Enhancing Value or Stifling Innovation:

Examining the Effects of Shareholder Activism and Its Impact on American Capitalism

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Abstract

Shareholder activism is an increasingly common practice in American capitalism. In fact, in 2016 alone, 21% of the S&P 500 was approached publicly by an activist shareholder. The existing thought on shareholder activism is split into two sharply divided camps. On one side, experts decry activism as a detrimental, "short-term" practice that must be guarded against. On the other, scholars and hedge fund managers argue that activists enhance shareholder value and improve underperforming corporations. This paper seeks to understand why there is such disagreement over the same data. Using interviews of key actors, primary and secondary research, and corporate governance theory this paper finds that activism can deliver greater management and board accountability and improve the way in which capital is allocated. However, despite its potential to call attention to and improve issues in some situations, we argue that activism is a negative influence for the long-term health of corporations, as it frequently overlooks important measures of corporate success and stifles innovation.

Keywords: shareholder, activism, capitalism, corporate governance, capital allocation, innovation, shareholder theory, stakeholder theory, hedge fund, management

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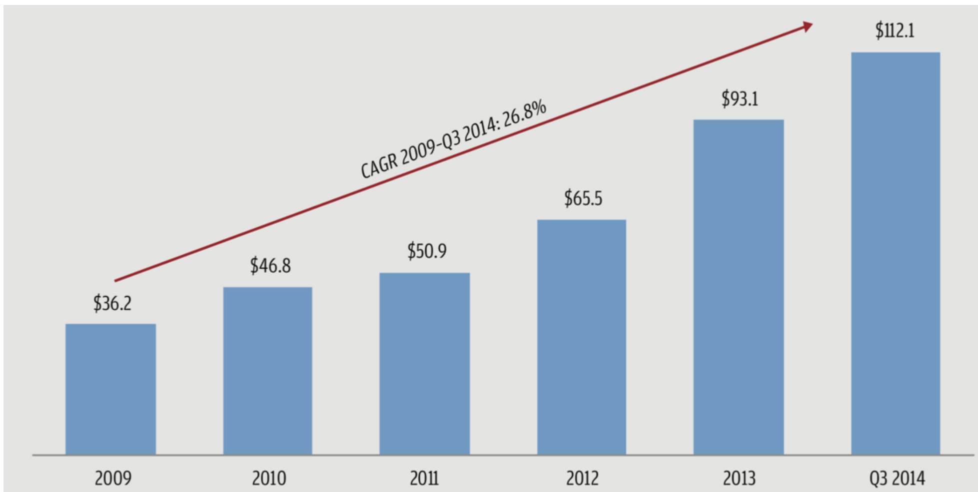
Chapter 1: Introduction:

In October 2017, hedge fund manager Nelson Peltz waged the most expensive proxy fight in history against Proctor and Gamble (P&G). As the world's largest consumer products maker by market value and creator of such iconic household names that include Gillette razors and Tide detergent, P&G represents the formidable greatness of American business. However, despite P&G's massive size, as seen in its market capitalization of nearly $200 billion, Peltz's Trian Fund Management shook the behemoth of a company by announcing just a 1.5% ownership. Over the course of a year, Trian and P&G spent a combined $100 million on mailings, advertisements, and phone calls as part of a proxy contest to win the support of shareholders in order to seat directors on the P&G board (Flaherty & Ramakrishnan, 2007). Although the fight for a place on or even the control of a board is frequently publicized as the culmination of the relatively novel phenomenon of shareholder activism, proxy fights represents just one example of the longstanding practice of shareholder intervention in the governance of public companies.

Upon opening *The Wall Street Journal* or *The Financial Times* on any given day, one is destined to notice the mention of "shareholder activism." Frequently referring to hedge fund interventions in public companies, this term has become prolific in describing the way in which investors interact with companies in an effort to get their views known. It is not only the use of the term that has grown; the practice of shareholder activism has expanded greatly in the last number of years, primarily as a result of the expanded role of institutional investors and cash-flush asset managers. Following the financial crisis in 2008, "activist" funds have ballooned from managing just $36 billion in 2009 to over $112 billion in 2014 (J.P. Morgan, 2015). This growth in assets under management (AUM) at hedge funds considered "activists" is shown in figure 1.

Figure 1: Total Activist Hedge Fund AUM ($bn)



Note: AUM numbers only account for single-strategy activist managers—multi-strategy funds and investment managers engaging in activism as a sub-strategy are excluded. Source: (J.P. Morgan, 2015)

Only two years later there was more than $120 billion in dedicated activist funds, deployed in nearly 300 activist campaigns. The scale of interventions is so large that 21% of the S&P 500 was approached publicly by an activist shareholder in 2016 alone (Taxin & Atkins, 2017).

Although many are familiar with examples of shareholder activism today, such as Peltz's fight with P&G, broadening its definition illustrates a long history of activist interventions. Activism can be defined as a set of actions taken by shareholders of a public company with the explicit intention of influencing a change within the organization in order to enhance the value of the company's stock (Taxin & Atkins, 2017). While in most cases, shareholder activism is directed at publicly held companies, there are notable exceptions, such as Benchmark Capital's suit against Uber to remove founder Travis Kalanick from management. It has long been argued that shareholder activism is a relatively recent phenomenon in American capitalism (Lanchester, 2016). However, the insistence by investors of speaking up, and in some cases, acting to stimulate corporate executives and boards to focus more on strategies in order to create shareholder value has a long history in American capitalism.

