

research newsletter

Hedge Funds and Activism

Introduction

This, the fourth edition of the ECGI Research Newsletter, focuses on the topical issue of hedge funds and shareholder activism. The hedge fund industry has grown hugely over the last few years, topping \$1trillion in the US in 2006 where the number of funds has increased by over 60% in the previous three years. Research shows that mainstream institutional investors in the US have only spent a limited amount of money on overt activism efforts and that when they do, their actions have little impact on the firms they target. Hedge funds have a different fee structure and fewer institutional constraints. When they want to engage with companies they have the means and the incentives to do so.

The latest research on hedge fund activism indicates that, contrary to received wisdom, hedge fund activism generates substantial positive abnormal returns for shareholders. Researchers still debate if shareholder activism unlocks value or squeezes cash and assets out of target companies without improving their performance.

In the UK, with its different legal environment which is less favourable to incumbent management, shareholders are given more power to have influence over the board. In a piece of unique research (because the authors had unprecedented access to the entire records of a fund's activity over six years), the Hermes UK Focus Fund was shown to have been very successful in generating returns for its investors over the period, measured by both annual raw returns net of fees of 8.2% and abnormal returns net of fees of 4.9% against the FTSE all-shares index. The authors estimate that 90% of such Fund returns is due to activist outcomes.

The two practitioners featured have very different viewpoints. The philosophy at Arlington Capital Investors is to make investments in relatively few companies in Europe, and engage with the management of those

companies as an active and involved investor. Colin Kingsnorth describes the approach of Laxey Partners as being aggressive in non-aggressive assets. Laxey concentrates on cash-rich, property-heavy companies and looks to release the intrinsic value.

Our featured book, *Hedge Funds – Risk and regulation*, by leading German academics, Theodor Baums and Andreas Cahn, is a thought-provoking look at the topic and provides a very useful summary of the current state of play of the hedge fund industry in various jurisdictions.



www.fee.be

The ECGI is extremely grateful to the Fédération des Experts Comptables Européens (FEE), the representative organisation for the accountancy profession in Europe, for kindly agreeing to sponsor this new initiative over the next three years in recognition of the valuable work they believe the ECGI is undertaking.

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Research digest

Six working papers on this topic have been published by the ECGI. The papers set out the authors' propositions in detail and supply the accompanying evidence. This Digest pulls out some of the key strands from the papers which can be downloaded from the SSRN website via the ECGI website www.ecgi.org.

Hedge Fund Activism

April Klein, Department of Accounting, Taxation & Business Law, New York University; and Emanuel Zur, Leonard N. Stern School of Business, New York University (ECGI Finance Series No 140/2006)

The hedge fund industry has grown hugely over the last few years. In 2006 Fraidlin estimated that in the US investments in hedge funds topped \$1 trillion that year and that the number of hedge funds had increased from approximately 5,000 in 2002 to 8,000 in 2005.

The authors cite research which show that institutional investors in the US spend only a limited amount of money on overt activism efforts and that, when they do, their actions have little impact on the firms they target. Specifically there is little evidence that activism by institutional investors elicits change in the corporate governance structures of target firms, removes directors or produces long term tangible benefits for investors.

The authors explain this by citing three possible reasons. The main reason is the free rider problem (ie many investors benefit from the activist investor's actions without having to carry a share of the costs of those actions) compounded by the huge cost of taking action under the US system. In the UK, any shareholder or group of shareholders with at least 10% of the voting rights in a firm can call a special shareholders' meeting to introduce a binding shareholder proposal. According to US federal and state laws, the only way a shareholder can force a firm's existing managers to pursue alternative strategies or changes in corporate governance is through a contested proxy fight, which is very costly. Interestingly enough, the authors find that often the mere threat of a proxy solicitation is enough to persuade the incumbent management to make the changes requested.

The second reason posited is that there are conflicts of interest faced by mutual funds and public pension funds in voting against management. The authors cite Davis and Kim (2005) who found a positive correlation between mutual funds voting with management and the amount of pension business those funds have.

Finally, the fact that almost all mutual funds (97%) charge investor's a flat rate based solely on the mutual funds assets means that the results of any increase in share value is not of such direct relevance to the fund managers involved.

The authors argue that the key differences between hedge funds and mutual funds makes the former more apt to be activists, mainly because they are relatively unregulated. Unlike mutual funds, hedge funds can hold more than 10% of any firm's stock and can invest more than 5% of their assets in any stock. They are not required to have sufficient capital to cover redemptions and can restrict investors from exiting their funds. They are also not required to disclose their holdings, investment strategies, short-selling positions or leverage ratios. This enables hedge funds to use stock lending or derivative markets to acquire voting rights without owning a long position in a firm's underlying stock, which enables them to build up voting rights in a target firm to buttress a threat of an impending proxy fight.

