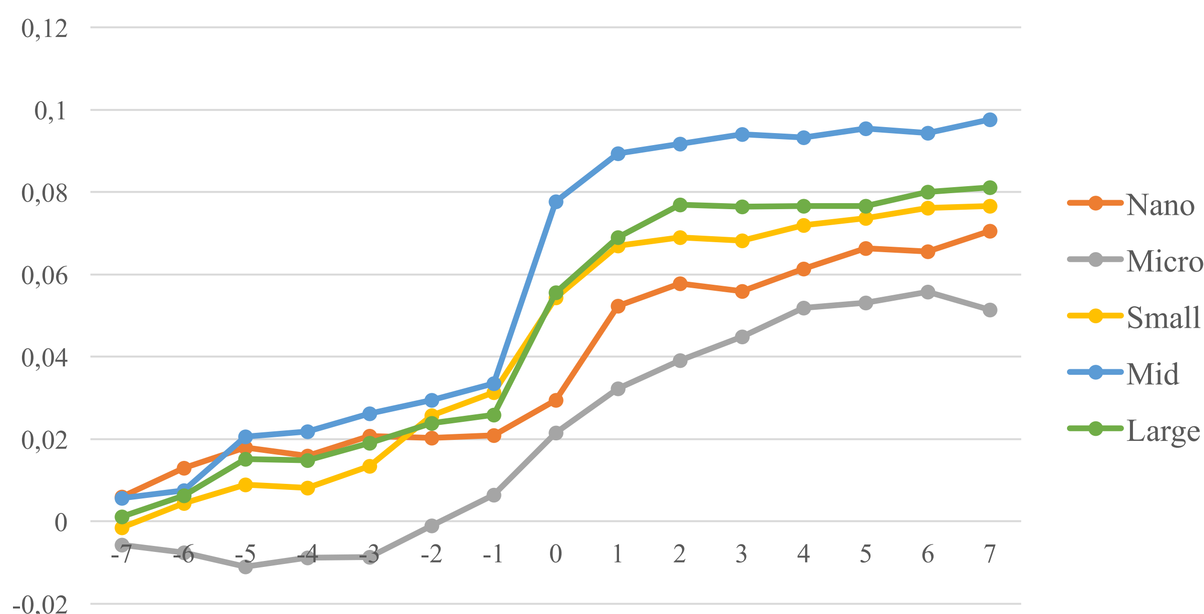

Figure 12. 7-days CAARs by different market capitalization of targets

As the chart depicts, all categories of market capitalization demonstrate quite similar pattern of cumulative returns behaviour. The highest return was generated by investing in targets of middle and large cap stocks, while peers from micro and nano capitalization groups

demonstrated the least returns. On the one hand, the result may be seemed as unexpected, because small cap stocks are considered to be more volatile and higher abnormal return is expected, on the other, these cap stocks have more speculative nature, that is why CAARs behaviour may be justified by saying that activists' entry as an information is less valuable and informative for small cap stocks than it is for large cap companies. Also, it should be stated that 7-days period frame does not provide any statistically significant result on each of the groups, however, for longer time frame the situation changes.