In *Dear Chairman* (2015), Jeff Gramm traces this type of activist intervention by shareholders back hundreds of years. The concept in itself—shareholders of a company rising from passivity to voice demands—is recorded as long ago as four hundred years when shareholders accused the executives at the Dutch East India Company of corruption. One of the first instances of activism led by professional fund managers, as has become the trend today, is visible in the twentieth century. In 1927, noted investor and Columbia professor Benjamin Graham wrote a letter to Northern Pipeline, a subsidiary of John D. Rockefeller's Standard Oil monopoly, calling for the company to dividend out its excessively large pile of cash and improve its capital structure.

Although there is no language of the massive proxy fights or public relations strategies that are associated with activist campaigns today, the concept of an investment firm buying into a public company to push for improvements represents the same underlying principle of activism. More recently, the 1980s phenomenon of "corporate raiders," in which actors such as T. Boone Pickens and Oscar Wyatt sought to ignite hostile takeovers and the breakup of companies similarly illustrate the presence of outsiders attempting to influence company actions (Cloyd, 2015).

While the long history of shareholders voicing demands makes it is clear that activism itself is not a new concept, the context around activism has shifted as corporate ownership has become concentrated in fewer institutional hands. The SEC defines an institutional investor as an investment manager with over $100 million in assets (Blume & Keim, 2012, p. 1). From 1900 to 1945, the proportion of equities managed by institutional investors hovered around five percent. As of 2010, institutional holdings controlled 67 percent of all stocks, showing that institutional investors control a large proportion of the equity of publicly traded corporations (Blume & Keim, 2012, p. 4). The growth of pension funds, mutual funds and hedge funds, which include mega-investment firms such as BlackRock and Fidelity, has empowered money managers with greater influence and control of public corporations through activism (Dai & Helfrich, 2016, p. 9). The changing financial landscape, in which a few investors retain such concentrated power, has raised a hotly debated question of whether the resulting activist intervention by hedge funds, with the agreement or complacency of mutual and pension funds, has a positive effect on a company's stock value. This paper seeks to address this question and the reason for the disagreement about the results of shareholder activism.

By synthesizing primary anecdotes from relevant actors—investors, management, and academics—with existing scholarly research and theory, this paper finds the following:

On the "pro" side, activists argue that they help unlock value by fostering greater management and board accountability, questioning the decisions that the company makes, and forcing executives and directors to allocate their capital wisely to create value. Although, based on our findings, we conclude that activism can address governance shortcomings and improve returns in certain situations, it frequently stifles innovation and overlooks additional measures of corporate success including sustainability, risk, corporate practices, and customer satisfaction, which are key to the long-term value of the enterprise. This paper argues that despite its potential to call attention to and improve issues in some situations, activism is a negative influence for the long-term health of corporations.

Chapter 2: Literature Review and Theory:

Theoretical Framework

In order to analyze activism, it is important to consider two competing frameworks for understanding how corporations are run and set their goals: shareholder theory and stakeholder theory. Shareholder theory argues that a company manager's primary responsibility and fiduciary duty is to develop a business strategy that, over a reasonable period of time, will enhance shareholder returns. Shareholders are defined in this view as the individual owners of a company's private or public stock. These owners advance capital to a company's management, which then makes decisions on the basis of whether or not value is directly created for the owners. Shareholder theory became popularized in 1970 when Milton Friedman, an American free-market economist at the University of Chicago, argued against early corporate social responsibility practices. Friedman famously said: "There is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud" (Friedman, 1970). Friedman explains that managers have a fundamental obligation to do only that which maximizes the shareholders' returns. To that end, spending corporate funds on socially beneficial endeavors does not create value and ultimately reduces shareholders' returns.

Stakeholder theory, on the other hand, provides a different conception of the ultimate goals of a corporation by adding the interests of other groups, such as employees and customers, into the mix. According to stakeholder theory, managers are the agents of all stakeholders—employees, customers, communities, among others—and must guarantee the ethical rights and balance the legitimate interests of a broader base in making decisions (Smith, 2003). Stakeholder theory arose soon after shareholder theory, in part due to Edward Freeman's *Strategic Management: A Stakeholder Approach*. In his book, Freeman defines a stakeholder as, "Any group or individual who can affect or is affected by the achievement of an organization's purpose" (Freeman, 2010, p. 53). By this definition, stakeholders extend beyond just employees and customers to include the local community, suppliers, competitors, financiers, trade unions, governmental bodies, and many others. Stakeholder theory argues that managers must balance the different interests of all stakeholders, and balance the urgency and legitimacy of their respective claims, in order to make decisions that maximize outcomes (Mitchell, Bradley, & Wood, 1997). Varying attributes, however, frequently complicate management's ability to make decisions that both maximize the total combined value and maximize the individual benefit of each group.

Despite the prominence of profit-minded stereotypes of American society and the embrace of shareholder theory by academics, many have begun to embrace varying degrees of stakeholder theory. Supporters of pure shareholder theory believe that companies exist solely to produce a profit through the creation of goods and services. Furthermore, these supporters believe that accounting for the interests of other stakeholders will in no way aid the pursuit of profit and is therefore unwise. However, there is a discrepancy between what the theory favor and what industry practitioners actually believe. In a recent survey of 15,000 managers worldwide, a majority supported the view that companies are responsible for the well-being of various stakeholders, as opposed to only the pursuit of profit. This shows a misalignment between theorists and managers' view on the ground (Hampden-Turner, 1993).