Another key difference lies in the way hedge fund managers are remunerated. A hedge fund manager's compensation typically includes both a percentage of invested funds as well as a percentage of the fund's profits which gives hedge fund managers enormous personal incentives to use activist campaigns to earn abnormal stock returns.

The authors argue that activism by institutional investors tends to target under-performing firms which they then seek to turn around. By contrast, the authors find that hedge funds target profitable and financially healthy firms and after gaining control they increase the debt load, reduce the cash at hand and pay out increased dividends to the shareholders, including themselves. One year on from the initial investment, typically Earnings Per Share, Return on Assets and Return on Equity decline, there is no increased investment in research and development or capital expenditures. As the authors comment: "Thus, unlike previous block-holder activist studies

that imply that activists target and improve poorly-performing firms, we find no such 'turn-around' for the hedge fund targets."

Hedge Fund Activism, Corporate Governance and Firm Performance

Alon Brav, Fuqua School of Business, Duke University; Wei Jiang, Finance and Economics Division, Columbia Business School; Frank Partnoy, School of Law; University of San Diego and Randall Thomas, School of Law, Vanderbilt University (ECGI Finance Series No 139/2006)

The authors have collected together data based on 888 events launched by 131 activist hedge funds during the period 2001 to 2005 and in so doing have brought an empirical basis to the analysis of hedge funds which has been lacking up to now. Most importantly, they collect data appertaining to both hostile and non-hostile interactions between funds and targets. Their sample is based on Schedule 13D filings which are required, under the Securities Exchange Act 1934, whenever anyone acquires, directly or indirectly, beneficial ownership of more than 5% of a company's shares.

The evidence they have gathered indicates that, contrary to the received wisdom, hedge fund activism not only generates substantial positive abnormal returns but it also generates long term benefits for shareholders. They found that the announcement of a programme of activism by a hedge fund, which often occurs when the fund files a Schedule 13D, results in large positive abnormal

returns, between 5 to 7%, during the announcement window and that these returns are not reversed one year after filing.

It also appears that the events which are associated with positive abnormal returns tend not to fall into the area of governance related events, nor to capital structure related events. The events which generate these positive returns tend to involve changes in business strategy (such as refocussing and spinning-off non-core assets) or the sale of target company. Two key governance related events could be seen as the removal of the CEO and/or the restructuring of the CEOs remuneration package. Although these two events fall into the category which did not have a statistically significant market response when the activism is announced, nevertheless the authors found that during the year after the announcement average CEO pay declines significantly and CEO turnover rates increase by 9% as against firms of a similar size and stock valuation.

The data also shows that only 26% of hedge fund activism is actually hostile. It is far more common for hedge funds to work with the management and other shareholders than is perhaps generally perceived to be the case. And hedge funds success rates are respectable, in about 41% of cases the hedge funds attained their main stated goals and in another 26% they achieved partial success, gaining significant concessions from their targets.

Typically hedge funds achieve these aims without taking control of the targets. The median ownership stake is only about 10% and these small stakes

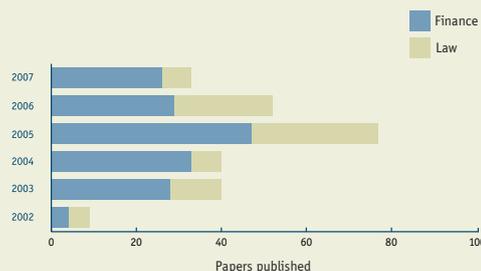
Working papers in the ECGI Finance and Law series

Both series started in 2002, since when (in June 2007), some 251 papers have been published, 167 in the Finance series and 84 in the Law series.

The papers can be downloaded free of charge from the Social Science Research Network's Financial and Legal Research Institutes Papers Series via the ECGI website.

Two editorial boards, chaired by Paolo Fulghieri, Professor of Finance at the University of North Carolina (Finance) and Guido Ferrarini, Professor of Law at the University of Genova (Law), scrutinise papers from ECGI Fellows and Research Associates for inclusion in the two paper series.

Further details can be found on the ECGI website at www.ecgi.org/wp/index.php



differentiate them from the corporate raiders prevalent in the 1980s. The hedge funds in the sample were reliant upon co-operation from the management or, in its absence, co-operation from the other shareholders to implement their stated agendas.