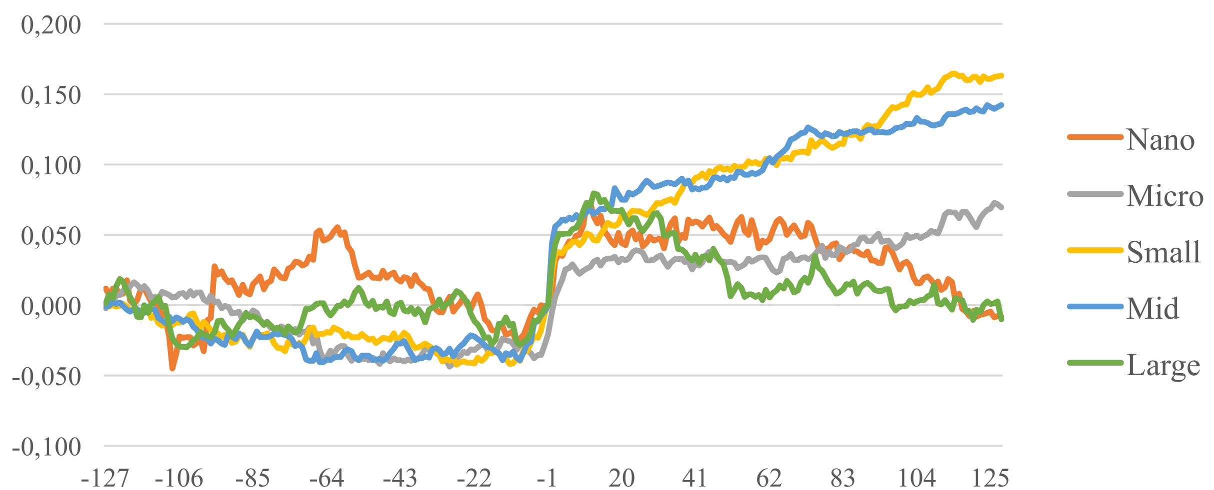

Figure 13. 127-days CAARs by different market capitalization of targets

Significant results according to the model are demonstrated only by small and middle cap stocks, while they generated average cumulative abnormal return of 16,3% and 14,3% during six calendar month, respectively.

An interesting observation was found, that while CAARs behavior around the event date in the short run demonstrated similar patters as it was discussed earlier, but in the long-run the results are opposite. Small cap stock continued to stay on top in terms of total abnormal return and mid cap stocks continued to rise as well, however, large and nano cap stocks CAARs ended up in the negative area. As for the nano cap stocks, one of the possible explanations of such behavior is that executives of this capitalization group are more prone to use aggressive defense mechanisms such as poison pills that managers of significant capitalization companies due to lack of experience in coping with activists and weak PR function to deal with the public pressure associated with activists' intervention in the company. As for the large capitalization stocks, possible explanation is opposite to the previous one – management is experienced and have tools to offset activists' efforts while not using value destructive mechanisms. This idea is supported with the statistics provided earlier in this paper – activists rarely approach large cap companies as they may not have

enough capital to accumulated significant stake in a company to make propositions and have real weight in proxy fights or attracting additional capital is costly.

The author also analyzed the market reaction on activists' entry in a company in accordance with targets' divisions. The sample contains plenty of companies representing different industries and as the sample is not very big for a such diversified variable as industry, the decision was made to group companies in accordance with Standard Industrial Classification system. The system enabled the researcher to spilt companies into the following groups (Note: divisions with less than 10 representatives were united for the research purposes):

Table 7. Event-study results by targets' division of operations

Division	# Campaigns	CAAR (-7;7)	t-test (-7;7)	CAAR (-127;127)	t-test (-127;127)
Construction, Mining, Electric & Gas, Wholesale trade	14	0,141	0,600	0,297	1,877
Manufacturing	96	0,072	0,610	0,113	1,882
Transportation	15	0,060	0,785	0,121	1,066
Retail	23	0,055	0,425	0,127	1,251
Finance	64	0,038	0,701	-0,020	-0,376
Service	47	0,104	0,630	0,096	1,310
Total	259				

This point of view on sample performance does not significantly differ from demands and market capitalization perspectives. Visually the picture remains similar as all groups demonstrate positive abnormal returns at the date of the event.