Additionally, there is growing support for the view that commerce is not necessarily a zero-sum game in which the interests of shareholders are at odds with other stakeholders. An article in *Business Ethics Quarterly* explains that, "Certainly, there are those who defend the view that managers' primary fiduciary obligation is to shareholders, as well as those who argue for the importance of shareholders in corporate governance. But the view that a successful company could be built without even considering the interests of other stakeholders is simply too implausible to be taken seriously" (MacDonald, 2009). Fully understanding the interests and desires of customers is especially relevant for a company's profit, which is a product of customer sales, satisfaction and loyalty. Prioritizing customer needs, although it may require additional expenses and product refinement that can cost shareholders up front, ultimately maximize the shareholder returns and stakeholder benefits.

The main criticism of stakeholder theory is that the presence of various, often competing, interests makes it difficult for management to determine the collective interest and direction for the firm's objectives. Critics argue that this dilemma has the potential to give unscrupulous management an excuse to act in their own self-interest (Nwanji & Howell, 2005). The complexity of stakeholder theory in practice consequently leads some to support the traditional shareholder theory that certain actions should be taken only if they improve a company's profitability and, by so doing, increase shareholders' returns.

In the context of shareholder activism, these frameworks are critical for explaining the motivations of investors. Some activist investors are clearly motivated by a belief that companies should only prioritize shareholder returns. However, certain activists, such as Barry Rosenstein of JANA Partners, contend that companies have a larger ethical purpose than just profit maximization. According to Rosenstein, activism can be a vehicle to best serve both shareholders and greater stakeholders. In a 2017 presentation on Activism and Ethics at Lehigh University, Rosenstein said, "Activism is like most other professions, except perhaps reality TV, in that you can make it ethical. That is why I, my partners, and my team try to do it every day" (Leck & Thren, 2016). Rosenstein is just one example of the many different viewpoints expressed by shareholder activists.

Literature Review

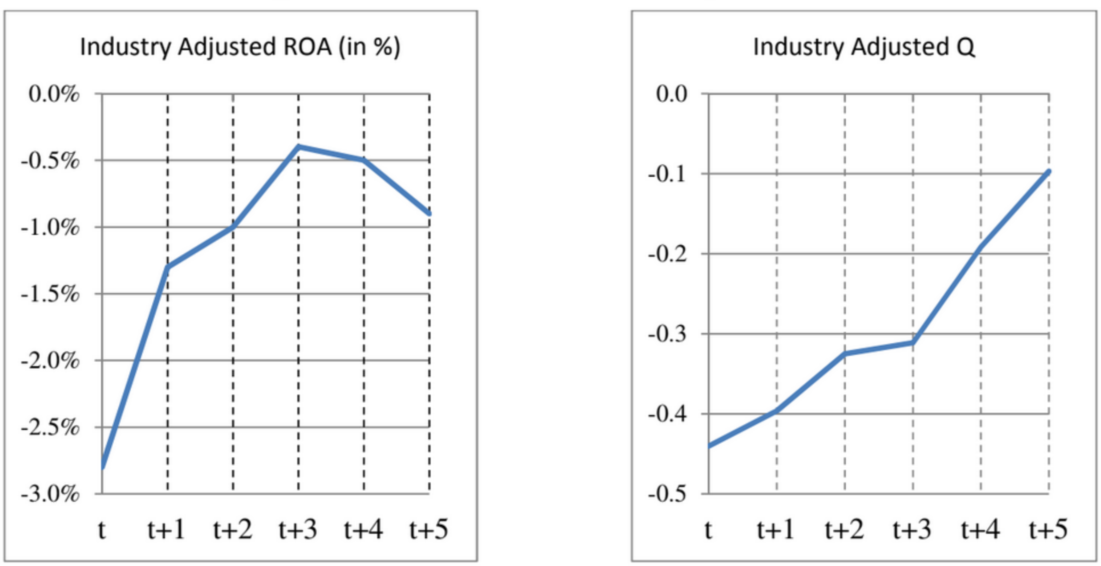
Within this theoretical framework of the objectives of corporations, there exist two primary views about the impact of shareholder activism and its ability to benefit shareholders and stakeholders, respectively. On one side of the debate, experts such as Martin Lipton of the leading law firm Wachtell, Lipton, Rosen & Katz, argue that activism is short-term focused and detrimental to companies. In an April 2018 memo (Wachtell, Lipton, Rosen, & Katz, 2018), Lipton illustrates the attack strategies of activist hedge funds, and explains the need and ways for companies to defend themselves. This document implies the negative consequences of activists, due to the potential misalignment between activist interests and long-term investors, and the consequential need for defense. Laurence Fink, Chairman and CEO of BlackRock, takes this view further by directly charging that activist hedge funds undermine the long-term value of all stakeholders:

> "Without a sense of purpose, no company, either public or private, can achieve its full potential. It will ultimately lose the license to operate from key stakeholders. It will succumb to short-term pressures to distribute earnings, and, in the process, sacrifice investments in employee development, innovation, and capital expenditures that are necessary for long-term growth. It will remain exposed to activist campaigns that articulate a clearer goal, even if that goal serves only the shortest and narrowest of objectives. And ultimately, that company will provide subpar returns to the investors who depend on it to finance their retirement, home purchases, or higher education" (Wachtell, Lipton, Rosen, & Katz, 2018, p. 10).