Although it is too early to be certain of the future of hedge fund activism, there are indications that the abnormal returns are declining. The authors suggest that this seems a likely outcome given that there are more funds chasing after fewer attractive targets where the opportunities exist to significantly add value. This does not mean that hedge fund activism will die out though, merely that the level of profits may not be as high.

In terms of corporate governance the new evidence presented in this paper suggests that activist hedge funds occupy an important middle ground between internal monitoring by large shareholders and external monitoring by corporate raiders. Activist hedge funds are more flexible, incentivised and independent than large institutional shareholders whilst at the same time the fact that they have smaller stakes than a typical corporate raider means they have to work with the co-operation of the management and the support of the other shareholders. The authors argue that this hybrid role puts them in a potentially unique position to reduce the agency costs associated with the separation of control and ownership.

The Corporate Governance Role of the Media: Evidence from Russia

Alexander Dyck, University of Toronto, Natalya Volchkova, New Economic School and CEFIR and Luigi Zingales, University of Chicago, NBER, CEPR and ECGI (ECGI Finance Series No 154/2006)

One of the most prominent tactics amongst hedge fund managers is to focus public attention on an under-performing company and to shame the CEO into either resigning or changing policy. The authors wanted to establish whether or not hedge funds (or shareholders in general) really could influence the level of media coverage about a firm and, if so, whether or not that increased coverage affected corporate governance within the firm.

The problem with trying to ascertain the level of impact that a media campaign has in the US or Europe is that, because of the range of other options the investor has to confront bad governance, it is difficult to know whether activists succeed because of their public relations campaign or because of their legal rights. However, in Russia shareholders are very limited in their legal rights, so a media campaign is likely to be of significantly more relevance than in other better-regulated jurisdictions. In addition, during the late 1990s, corporate governance violations in Russia were easily identifiable because they were very extreme, very common and very visible. And finally, and most importantly, is the existence of an investment fund, the Hermitage Fund, in Russia which consciously and publicly played a media strategy for companies within its portfolio which it felt were guilty of corporate malfeasance.

News coverage is a useful tool for the investor; the media collect, select, certify and repackage information and in so doing they dramatically reduce the cost of research, bringing together all sorts of sources to make reader's life easier. This encourages large numbers of investors to use the press which ensures a wide relevant audience and increases the effect on the reputation of the firm's managers. This is particularly important with the financial markets as a firm's reputation will affect the terms of future financing.

It is not only the firms themselves who are affected by press coverage, regulators can also be pressed into action by targeted public coverage. If there is a corporate governance violation which is widely reported and the regulator is seen not to be taking any steps to enforce the relevant regulations, that can have a detrimental effect on the reputation of the regulator. In roughly half the cases the authors looked where changes were made, it was the regulator or a politician that intervened, whilst in the other half it was the firm itself which took action.

The authors accept that the conclusions they draw in this paper are particular to Russia, during the period 1998 –2002, and that the specific conditions present then make it difficult to extrapolate their findings to other environments. However, they do think that two facts can be extrapolated. First that news coverage is driven not only by the intrinsic

appeal of each piece of news, but also by the lobbying effort exerted by those with an interest in the news being published. Secondly that media coverage is not merely reportage, it can have significant and real impact on events, particularly on corporate governance.

One final point that arose out of this research is that, when looking at the impact of the news coverage, the authors found that coverage in the Anglo-English papers (*The Wall Street Journal* and *The Financial Times*) exerted much more influence than coverage in local language papers. This points to an important implication for emerging economies which will need to be aware of the enormous influence of the Anglo-American media, especially countries in need of foreign aid and investment.

Hedge Funds in Corporate Governance and Corporate Control

Marcel Kahan, School of Law, New York University and Edward Rock, School of Law, University of Pennsylvania (ECGI Law Series No 076/2006)

In this paper, the authors look at the nature of hedge fund activism, how it differs from activism by traditional institutional investors and its implications for corporate governance and regulatory reform.

Hedge funds are emerging as the most dynamic of shareholder activists. This paper looks at the positive side of hedge funds, arguing that they can help overcome the classic agency problem of publicly held corporations by dislodging under performing managers, challenging ineffective strategies and making sure that merger and control transactions make sense for shareholders.

The authors also consider the negative side of hedge funds, particularly when the interests of the hedge fund conflict with those of other shareholders. When a hedge fund is a potential buyer of a firm in which it is also a shareholder, the interest of the hedge fund (which wants to pay the lowest possible price) are clearly at odds with those of other shareholders (who want to sell at the highest possible price). There can also be situations when the hedge fund holds securities in other firms, the value of which is dependent upon a certain transaction succeeding or failing, regardless of the impact that will have on the shareholders in the original firm. Added to this is the

potential problem of "empty voting" which involves the separation of legal and beneficial ownership with the hedge fund acquiring voting rights in a firm without have any economic stake in it. The authors do point out that as yet not enough is known about the extent of 'empty voting' so it is hard to make definitive recommendations on possible responses. Finally there is the age old problem of short termism at the expense of long term profitability, the most common criticism levied against hedge funds.