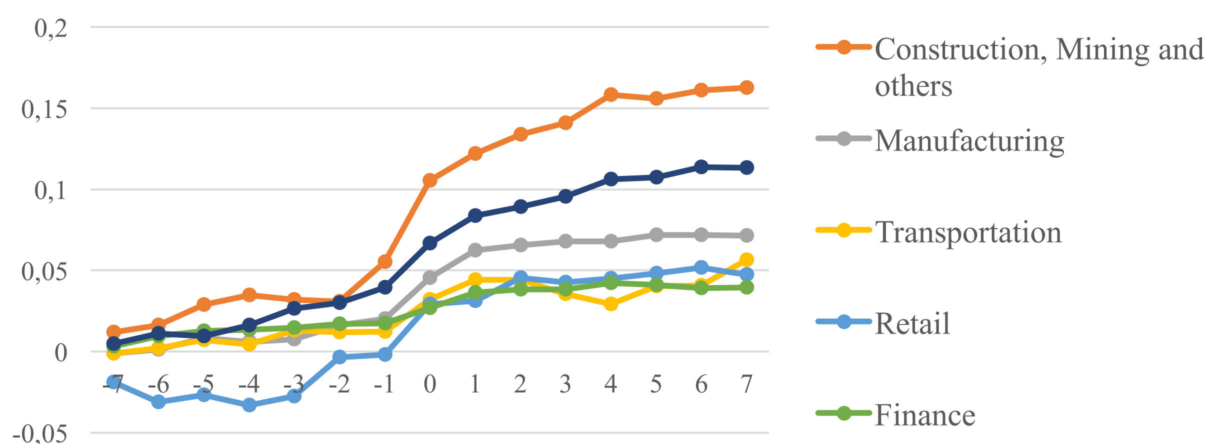

Figure 14. 7-days CAARs by different divisions of targets

In the short-term, the highest return is shown by the combined group of Construction, Mining, Wholesale and Trade that accumulated around 15%. The lowest returns are shown by companies from finance sector that might be justified by their more regulated operations and high correlation of their stock performance with their portfolio's performance in the case of funds and

REITs. As for the significance, t-test results do not provide any statistically significant result in the short run.

Conducting event-study analysis for these groups in the long-run demonstrated the following results:

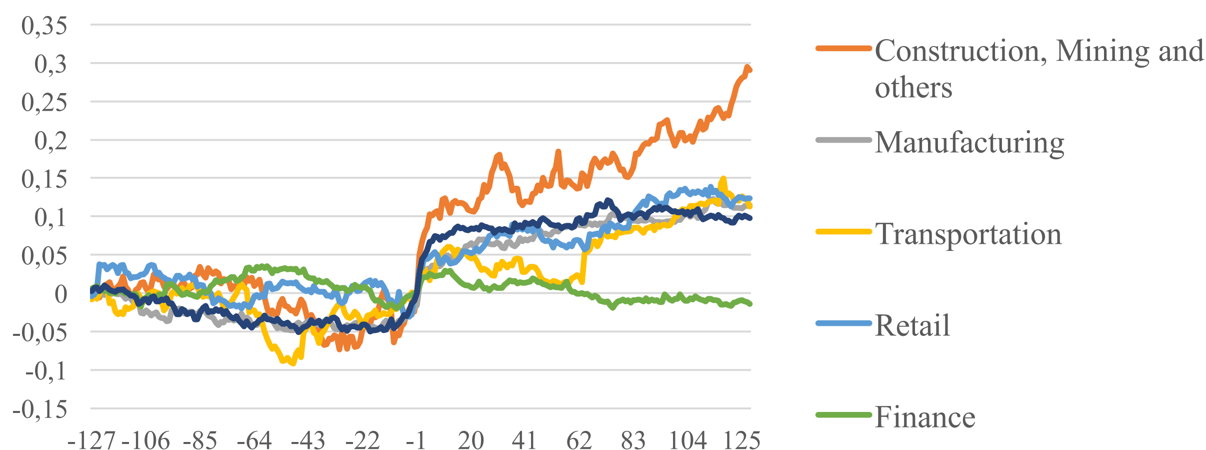

Figure 15. 127-days CAARs by different divisions of targets

In the long-run, finance division of companies is the only group which CAAR not just diminished significantly, but resulted in the negative zone. The combined group generated the highest return in 127-day period as it did in the short period, while others' CAARs closed around 12%. Classifying the sample by divisions of companies' operations does not provided many significant results in long run as well. Only the combined group of companies and stocks representing Manufacturing division are significant at 10% level.

To sum up the result, the total sample of 259 campaigns run by the most active activist hedge funds during the last five years demonstrates significant positive abnormal returns around the date of 13D Schedule filing. Therefore, the obtained outcome of the research proves the hypothesis that activist hedge funds interventions in companies increases targets' shareholders' wealth.