Fink argues that activism inhibits a company's ability to innovate and perform strongly in the long-term. This would hurt not only the company but also other shareholders that depend on a better long-term outlook.

On the other side of the debate, Harvard Law Professor Lucian Bebchuk argues against the previous “short-termism” argument, suggesting that activism is a positive phenomenon. In a study of over 2,000 activist hedge fund interventions from 1994 to 2007, Bebchuk empirically tests for the effects of activism on the company's’ operating performance and stock price, up to five years after each intervention. In examining ROA (EBITDA/Assets) as a proxy for evaluating operating performance, Bebchuk explains that this performance is higher in each of the five years after an intervention. Similarly, Bebchuk invokes a measure designed by 1960’s Nobel Prize-winning economist, James Tobin. Tobin’s Q (Total market value of firm / Total asset value) reflects the effectiveness with which a company turns book value into market value accrued to investors (Bebchuk, Brav, & Jiang, 2015, p. 7). Bebchuk finds that Tobin’s Q is improved five years after an intervention, as shown in Figure 2.

Figure 2: The Evolution of ROA and Q Over Time



Note: Despite the decrease beginning in year t+3, ROA is still higher than before the observed intervention. Industry adjusted Q consistently increases following the intervention. Source: (Bebchuk, Brav, & Jiang, 2015, p. 10)

Although activists target underperforming companies relative to peers, Bebchuk concludes that short-term earnings are not increased at the expense of long-term earnings. Bebchuk defines underperformance as returns of targeted companies being systematically lower than what would be expected given standard asset pricing models or returns of targeted companies being lower than those of firms with similar size and book to market (Bebchuk, Brav, & Jiang, 2015, p. 17). Even after activists sell their shares and dip below 5% ownership, there is no support for the "pump and dump" view that the value of the company will decrease in the long-term, as is frequently argued by vehement opponents of activism. Furthermore, Bebchuk's research notes that even though 19% of activists sought to reduce long-term investment and resources, there is no evidence that these cuts are bad in the long-term, but on the contrary, increase shareholder value as seen in figures 1 and 2. Even when an activist is adversarial and threatens a proxy contest, lawsuit or public campaign, no negative impact is found on the company (Bebchuk, Brav, & Jiang, 2015).

Suraj Srinivasan of Harvard Business School builds on Bebchuk's work to provide additional support for the positive operating performance effect of activism (Gow, Shin, & Srinivasan, 2014). Srinivasan finds that ROA increases by more than 2% over the five years after interventions. Proxy contests, regardless of the outcome, have a statistically significant positive effect on share prices. Other findings include increased divestiture, decreased acquisition activity, higher probability of being acquired, lower cash balances, higher payout, greater leverage, higher CEO turnover, lower CEO compensation, lower capital expenditures and lower R&D. These effects are even greater when activists gain board representation, which is consistent with the view that board seats are an important vehicle for bringing about the demands of activists. When activists receive a board seat, their average holding period increases from 2.4 years to 3 years.

However, even though Bebchuk and Srinivasan argue that activism is consistent with better operating performance and stock price appreciation for shareholders, their explanations omit a discussion of other stakeholders and consequently only value each company from the perspective of shareholder theory. These results are therefore not enough to prove that activism is genuinely value-enhancing, as opposed to simply consistent with better operating performance and stock returns (Gow, Shin, & Srinivasan, 2014).

These dual literatures provide an important space to insert primary research and determine why activism is quite so polarizing. In the following sections, we work within these frameworks of existing theory and understanding of activism to explain why there is such disagreement over activism. It is clear that the practice of activism can be both positive and negative depending on the factors one considers when valuing the effects of corporate decisions on shareholders. In the next section, the potential for positive impacts of activism are discussed.

Chapter 3: The Positives of Shareholder Activism:

To fully understand and evaluate shareholder activism, it is important to consider the arguments put forward by its supporters. Given that such a range of professionals speak in favor of activism—academics, hedge funds, mutual fund directors, and even a select few corporate managers—it is clear that activism *may* have a positive impact under certain circumstances. In fact, activism can be a positive force in some situations by filling a corporate governance shortfall. There is a major issue in the United States in which corporate governance is frequently ill-suited to maximize shareholder value and protect the interests of all shareholders. While activism can correct this issue by intervening, chapter four explains that it overlooks other important factors than just operating metrics when it fills this corporate governance hole. This chapter discusses the systemic governance issues of public corporations, and the way in which activists can unlock value by fostering greater management and board accountability, questioning the decisions that the company makes, and forcing executives and directors to allocate their capital wisely. The potential for a positive impact is particularly exemplified in activists' partnerships with passive investment funds and the examples of DuPont and Microsoft.

Delivering Accountability

One of the strongest cases made in favor of activism is that it encourages greater accountability to shareholders. In the United States today, there is a systemic argument that holds to the view that poor corporate governance rises from the structure of many boards. This view is buttressed by the belief that too many directors are selected by, or at least that candidates are put forth by, management. Thus, an "old boys" network is self-perpetuating with board members owing their selection and fees to incumbent executives. Hence, it is argued that governance at a company is conflicted from the start by this process.