Some of the above conflicts also occur in traditional institutional investors. For example, index funds will own shares on both sides of many mergers between public companies. Where hedge funds differ, argue the authors, is that they choose to invest in both sides of a deal and acquire stakes in order to influence the outcome, potentially exacerbating the pervasive conflicts. Index funds simply find themselves on both sides as a result of their diverse portfolios.

It is this conscious and strategic activism which is cited as the biggest contrast between hedge funds and more traditional investors. Hedge funds pursue activism as a profit making strategy, they make investments in order to become activist rather than as an afterthought to a failed portfolio investment, and thus blur the lines between risk arbitrage and governance and control battles.

However, it is also important to keep in mind that only a minority of hedge funds pursue shareholder activism. According to a recent estimate by JP Morgan only 5% of hedge fund assets, or about \$50 billion, are available for shareholder activism.

The authors are convinced that more regulation for hedge funds is not the correct way forward. Their view is that market forces and adaptive devices taken by companies individually are better designed than regulation to deal with the potential negative effects of hedge fund short-termism while preserving the positive effects of hedge fund activism.

Hedge Funds and Governance Targets

William W. Bratton, Georgetown University Law Center and ECGI (ECGI Law Series No 080/2007)

This article takes an empirical approach to the controversies surrounding hedge funds by looking at the evidence, so far, on what hedge funds have

actually done to their targets. The author has collected information on 130 domestic firms identified as business targets of 'activist' hedge funds since 2002. He looked at the funds' demands, their tactics, and the results of their intervention on the governance and finance of their target firms.

Hedge funds of course are not a homogenous group but the author argues that the tie that binds the hedge funds together, despite the variety of their investment styles, is their promise to deliver above-market returns, a task which becomes harder and harder as more funds pursue the same strategies.

The author looks at three ways an outside investor can direct its input to get an immediate return on investment. The investor either gets the target firm to sell itself at a premium to another firm; or it gets the target to sell or spin off a significant asset; or it gets the target to pay out any spare cash. The fourth way to get an increased return is harder and longer term, it involves getting the target to change its long term business plan for the better.

In 33% of the cases in the sample, the press reported the hedge fund's contention that the target should be sold. Merger activity occurs in waves over time and within these waves activity tends to focus on a particular industry. In these instances the hedge funds look for smaller, weaker, underleveraged firms within a concentrating industry.

In 32% of the sample, the hedge fund was reported as contending that the target should sell or spin off specified assets. Selling of a significant, but unrelated or under-performing, asset is generally expected to increase the stock price. Hedge funds therefore look for firms that have recently closed acquisitions within their own industries, suggesting that they sell their purchases and redirect the proceeds back to the shareholders. They also look for firms with an attractive property portfolio and encourage them to sell. If the property is actually needed by the firm, it can be sold, the proceeds distributed and the actual property can be leased back from the new owners.

Cash rich firms existed in record numbers in 2006. Holding onto the cash enhances management's freedom of action and insulates the firm from adverse economic shocks. To the shareholders, however, it is free cash flow cash in excess of the businesses' needs that ought to be paid out. 38%

of the target firms in the sample could be defined as 'cash rich'.

Looking into the longer term, sometimes the hedge fund will seek to get the target to change its long term business plan which involves making a significant investment in understanding the business and a commitment to a long term investment. Typically the hedge fund will have a list of governance issues such as poison pills, lack of director independence or flawed incentive compensation. But the author finds that corporate governance alone is never given as a reason for intervention. *"Hedge fund activism is about value; governance and the processes of capital market discipline take second place on the agenda."*

What the analysis of the sample does show is that the accusation against hedge funds of short-termism is not borne out by the evidence. And that the radical transformation of the target's capital structures which was prevalent in the 1980's is not typical of engagements today. Although large cash pay-outs are often a result of intervention, this is not to the extent that would cripple the target. Nor, except in one case, was there any evidence of destructive cost cutting, indeed there was not much evidence of cost cutting at all.

Possibly the most interesting result of the analysis is the fact that today's activists often use their power to acquire board seats, this occurred in 40% of the sample's hostile cases. As the author points out *"With boardroom entry come fiduciary duties to the entity as a whole and an implicit commitment to pursue the value agenda in a co-operative framework...Whether the activists succeed in thus mediating between their agendas as fund managers and as boardroom fiduciaries remains to be seen. Meanwhile they conduct an important experiment in corporate governance"*.