Table 8. Event-study results

# Campaigns	CAAR (-7;7)	t-test (-7;7)	CAAR (-127;127)	t-test (-127;127)
259	0,073	3,089	0,089	2,202

The result also demonstrates market efficiency – the biggest part of abnormal return occurs during the first few day after the announcement, however, the positive drift further is important for further discussion.

The paper also made an attempt to conduct the analysis for different demands, targets' market capitalizations and divisions of operations, however, in the most cases due to small

sample in total and subsamples for the intended for the further analysis, the results are insignificant in the most cases, however, abnormal returns are positive in all cases and visually results are similar in the most cases. Further we discuss the obtained results from managerial point of view.

Chapter III. Discussion

§1. Managerial implications and discussion

This paper aimed to define whether activist hedge funds entry in a company increases the targets' shareholders' wealth. Hedge funds are the most aggressive investors seeking short-term profits that is why many practitioners and scholars challenge activists' intentions and proposals. Another factor against hedge fund activism is their perception as belligerent corporate raiders rather than responsible investors unlocking value of firms by some of the market participants. The literature review section provides arguments for and against activism and describes why there is no consensus in the literature. That is why an activist hedge fund acquisition of a stake in a company raises such questions for shareholders of target company as what to expect from activists and their proposals and how their engagement with the board and proposed changes can affect stock prices and shareholder's wealth accordingly.

The result of conducted event-study in this paper shows, that stock prices of target companies experience positive abnormal returns around the Schedule 13D filing by activist hedge funds. This result is consistent with other works dedicated to the topic as other researchers also found that stock prices of companies approached by activists experience abnormal returns in the short-term, while others even claim that the positive effect lasts for several years (Akhigbe, Madura, 1997). However, many of these papers' results are not significant at conventional levels.

The most important result of this paper is that outcome of event-study not just demonstrated positive abnormal returns, but also provided significant results at conventional levels. This means that shareholders of approached companies experience positive changes in their wealth.

As it was covered earlier, stock prices reflect market expectations on further performance of a company as new information comes up. Significant positive abnormal return may signalize that the market views activist hedge funds positively or, as activists' intervention is always accompanied with a proposal, the market also positively reacts on these proposals. That is why some may claim that taking into account all recent trends in investing, activists are indeed good investors which action may cause positive changes in corporate governance, operational or financial performance. However, the issue regarding influence of activism on these items are left beyond this research, rather, it focuses on stock performance and what it implies for shareholders in both short and long-term.

The results of the research show that results are quite good and shareholders benefit from intervention in short term and that cumulative return rises during the consecutive six calendar month, on average. It was found, that average abnormal return on the date of filing Schedule 13D is 4,7%, while it rises to 7,3% during the first 7 business days and to 8,9% during the following

127 days. Some may assume that this statistic demonstrates good investing opportunity, but different proposals have different market reactions that should be analyzed and at different time frames before stating it for sure. The paper made such an attempt by conducting additional event-study analysis by viewing at the sample throw different perspectives and using 7- and 127- day time frame.

First of all, no matter what company is targeted and what are the pursued goals of activists, the target experience abnormal positive returns during the first seven days. But in the long run stock performance varies in accordance with different factors. First of all, the paper analyzed stock price reaction on different demands. In the long-run, the highest return is demonstrated by demands on selling company or activists' intention to acquire the target. As it was discussed, the continuous abnormal return is associated with expected higher price of acquisition. The decision on investing in a target company in this case depends on investors' view on the activist and its chances of pursuing the board. That is the case when activist reputation and experience plays huge role. This paper shows significant results in outcomes of these demands and as the sample includes famous frequent activists that are big enough to acquire at least 5% stake in targets and, therefore, have a real chance to get the deal done, being part of such a deal is considered a good investing opportunity. Profitable investing in companies that are under pressure with other proposals may not be feasible as CAARs of these proposals remain flat or go down.