This reality runs counter to the concept of good corporate governance. By definition, directors on boards of public corporations are elected by shareholders to serve as *their* agents (Montgomery & Kaufman, 2003). According to the Commonsense Principles of Corporate Governance, a series of corporate governance principles intended to provide a basic framework for sound, long-term oriented governance, there are a number of clear roles that a board should play. Specifically, this document, which is supported by firms ranging from BlackRock and Berkshire Hathaway to General Electric and ValueAct Capital, explains that the Board of Directors' responsibilities include: communication of the board's thinking to the shareholders, reviewing the performance of the CEO and key management, creating shareholder value with a focus on the long term, evaluating strategic issues such as acquisitions and capital commitments, setting standards of performance, evaluating risks, and determining compensation (Popper & Verbinnen, 2016, p. 4).

In many public companies, however, boards are not directly accountable to shareholders, as the shareholders are not able to effectively monitor a board's action (Keay & Loughrey, 2015, p. 261). As a result, directors often fail to execute their responsibilities of properly overseeing a corporation to ensure long-term value for shareholders. Michael Goldstein, former Chairman and CEO of Toys "R" Us in the 1990s and an outside independent director on a number of public corporations, explains that many boards only meet four times each year, and are not sufficiently active. According to Goldstein, boards often lack members with relevant expertise to monitor and advise on corporate strategy, and are unwilling to improve the board and consequently the company out of a desire to remain "collegial" (M. Goldstein, personal communication, March 23, 2018).

This concept is similarly expressed in a 2003 *Harvard Business Review* article, in which Montgomery and Kaufman explain that serving on a board is a perk that directors have little incentive to give up or threaten by pushing for change that could help shareholders: "[Boards carry] prestige and other intangible perks associated with membership in an exclusive club. Almost all of these benefits can be had whether or not the stock is soaring" (Montgomery & Kaufman, 2003). Furthermore, board members are not personally liable for company failures, so do not face significant consequences from poor performance (Zipes, 2015, p. 108). Although board members want to prevent disaster that would damage their personal reputation, their interest frequently lies in preserving their position in the exclusive "club" of the board rather than thinking creatively or advocating for improvement.

This desire of board members to hold onto their position and incentive to not rock-the-boat can provide an opening for activists to better enhance shareholder value. Given that directors rarely have direct input from shareholders, and have little incentive to spend political capital and emotional energy on anything but the "path of least resistance," boards may overlook poor strategy and fail to promote growth (Montgomery & Kaufman, 2003). Activists argue, therefore, that they can bring value to shareholders by voicing new ideas and difficult changes that passive board members are not willing to entertain. For example, while board members may not challenge the CEO on his or her compensation plan, who is simultaneously Chairman in 52% of S&P 500 companies, an activist will often voice concern and demand a better alignment of compensation to performance, thereby protecting shareholders from management abuse (Larcker & Tayan, 2016).

In another example, boards may be overly trusting of management, and not question decisions of acquisitions and growth strategies. Activists, on the other hand, argue that they can deliver higher returns and better performance to shareholders by demanding that the board more closely monitor strategic decisions and even push for other actions to create shareholder value. The argument generally put forth is that activists, many of whom own significant shares in a company, have interests that are more aligned with other shareholders than do the incumbent management and board. One activist investor who is frequently pointed to as a model for delivering new ideas and effective pressure is Jeff Ubben of ValueAct Capital. ValueAct pitches itself as a "management friendly" investor, which eschews the public fights and bellicose campaigns against CEOs that are often associated with activism, in favor of working with companies to improve performance and identify better strategic decisions (Ovide, 2013).

One well-known example of ValueAct's positive influence was its 2013 intervention in Microsoft. In 2013, ValueAct was rumored to have orchestrated the resignation of CEO Steve Ballmer and the replacement by Satya Nadella, an action that a large number of shareholders had supported after watching Microsoft's shares and innovative leadership languish for over a decade (Greene, 2013). ValueAct encouraged Microsoft to refocus attention and resources on its popular software systems and cloud infrastructure, while simultaneously responding to shareholder demands to increase dividends. These actions critically contributed to the company's reinvigoration—as evinced in its doubling share price—and increased responsiveness to shareholders (Duggan, 2016). This example demonstrates how activism can fill oversight gaps in a positive manner and be a catalyst managerial change (Gandel, 2013).

Improved Capital Allocation

In addition to increasing the general accountability of directors to shareholders, activism can have a clear impact on a company through scrutinizing the method by which capital is allocated. By presenting boards and management with new ideas and concerns, activists can often bring reasonable suggestions for how to improve a business. Stemming from the lack of sufficient oversight at many companies and failure of directors to question strategic decisions, there can exist an opening for activists to affect valuable change. For example, even in public and contested proxy fights publicized in the news, such as that between DuPont and Trian Fund Management in 2011, activists can suggest value-enhancing measures. In this case, a few of Trian's demands included completing the spinoff of a chemicals division and cutting high costs that were not profitable (Trian Partners, 2014). Although former-CEO Ellen Kullman indicated that DuPont had already planned to spin-off its Chemical division and that Trian demanded actions such disagreed with such as increasing leverage, Trian at the very least acted as an impetus to complete the spin-off and forced the company to reexamine and defend its strategic capital allocation decisions to ensure profitability (E. Kullman, personal communication, April 9, 2018).