Returns to Shareholder Activism Evidence from a Clinical Study of the Hermes U.K. Focus Fund

Marco Becht, Free University of Brussels (VUB/ULB) - ECARES, and ECGI, Julian Franks, London Business School, CEPR and ECGI, Colin Mayer, Saïd Business School, University of Oxford, CEPR and ECGI, and Stefano Rossi, Stockholm School of Economics (ECGI Finance Series No 138/2006)

This paper studies an experiment initiated by the

trustees of one UK pension fund, the Hermes UK Focus Fund, to overcome free riding problems in an institutional environment that is friendly to shareholders. The analysis provided is unique because the authors had unprecedented access to the entire records of the fund's activity over the period 1998–2004 including letters, memos, presentations, transcripts and recordings of telephone conversations and client reports.

Current thinking argues that institutional investors in the US don't undertake much activism and such activism as they do carry out doesn't make much difference (see above). The reasons cited for this, as mentioned above, are the problem of free riders, legal obstacles and incentive problems. The UK has a different legal environment which is less favourable to incumbent management, giving shareholders more power to have influence over the board.

The Hermes UK Focus Fund operates targeted high-intensity shareholder activism. It seeks to overcome the free riding problem by over-weighting the Fund's position in under-performing stocks that are to be engaged more intensively. The Fund applies a triple investment criterion. It asks a) is the firm under-performing; b) does the Fund believe it can engage the firm successfully; and c) does the Fund expect to obtain at least 20% more value over the current share price? Only if the answer to all three questions is yes does the Fund invest with a view to bringing about governance changes.

The Fund has been very successful in generating returns for its investors over the period, measured by both annual raw returns net of fees of 8.2% and abnormal returns net of fees of 4.9% against the FTSE all-shares index. The authors estimate that 90% of such Fund returns is due to activist outcomes.

The authors found that the Fund tended to carry out its activism in private rather than in public, eg by shareholder proposals at the annual meeting or filings of proxy statements. It invested in forty-one companies and engaged with thirty of them. The engagements involved numerous meetings and telephone calls with Chairmen, CEOs and CFOs. In more than half the cases the Fund also engaged with other executives such as divisional managers,

heads of investor relations and non-executive directors. It also privately contacted other institutional investors, communicating its engagement activities and soliciting support.

In 28 out of the 30 engagement cases, the intention was to bring about a substantial restructuring of the operations of diversified firms in order to provide more focus, for example by selling non-core divisions and assets, and by limiting diversifying investments and acquisitions. In more than half the cases the Fund explicitly aimed at replacing the CEO or Chairman and appointing new executives who were more willing to implement the required restructuring. Finally, in more than half the cases the Fund sought an increased cash pay-out to shareholders, often related to proposed divestment policies.

Although the results reported in this paper look at one fund only and cannot be generalised for other shareholder activist funds in the UK, the authors' findings are very different from previous studies. They found in this instance that there is a large amount of active engagement, that these engagements have a substantial effect on corporate activities and that the returns are large. They provide the first substantive evidence of gains to shareholder activism and suggest that well focused engagements can result in substantial public returns to outside shareholders as well as to those actually involved in the engagements. This suggests to them an interesting further line of research, namely that the legal environment might have a significant impact on activism by institutional shareholders.

An academic viewpoint

Professor Luigi Zingales is the Robert C. McCormack Professor of Entrepreneurship and Finance at the University of Chicago. *"Hedge funds are a very positive force in corporate governance. On the one hand, they have the flexibility to take relatively large positions in a short period of time to put pressure on underperforming companies. And they seem to achieve substantial results. On the other hand, they have strong incentives to deliver the results and are not tied down by the need to please corporations, like pensions funds. I'm not surprised that the corporate world does not like them and this is reflected in the press."*



Professor Luigi Zingales

Having said that, he is not a complete fan of every aspect of hedge funds. *"My concern is the complete lack of transparency of their operations which could facilitate some violation of basic norms, for example, on insider trading. I'm not suggesting, of course, that this is what they do. But the lack of transparency creates the suspicion and this feeds the public perception. I do understand the importance of keeping their positions covered for a little while - after all if you have devised a better trading strategy, you don't want everybody to copy it right away - but I don't see any reason why there should not be delayed disclosure in some form. For instance, I think it would be beneficial if they let the regulators and the academics study their historical position to understand the amount of risk they are taking. I don't think that themselves even the most sophisticated players have an idea of how much risk they are taking with their strategies. These analyses would also bring to light any improper behaviour, if there is any."* He is not arguing for extensive regulation, just that hedge funds should have a disclosure requirement with a suitable delay, eg they should be obliged to report their trades a year after they take place.