Secondly, investigating approached companies as investing opportunities is presumably reasonable throw the prism of market capitalization of targets. The research outcome shows that only mid and small cap stocks experience continuous increase in CAARs. As it was discussed, those companies are the most frequent targets, because in the case of nano cap stocks managers may use poison pills, while proxy fighting with large cap companies is costly and results are not clearly predictable.

Finally, the paper made an attempt to analyze stock performance depending on division of company operations. This parameter does not provide clear results, as the most groups ended up with almost the same CAARs at the end of six-month period. The combined group of Mining, Oil and Gas, Wholesale trade and others demonstrated the highest return, however, the sample is too small to make inference. However, the most volatile result is demonstrated by finance division, that is why investing in such companies during activism campaign requires thorough consideration.

To sum up, an activists' filing Schedule 13D increases the target's shareholders' wealth in the short term in spite of the intention. In the most cases, the market is efficient and the biggest portion of CAAR is implemented in stock prices during the first several days after the event, thus, beneficiaries of activists' intervention are the investors that had stakes before the event. However,

proposal regarding selling the company to a third party or to acquire it by activist himself can provide a solid investing opportunities even for those investing after the event date. Applying this factor to middle and small cap stock may provide a solid investing opportunity: 17 campaign from the sample satisfied this condition and event-study shows that 8,2% abnormal return on the event date, CAAR(-7;7) equals 16,6%, CAAR(-127;127) is 25,7% while the last one is significant at conventional significance levels. Therefore, that is worth of further investigation.

§2. Research limitations and further discussion

The obtained empirical results and managerial implications were discussed, however, there are certain research limitations that should be covered. The first and the most important concern is the sample size. The sample includes the most frequent hedge funds activist campaign during the last five years that required Schedule 13D filing. Basically, the sample is limited to the amount of campaigns run within the period concerned. In total, there were 312 campaigns satisfying proposed conditions, but as it was decided to exclude investments in other hedge funds and REITs, the sample size was decreased to only 259 campaigns.

This sample size is large enough for testing the hypothesis and producing significant outcomes, however, as the paper makes an attempt to conduct event-study analysis via different perspectives – activists' demands, targets' capitalization and divisions of operations, the research struggles from small sample categories within each of the category. In many cases, obtained results are not significant, or subsample is too small to make any inferences while showing significant results according to t-test.

The problem of small subsamples may be solved by combining some categories as the research does with grouping Construction, Mining, Oil and Gas, Wholesale trade division together. However, the logic of getting different groups together is not always applicable. In the case of division of operations, distinguishing between different groups is a point of interest on exploring the market reaction on them, rather having a hypothesis of different performance in dependence on this criterion. However, due to different and actually contrary demands, combing small subsamples does not have a reasonable justification, as it would result in aggregated results that do not demonstrate absolutely different market reaction on Oppose Sale and Shareholder Rights demands, for example. The same principle applies to market capitalization criterion, as different market caps directly affect activists' chance on running a successful campaign, not mentioning different prices behavior of various capitalization stocks.

Moreover, the deeper analysis of activist demands can be conducted further. However, it is a challenging task due to the following issues. The first problem is that it is not always clear what are the demands of shareholders at the moment of filing 13D Schedule. Some activists state

in Item 4 of the schedule their concrete reason, but in the most cases a wide wording is used. The most frequent one is that a company is undervalued and represents a good investing opportunity. That is why activists demands become publicly available after activists' letters publishing or company executives' interviews. That is why the market not always understands what are the exact motives of activists.

The second point is that the market reaction on proxy fights should be analyzed. Proxy fights or contest is a continuous process without a clear predictable outcome. On the one hand, activists win 0,64 board seats per campaign on average, that means the win is more likely. On the other, the statistic imbeds campaign with several seats requests that dilutes win percentage per campaign and executives use different defending schemes like poison pills.

Therefore, an alternative date for analysis could be the proxy fight results announcement. At this moment, the described problem of unclear activists' goals is solved, but a new issue arises. What outcome is considered as a win? In the case of one demand – board representation, the answer is clear, but in the case of multiple proposals the task becomes more complicated.