In another example, activists frequently demand a review of investment and R&D expenditures. While investment and R&D are crucial to companies' long-term health, there are cases in which activists can validly demand improvement to an unwise or inefficient allocation of capital. In a 2014 intervention by Starboard Value in Darden Restaurants, Starboard demanded that Darden cut costs, spur creativity and remain closer to its core business of serving food by spinning off its real estate holdings. This action forced the board to reconsider the action it had been taking for many years in regard to capital allocation, and eventually agree that value would be enhanced by ceding control of its property investment and changing many of its practices in its restaurants. In the end, by the time Starboard's Jeff Smith resigned from the board in 2016, Darden's stock had risen 47% versus the 6% of the S&P 500, and its year-over-year sales had increased for six straight quarters (Jargon & Benoit, 2016).

While many critics assert that activists are only “short term” thinking because they curtail investment and R&D, a frequent assurance of the profitability of investment practices is necessary for companies to remain profitable. Many critics charge that activists’ encouragement of dividend payments and share buybacks in the place of this investment defines their intentions as short term focused. However, dividend payments and share buybacks alone can be critical to driving increased shareholder value and long-term financing by increasing the perception and stability of a stock, making it inaccurate to assert that these actions are always short-term focused (Sindreu, 2018). Furthermore, while Bebchuk’s work shows activists’ ability to improve equity value quantitatively, this potential for a positive impact can also be extrapolated from the ongoing partnerships with mutual funds. As explained in chapter 1, mutual and pension funds have grown substantially in recent history to control large portions of public companies. These funds, which are not activists in themselves, frequently support activist hedge funds in proxy fights or their demands for change. Jeff Smith of Starboard Value explained that passive investors such as Fidelity even solicit his firm many times to target one of their investments and improve their poor strategy (J. Smith, personal communication, March 28, 2018). The ongoing support by passive funds debunks the claim that activism is always short term, as these pension funds are invested in companies for far longer.

Shareholder activism is a practice that is being employed by a greater number of hedge funds and institutional investors. While the increased denominator increases the chances that some are only looking out for their own return, many activists’ actions have the potential to enhance the value of all shareholders. The argument that activists are only short-term focused, therefore, is an inaccurate generalization. The following chapter illustrates, however, that activists ignore many other metrics to a company's success, consequently outweighing the potential for positive impact.

Chapter 4: Harmful Effects of Shareholder Activism

Despite the potential for shareholder activism to deliver improved financial performance in certain situations, many argue that activism overlooks other important measures of a company and discourages actions that are critical to long-term success. In particular, the "con" perspective argues that activists frequently ignore long-term drivers of success, and promote tactics that do not solve the core operational issues of corporations. While we acknowledge the positive effects that activism can promote in select circumstances, the following sections discuss the negatives of shareholder activism that detract from ideal corporate decision-making. As a result of these major drawbacks and the excessive growth in the use of activist techniques by new players, we conclude that shareholder activism is not worth the positives that it can bring, but rather is a harmful practice that threatens to make the American economy hostile to innovation and creative thinking.

Misaligned Incentives and Overlooking Long-Term Drivers of Success

Chapter 3 explains our view that American capitalism currently faces a corporate governance issue, in which boards are ill-suited to guide complex organizations and remain accountable to the interests of shareholders. Many proponents of shareholder activism, including activist investors themselves, argue that this practice is necessary to enhance profitability and protect shareholders. However, while activism may deliver value in certain circumstances, as described in the previous chapter, the presence of an investor such as Bill Ackman or Nelson Peltz introduces a host of new issues. One of the most blatant issues—a misalignment of incentives—leads activists to overlook aspects of companies that are critical to long-term success.

Most activist investors maintain a desire to protect and even promote their own reputations. When activists approach a corporation, they typically advertise their investment as beneficial to the wider base of shareholders, and use strategic communication and the media to promote this message (NYSE Governance Services, 2016). Hedge funds in particular spend millions of dollars working to convince shareholders through presentations, regulatory filings such as SEC compliance documents, mailing materials, and marketing as part of proxy contests and general campaigns to win board seats (Weiss 2017). While other shareholders may benefit from activism in certain cases, the interests of activists are simply not the same as those of other investors, creating a critical gap and misalignment of interests. For example, an investor looking to remain in a stock for many years may not benefit from the cost-cutting actions and financial engineering demanded by an activist, who frequently sells his or her shares within two to three years (Edmans, 2017).

Concurrent with their desire to increase a portfolio company's share price and generate a return on investment (ROI), activist hedge funds have an interest in enhancing their reputation and public image. In a 2015 Global Hedge Fund Survey, EY notes that hedge fund managers report assets under management (AUM) growth as one of their top priorities, and as a critical success factor (EY, 2015, p. 2). Given that hedge funds make a profit by charging a fee—typically 2% of assets under management and 20% of any gains generated—they have a clear interest in increasing their reputation, as this will likely encourage additional actors to entrust them with capital (Gad, 2013). It is paramount, therefore, for hedge funds to protect their reputation and to grow their AUM, especially in the increasingly crowded investor space with private equity and real estate firms competing for capital (EY, 2015, p. 7). This creates an inherent misalignment of interests, as activists are primarily concerned with promoting actions that look good immediately to enhance their reputation and promote their image.