Luigi is not very hopeful that current political forces will lead to this outcome. The strongest pressures are

toward extreme and equally unpleasant outcomes. On the one hand, the corporate lobby just wants to limit the power and aggressiveness of hedge funds and tends to demonise them. On the other hand, the funds themselves are resisting any regulation at all on the grounds that once a small concession has been made, who knows where it all might end? There's always the danger of throwing the baby out with the bath water.

The only hope is that hedge funds choose to increase their transparency themselves, perhaps in response to pressure from the media. To facilitate this outcome, the media should pressure hedge funds towards transparency, rather than attacking them frontally, which will only serve to entrench their positions. But this outcome is still unlikely because more transparency will make it easier to calculate the true, risk-adjusted performance, and many funds will appear much less attractive than they appear today.

As far as the future of hedge funds are concerned, Luigi feels we are clearly at the peak of excitement over this particular vehicle and he thinks there will be a correction in the near future, a healthy correction. It's impossible to be exact about how or when this correction might take place but it's perfectly possible to imagine that a crisis in a large hedge fund could be the catalyst. Once that happens, as long as there is no backlash of overly restrictive and heavy regulation which is always a danger in such circumstances, then he feels hedge funds have a good long term future. *"They do cover an important niche of the market, they are an important asset class and they provide a flexibility that mutual funds don't offer. The question is will we see mutual funds becoming less regulated so that they can act more as hedge funds? Or will hedge funds be a little bit more regulated and move closer to mutual funds?"*

A practitioner viewpoint

Henry Blackie is Chairman of Arlington Capital Investors. Henry managed his first hedge fund in 1972 but he says he no longer knows what a hedge fund is. The true definition, he feels, is a fund which hedges, or takes a position in some instrument which acts contrary to the main investment, but

recently it seems to have got caught up with the notion of being a specific type of activist investor. Arlington Capital Investors are not a hedge fund, they are an old fashioned, long-only portfolio management fund, they don't hedge their risk and they've been managing their fund in this way since 1992.

The philosophy they developed was to make investments in relatively few companies in Europe, and engage with the management of those companies as an active and involved investor. Henry and his American co-founders chose Europe because at this period, particularly after the Single European Act, Europe was a very interesting market and was opening up to asset management. Before this, the individual markets were very separate from each other but the SEA required, amongst other things, the free movement of capital within Europe so that not only was it easier to invest across borders, it also opened the market up to outside money.

The current fund is the European Renaissance Fund and they only ever invest in 10 to 15 companies at a time, they select them very carefully and do a lot of due diligence, much more than might be expected in a normal portfolio. They often seek out companies that might not appear attractive on the surface but which have potential to be unlocked.



Henry Blackie

"You used to need to have at least 10% of a company before you would be taken seriously," explains Henry "but now we find that you can be just as vocal, and just as much listened to, if you do your work properly, with as little as 2%. It's not about legal influence, it's all about how you treat the company and who you speak to." Arlington only ever speak to the CEO or occasionally to the Chair of the Supervisory Board but they do also work alongside other shareholders as well, forming informal groupings to gain support for their proposals. "All one is doing is stating the obvious and sooner or later people will realise. You don't have to be a rocket scientist. It's just terribly obvious when you see a company being wrongly led."

Activism is the mechanism they use for to generate returns for their shareholders. What worries Henry about the activism process as it has developed over the past few years is that it seems to be seeking publicity, and publicity does not generate returns. *"That's why you don't see Arlington in the newspapers that often. We don't get paid for newspaper stories. We get paid for making good investments and managing them well. We go public when we think extra pressure needs to be brought on the company, but only as a last resort. In Continental Europe, in the non-Anglo Saxon world, if you have a reputation for being a publicity seeking activist, you just don't get the same kind of relationship with the company. On the whole we like to be in good communication and good dialogue with the companies we invest in. If that breaks down and you are viewed with suspicion, you end up banging on tables and then you get nowhere."*

The Arlington approach is to be much more engaged with the individuals in the company, they get really involved, they work hard to understand the company and often they are told that they are the investor which the management most appreciates talking to. *"They know we're going to be open with them, they know we're going to be honest with them. They know we're going to know about their companies and what their problems are. We have a managerial approach, rather than just simply leveraging, restructuring, financial engineering etc and on the whole our returns will stand up to scrutiny from anybody."*



Colin Kingsnorth

An alternative practitioner viewpoint

Colin Kingsnorth founded Laxey Partners Ltd in 1999 with Andrew Pegge. He describes their approach as being aggressive in non-aggressive assets. They don't buy inherently risky businesses, they concentrate on cash-rich, property-heavy companies and look to release the intrinsic value, and he says he has the results to prove the soundness of their investment strategies.