To generalize things mentioned about activists demands, the paper made an attempt to split proposals and analyze market reaction on each of them. However, due to the small sample, unclear demands priority taken from Thomson Reuters report and multiplicity of simultaneous demands not clearly stated at the moment of filing Schedule 13D, the results may turn out so be deceptive. However, it is important to remind, that the market expectations about companies' future after activists' entry are positive that resulted in high average abnormal return at the date of event and values of CAARs.

It should be stated, that it is possible to increase the sample size by either considering a longer time frame or including campaigns that did not required acquisition of 5% stake in a company. In the literature section of the research it was said, that the market's perception of activists and their proposal evolves over time and that the research aims to define the most recent market reaction on activists' entry. Including campaigns that were not associated with mailing Schedule 13D is an option, but the task of clear event date identification becomes extremely challenging. In the case of Schedule 13D the event date is defined by publication of the report on SEC website, but in the second case a researcher has to find the first mentioning of the campaign in some public sources such as activists' websites or news in financial magazines that is extremely time consuming and may spoil clean event-study if an error occurs.

Also, in managerial discussion section of the work, a notion is made that the results raise a question on how react on the information of activist hedge funds' stake acquisition in a target company. Looking at stock performance in dependence on combination of different factors such activists' demand, market cap and division of target, creates a field for investigation of short-term

investing opportunity for third parties. Moreover, the reasons behind occasional falling CAARs should be examined; a possible hit of this drop is that it is associated with actual activists' performance and chances to win over the board and management.

To sum up, the research made significant contribution to the topic by demonstrating that activists' entry in a company is associated with significant positive abnormal return and makes attempt to define the link between different criterions of a deal and target's stock performance. The main limitation of this research is the sample size that is very limited due to small amount of total activist hedge funds campaigns run over the last five years. The sample could be extended by taking into account other campaigns that were not required mailing Schedule 13D, but as it was discussed, this extension leads to issue in identification of the event date. The further research can be conducted by addressing the same questions but by conducting an event-study on bigger sample.

Conclusions

This paper aimed to define how the market reacts on activist hedge fund entry in a target company and what does it mean to other shareholders of the firm. The hypothesis was that stocks of approached companies experience an abnormal significant return at the date of filing Schedule 13D that is required by US SEC when a fund acquires stake exceeding 5% of a company and has an intention to engage with the board. Indeed, the hypothesis was confirmed as the event-study result showed significant abnormal returns around the announcement date. Significance of the obtained results is the major outcome of the paper that filled in the research gap as recent studies on the issue lacked significance of the results or the sample used in research does not include recent campaigns and thus does not reflect the most recent attitude of market towards activists.

Moreover, the paper made an attempt to analyze market reaction on campaigns using several criterions. First of all, activists' demands were analyzed both in short and long-term. It was found that the highest cumulative average abnormal return was demonstrated by stocks approached with the intention to sell a company to the third party or to acquire it by activists themselves. The result is consistent with conventional stock behavior when a rumor of or actual acquisition bid is made. Secondly, stock performance was analyzed via prism of market capitalization of targets. The top performers are small and mid- cap stocks, while CAARs of others went down in the six-month period that is consistent with the statistics of the most frequent targets of activists. Launching activist campaigns on large capitalization companies requires significant capital and is costly as executives of these firms have tools and experience of coping with activists, while nano-cap stocks are speculative in their nature and this type of event may not embed a significant information. Next, the decision was made to group sample in accordance with companies' divisions of operations in accordance with Standard Industrial Classification system, however, the analysis did not provide unexpected results as long-term CAARs ended up in the close corridor of values. Also, obtained results serve as a base for further investigation on stock performances depending on the chosen criterions, but on the bigger sample; it is reasonable to conduct several researches by analyzing one factor a piece.

The main limitation of the research is the sample size. It is big enough to provide significant outcome and meet research goal, however, splitting the whole sample in different categories led to small subsamples and nonsignificant results in many cases. Further research can be extended by including campaigns that were not accompanied with mailing Schedule 13D, however, as it was discussed such inclusion considerably complicates the process of sample collection.

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