Waging large proxy fights and engaging in a successful public campaign has also become a means to get more money invested in activist funds. Ellen Kullman notes that Nelson Peltz intentionally made of show of Trian's intervention in DuPont to enhance his self-image and name, and raise more capital for his own funds. Kullman elaborated, saying that Peltz wanted to get on CNBC and judge Kullman for the 10 years of company performance before she was even in office to make the scene bigger and more popular (E. Kullman, personal communication, April 9, 2018). Even if one does not take Kullman at her word, it is clear that activists maintain their own incentives to promote their reputation and show that they are responsible for improvements. This divergent interest suggests that many activists are not truly on the same "team" as other shareholders.

As a result of the primacy of this self-interest, many activists push interventions that are aimed at short-term profit at the expense of innovation and risk-taking. One particularly harmful tactic that is often invoked by activist investors is curbing the amount of research and development (R&D) a portfolio company undertakes. For certain companies, curtailing R&D in favor of a more targeted allocation of resources can increase profit and the efficiency of product improvement (Brav, Jiang, Ma, & Tran, 2016, p. 30). In these cases, activism can call attention to runaway spending on R&D and have a positive impact. For a great number of companies, however, R&D is the vehicle through which long-term innovations and successes are achieved. Activists' primary focus on increasing immediate profit motivates a decline in the latitude offered to management to innovate, remain creative, and research new technologies that are difficult to develop.

In the DuPont example, Kullman explains that Peltz explicitly demanded that the company not invest a single dollar in research that will not generate a positive return within five years (E. Kullman, personal communication, April 9, 2018). Peltz's attempt to cut R&D in such an extreme way is representative of an action taken by activists across the board. Data from Capital IQ illustrates that S&P 500 companies targeted by activists reduced capital expenditures in the five years after activists bought their shares to 29% of operating cash flow, down from 42% the year before. In the same period, spending on dividends and buybacks rose to 37% of operating cash flow from 22% (Monga, Benoit, & Francis, 2015). Despite disagreement in the field about the effects of these changes, they provide a strong indication that activist investors are willing to trade the potential for future profit and discoveries to earn more today (Benoit, 2016). Without a commitment to R&D, DuPont's agriculture business, which became one of the most profitable divisions, never would have developed or created substantial value for the company's shareholders. According to Kullman, it took twelve years of effectively profitless R&D in order to generate massive returns from this business (Reuters with CNBC.com, 2013). That, she noted, would not have been the case under the Peltz formula.

In addition to slashing research budgets, activists frequently downplay important drivers of success. For example, while Starboard Value identified a number of important improvements to Darden, as discussed in Chapter 3, the language used to justify these changes is exclusively based on margins and profitability. In Starboard Value's 2014 report, the hedge fund demands that Darden's Olive Garden chain curtail the number of breadsticks delivered to tables to save $4 - $5 million each year. Despite justifying this change by claiming that it will curb waste and improve the customer experience, the presentation lacks any surveys or support to indicate a care for what customers actually value (Starboard Value, 2014). This is just one example of a typical activist focus on margins and profit rather than customer experience, sustainability, and reputation, among other factors.

Many proponents of activism point to Bebchuk's research, showing the increase in share price even many years after an activist intervention, to argue that activism always creates value. However, equity value, which is driven by share price, "cannot and does not reflect all variables" to measure the value of a company (Dai & Helfrich, 2016, p. 16). While equity value frequently increases following an activist intervention, this measure fails to account for long-term innovation, as seen for example in DuPont's successful agriculture business that took over a decade to innovate and then commercialize. For example, even if share price may have increased by slashing R&D costs and consequently increasing short-term EPS, this action would have deprived DuPont of the later profit attributable to the agriculture unit. The problem this implies is that share price does always reflect the true value of a company; a true measure of the value of an entity must incorporate additional metrics including sustainability, risk, corporate practices, social responsibility, productivity, employee and customer satisfaction and reputation (Dai & Helfrich, 2016, p. 16). Whether one conforms to shareholder and agency theory, as many activists do, or the broader stakeholder theory, it is clear that activism overlooks these more nuanced drivers of success, and consequently is not better at generating genuine accountability to shareholders than the problematic boards of the present.

Lack of Operational Expertise

In addition to maintaining divergent interests with other shareholders, activist investors frequently rely on financial engineering to change companies, not targeted operational improvements that come from expertise in a given industry. While an activist intervention may solve an issue of a "sleepy" board, it can encourage pressure towards unwise actions. Hedge fund investors are undeniably intelligent people, with years of expertise in money management and boardroom battles. However, just as Michael Goldstein decried the lack of industry expertise on boards, the presence of an activist investor frequently does little to enhance operational insight. Despite some exceptions, in which an activist presents strong claims for improving a business, most activists rely either on replacing management or on financial engineering tools, such as using cash flow to engage in a major stock repurchase program, to create "value," rather than addressing core operational issues (Surowiecki, 2013).

One example of an activist relying on an ill-equipped toolkit of financial engineering is evident in investor Bill Ackman's 2007 intervention in Target, the nation's second-largest retailer. After forcing his way onto the board following his accumulation of a 9.6% stake in the company, Ackman successfully pressured the board and management into divesting much of its credit card business, and focused attention on creating a REIT to spin-off 20% of its real estate holdings through an IPO (Reuters Staff, 2009).