Colin defines a hedge fund by its fee structure, in particular the element made up of a percentage of profits. *"If you're an activist within that fee structure, you're called a hedge fund. When people are hugely incentivised in this way they are going to work hard, they will hire the best quality people and they are prepared to spend time being active because they see a very real benefit in doing so, as long as they do it right. Traditional investors are not likely to put in the amount of time which proper activism requires because they do not have the incentive to do so."*

The strategy Laxey uses will depend upon the individual circumstances. With one company in Sweden, Laxey took a 20% position and got an uncontested seat on the board. They felt that the company was essentially a US company listed in

Sweden and argued that the CEO should relocate to the US, should drive the company from there, and that he should be incentivised to do so, something which is difficult to achieve in Sweden because of the tax system affecting bonuses and options there. Having reorganised, after a two-year period the company had massively increased its productivity and its profits.

Or in the case of a Swiss company, which was undervalued but the management was very resistant to making any changes, the only way forward was to change the executive. Laxey tabled a resolution to do that and as a defence the company auctioned itself and sold itself off. *"Everyone knew it was worth more, but the company wouldn't act like that until someone came along and pushed them to it,"* explained Colin. *"Sometimes you push and sometimes you sit down and work with, and every combination in between."*

Laxey often has only a minority stake in a company and consequently will need to persuade, cajole and influence the other investors of the wisdom of its proposed course of action. However, even if the interests of the other shareholders are aligned, it does not necessarily mean there is support. Traditional institutional investors will tend to vote with management and Colin feels this comes back to the fee structure. *"They are not personally incentivised sufficiently for them to want to upset the status quo without a very good reason. They are also concerned about possibly losing clients to hedge funds who will outperform them. There has been a constant migration of money away from traditional markets towards hedge funds,"* comments Colin.

One of the common criticisms levied against hedge funds is short termism. Colin feels that this isn't necessarily the case. *"You'll find hedge funds who hold a position in stocks for a long time. Pension funds do tend to hold stocks longer but they also turn over their positions quite quickly sometimes. And in any event, why is it a good thing to hold stocks for a long time? You're in the stock market to make money so what is the difference between trying to make money on a one-year basis or a five-year basis?"*

He is also very scathing of traditional fund management. *"In the UK, pension funds are full of the most massive holes because traditional fund management has not done a good job. These*

traditional fund management groups have been appalling in terms of looking after the country's savings. They need to be better at it and could learn a lot from the hedge fund world. They've just been allowed to charge fees for mediocre performance.

"The market is getting more intelligent, there is more analysis, it is a deeper more liquid capital market because of hedge funds than it would be if they didn't exist. Hedge Funds have introduced a new level of professionalism into the market."

Working Paper prizes

Three annual prizes are awarded for papers published in the ECGI Working Paper series. To be eligible for a prize, a paper must have appeared in either of ECGI's Finance or Law Working Paper series and be deemed to have made a substantial contribution to the knowledge of corporate governance in Europe.



The Egon Zehnder International Prize

The €5,000 Egon Zehnder International Prize for the best paper in either series on company boards and their role in corporate governance is sponsored by the international executive search firm, Egon Zehnder International.

In 2007, the winning paper was **Independent Directors and Stock Market Prices: The New Corporate Governance Paradigm** by Jeffrey N. Gordon, Alfred W. Bressler Professor of Law, Columbia Law School (Law Working Paper No. 074/2006)



The Standard Life Investments Finance Prize

The €5,000 Standard Life Investments Finance Prize for the best paper in the Finance series is sponsored by the leading investment company, Standard Life Investments.

In 2007, the winning paper was **Benefits and Costs of Control-Enhancing Mechanisms in U.S. Family Firms** by Professor Belen Villalonga, Finance Unit, Harvard Business School and Professor Raphael Amit, The Wharton School, University of Pennsylvania (Finance Working Paper No.131/2006)

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The De BrauwBlackstone Westbroek Law Prize

The €5,000 De Brauw Blackstone Westbroek Law Prize for the best paper in the Law series is sponsored by the independent international law firm, De Brauw Blackstone Westbroek.

