Chairman Oberstar and Subcommittee Chairman Brown, it is a pleasure to appear before you today to discuss activist investing, with a particular focus on recent investment in the rail industry. I am an Assistant Professor of Business Administration at Harvard Business School.

My comments today draw on research that I have done on hedge fund activism, as well as summarize contributions of other researchers working in this area. In my own research, I have collected data on every incident of hedge fund investor activism in the United States between 1994 and 2006, nearly a thousand events in total. This large sample research has been complemented by two case studies and a number of interviews and site visits with activist investors. The objective in all of this research is to understand the causes and consequences of investor activism. While most of my work has looked at the short-run impact of activism, I will have some remarks about longer-term effects as well.

I will address four basic questions. First, what is the proper role of activist investors in publicly traded corporations? Second, why is there so much more activism today than ten years ago, and why are hedge funds doing it? Third, what sorts of firms do activists target, and what do they ask management to do? Fourth, in practice, what do activist investors accomplish, and how do their accomplishments relate to shareholder value?

What is the proper role of activist investors? In a publicly traded corporation, minority shareholders have little incentive to spend resources monitoring management, making sure that they take the steps required to maximize shareholder value. If a firm is being mismanaged, small shareholders vote “with their feet” and sell their shares. But larger shareholders have more to gain by voicing their complaints. These so-called activists build up larger positions in the firm, and then
engage in a dialogue with management – potentially friendly but occasionally hostile – about the best course of action. Most of us, as passive shareholders, benefit directly from the actions of the activists, yet, importantly, they bear all of these costs themselves.

Why is there so much more activism today than ten years ago, and why are hedge funds doing it, as opposed to mutual funds or pension funds? The answer, I believe, lies in the enhanced incentives of hedge fund managers, who are paid 20 percent of all gains. Compare this with mutual fund managers who receive a flat fee on assets under management. For them, activism is simply too expensive – both financially and reputationally. So it’s not surprising that with the enormous growth of hedge fund capital over the past 5-10 years, there has been a similar growth in activism: There were virtually no activism “targets” at all in the early 1990s, but by 2006, there were more than 200 such events per year.

What sorts of firms do activists target, and what do they ask management to do? Generalizing here is difficult, but my research reveals a few common themes. Not unlike the current focus on the rail industry, targets tend to have a high degree of industry concentration. Industries with valuable hard assets but sluggish returns on capital are popular targets. For example, oil and gas companies were popular targets in 2004 and 2005. A recurring theme is that firms are undervalued relative to the value of their assets – this is a theme that has also been applied to railroads. Within this broader theme, activists tend to choose targets that have underperformed relative to their peers. I believe this is because the management in these underperforming firms is more compelled to listen. What do they ask for? The list is long, but the most common things are: spinoffs and asset sales, asking that the company put itself up for sale, asking the company to take on more debt, asking for board seats, asking for removal of a poison pill, and reductions in capital expenditures. A good number of these demands have been levied on the railroads. But I’m not sure how much we learn from studying activist requests – I believe that they make numerous demands but are happy when companies comply with one or two.

The final questions are what do activists accomplish in practice, and how does this relate to shareholder value. Average returns to activism have been high, no matter how they are measured. Around the announcement of activism, the stock price increases by about five percent, on average, presumably reflecting the gains that investors expect the activists to bring. And following the initial
announcement, the stock price drifts up further. What are the activists getting rewarded for? In my research, the most significant outcome is undoubtedly when activists push the company into a takeover. When this happens, the activist collects a takeover premium of 20-50 percent, thus exiting with a handsome gain. And activists have a knack at making this happen. In most other cases, activism is a non-event – meaning that the stock price is roughly flat in the period after activism, adjusted for the performance of the market. Absent a takeover, I find that firms that remain independent tend to cut capital expenditures (something that is requested in the current campaign of TCI against CSX), increase leverage, and do indeed become slightly more profitable. On other accounting-based measures of performance, such as asset growth or dividend payout ratios, there isn’t much of an effect. But to reiterate, what’s interesting is that absent a takeover, the stock price is roughly flat around the time of the activism. In other words, activists have proved themselves to be good at putting companies into play, but not good at making operational or strategic change. While this may sound negative for so-called strategic activism, I should make clear that there isn’t any evidence that activism destroys value in these situations. That’s pretty interesting if you think the management claims that activists pose an unnecessary distraction.

A final point: I often hear the criticism that activists are short-term investors, not interested in long-term value creation. I certainly agree that activists are short-term investors, and parts of my research support that claim. At some level, it is obvious in their desire to secure a takeover and get a quick exit. But this misses the point that in theory, the rest of the market has a long horizon, and would not be willing to reward activism with a higher stock price if it felt that activists were destroying the long-term value. Specifically, if the market felt that activists were a distraction rather than a benefit, the stock price would fall as soon as investors found out about the involvement of activists. Thus, to gauge whether the market believes activists can create value in the rail industry, one need look only as far as the share price appreciation. Naturally, one can always argue that the rest of the market has it wrong and management has it right, but this is not giving investors much credit. Notwithstanding this, I expect future research will have more to say about the important issue of the very long-term effects of activism.