In 2007, the winning paper was **Hedge Funds in Corporate Governance and Corporate Control** by Professor Marcel Kahan, School of Law, New York University and Professor Edward Rock, School of Law, University of Pennsylvania (Law Working Paper No. 076/2006 – featured in this newsletter)

Details of earlier winners can be found on the ECGI website at www.ecgi.org/wp/index.php

Book review

by Contributing Editor, Lesley Stephenson

Hedge Funds – Risk and regulation

Edited by Theodor Baums and Andreas Cahn

Published by De Gruyter Recht, Berlin.

ISBN 3-89949-149-1

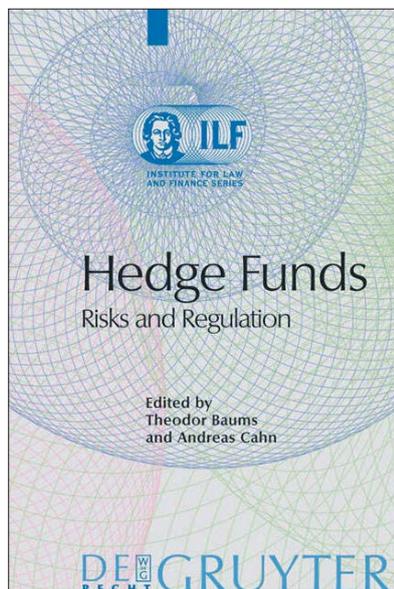
Available from Blackwell's for £60.72

see www.ecgi.org/books/books_id.php?auth_id=25

This is the inaugural volume of the Institute for Law and Finance Series, containing the proceedings of the ILF/DAI May 2003 conference entitled "Hedge Funds: Risks and Regulation" .

The first two papers look at the economics of hedge funds. The first paper, by Alexander M Ineichen argues that some of the commonly held beliefs about hedged funds are actually myths. One of the most commonly posited views is that investing in hedge funds is unethical. This paper argues that in fact what would be unethical would be a fiduciary who, in the context of a portfolio, did not give due consideration to investing in alternative investment strategies, and in particular in absolute return strategies.

In the second paper, Franklin R Edwards looks at the regulation of hedge funds with specific reference to



financial stability and investor protection. He spends some time analysing what happened in the near collapse of the hedge fund Long Term Capital Management (LTCM) during the summer of 1998, when it lost billions of dollars because of failed investment strategies that were not well understood by its own investors, let alone by its bankers and derivatives counter parties, and looking at the lessons that can be learnt from those events.

The next three papers all look at a particular aspects of the regulatory environment in three different jurisdictions – the US, the UK and Germany. Marcia L MacHarg from the US asks whether or not more regulation is actually necessary and argues that there are strong arguments that it's not, although she does think some regulatory change is inevitable. Ashley Kovas has a UK perspective and looks at the issue of the protection of the individual investor, asking if hedge funds should be marketed to retail investors. He argues that there is no obviously right answer to this, it will be up to individual jurisdictions to decide the correct level of regulation for their markets, with the proviso that it is essential that the regulators and, the retail customers they protect, understand sufficiently what sort of protection is, or is not, being offered in the regulatory regime. Finally in this section, Edgar Wallace looks at the regulation

of hedge funds in Germany, where neither German nor foreign hedge funds can be admitted to direct public sale according to German investment law, resulting in alternative structures having been developed by the hedge fund industry.

The last paper in the book is a detailed analysis of the legal aspects of the structure of hedge funds in Germany by Kai-Uwe Steck.

All the papers in this book are interesting and thought provoking, coming together to provide a very useful summary of the current state of play of the hedge fund industry in various jurisdictions.

Earlier editions of the Newsletter

Previously published newsletters have covered the following topics

Corporate Takeover

VOLUME 1/SPRING 2006

Controlling Shareholders

VOLUME 2/SUMMER 2006

Effective Boards

VOLUME 3/WINTER 2006

These can be viewed on the ECGI website at

www.ecgi.org/research

To request hard copies, please email

Christine Miller at admin@ecgi.org

ECGI Research Contacts:

ECGI Research Committee Chair: **Colin Mayer**

colin.mayer@said-business-school.oxford.ac.uk

Law Editorial Board Editor: **Guido Ferrarini**

wp@ecgi.org

Finance Editorial Board Editor: **Paolo Fulghieri**

wp@ecgi.org

Newsletter Editor: **Jeremy Miller**

jeremy.miller@ecgi.org

Contributing editor: **Lesley Stephenson**

wpeditor@ecgi.org

ECGI Website: www.ecgi.org

Disclaimer : The views expressed in this newsletter are those of the authors of the research papers and of those who were interviewed. They are not those of the ECGI, the FEE or the two organisations' respective members.