However, even though these actions may have succeeded in creating a better perception of the company upon a glance at its balance sheet, they failed to address the declining sales and profit margins that occurred throughout 2008. Target's inability to quickly adjust to this a rapidly changing customer base that was migrating to online shopping, coupled with the cut in consumption as part of the 2008 financial downturn, was responsible for Target's poor operating performance (Lee, 2015). Yet, Ackman's activism did not address these issues, but rather detracted from management's ability to focus on expanding digital commerce to compete with stores such as Walmart. The proxy fight cost Target more than $11 million and Standard & Poor's Ratings Services described it as a distraction for the retailer's management experienced board members (Zimmerman & Eaton, 2009). In this case, activism represents a harm to shareholders, as stock prices declined 39% from their peak in July of 2017, and Target's competitive position took a major hit that took until 2015 to improve. This is just one example of activist investors relying on actions that rework the balance sheet of companies, yet do little to address or improve operational issues for long-term success, showing the potential to distract from operational improvements.

Systemic Threat to American Capitalism

In addition to burdening the long-term performance of companies, shareholder activists' focus on immediate financial returns represents a threat to the innovation that has characterized American capitalism since the Industrial Revolution**.** In the business world today, the use, and frequently even the threat, of shareholder activism scares companies and quality managers from the actions necessary to excel and tackle problems.

One of the most important systemic issues presented by activism, as discussed in the first section of this chapter, is a fear to innovate, and a consequential "punishment" of outliers. Many of the great discoveries and innovations throughout history would not have been possible had companies been constrained to demonstrating that R&D would produce a return within a few years. In fact, two of the most forward-thinking and profitable businesses in the world today, Facebook and Apple, rose to supremacy despite many years of high R&D and expenses relative to return to shareholders (Molla, 2017). High R&D spending allowed these companies to think big and long-term, directly contributing to their sustained industry dominance.

In their focus on return, it becomes clear that shareholder activists maintain a different conception of the need to pursue immediate financial return. Outliers such as Steve Jobs of Apple or Jeff Bezos of Amazon, however, acknowledge the more nuanced aspect of measuring the profitability of a company, making them more in line with the view of stakeholder theory. By reinvesting quarterly profits year after year, Bezos enabled Amazon to pursue and perfect new endeavors ranging from its web services business to in-home smart devices (Ovide, 2016). Although Amazon could have simply distributed out the profits to shareholders as increased dividends, reinvestment was essential for the company's present dominance. Visionaries such as Jobs and Bezos, however, are more likely to be punished in the increasingly activist-dominated world today. The growing presence of shareholder activism in the American economy threatens their ability to think differently, beyond return for shareholders, and innovate. Companies are cutting R&D preemptively for fear of becoming the subject of activist intervention (Coffee & Palia, 2015, p. 50). This is a major, systemic problem. In our economy we need CEOs and management to think outside-the-box, and act as outliers. Activism, however, denies leaders a chance to demonstrate the effectiveness of their atypical thinking or techniques.

This "punishment" of outliers also opens the door to biases. While all activists explain that they target "underperforming companies," this can manifest as a search for weaknesses, or perceived weaknesses, at companies. This is evident in the language that defense lawyers, such as Martin Lipton, use about "protecting" companies against activist interventions and their "aggressive" attacks and tactics (Wachtell, Lipton, Rosen, & Katz, 2018, p. 10). In going after companies perceived as weak, it becomes increasingly likely that biases, such as targeting a high percentage of female CEOs, come into play. Ellen Kullman mentioned that effectively all peer female CEOs have faced an activist at some point (E. Kullman, personal communication, April 9, 2018). Similarly, Gupta, Mortal and Turban confirm in their 2018 journal article that female CEOs face a greater threat of shareholder activism than male CEOs (Gupta, Mortal, & Turban, 2018). Although it is difficult to prove empirically that activists target certain companies because of the gender of their leaders, Kullman believes that she and her female peers, including Irene

Rosenfeld, formerly of Kraft and now CEO of Mondelez International, were targeted partially because of their supposed "weakness" or perceived inability to lead effectively as a woman. Even if most activists are not motivated by an explicit bias toward minorities, females, or other underrepresented groups, activism still provides an opening to exploit those who simply are perceived as weak or vulnerable, suggesting that this practice creates a situation in which biased targeting and poor judgment is more likely.

Finally, it is important to circle back to the proliferation in the use of activism. The increasing number of activist interventions and players is creating an environment in which companies are disincentivized from entering public markets. The number of activist interventions has increased greatly in recent years (Grossman). In 2016, 758 companies worldwide received public activist demands, a 13% increase from the 673 companies in 2015 (Black, 2017). The recent period of low interest rates has also compelled many investors to seek alternative investment strategies, including activism, to achieve higher returns. The jump in the use of activism has taken a concept that, when used sparingly, has the potential to address issues in poor-performing companies to an extreme degree. Competition among hedge funds has made it clear that activists are going further to seek out targets which are not always poorly run companies.

This growth has discouraged many rising companies from tapping into the important source of capital of the public markets, which has supported the capital for innovation for hundreds of years. This development is clear in the growing presence of Unicorns, private venture capital-backed companies valued at $1 billion or more. These companies, which today include Uber and Airbnb, have been raising more money and staying private longer. In 2017, unicorns collectively raised $19.2 billion in capital, the highest of any year on record

(PitchBook, 2018). Despite the massive funding these companies received, their trepidation to access the public capital markets denies them a critical source of capital (A. Westbrook & D. Westbrook, 2017, p. 716). The growth of activism not only discourages companies from entering public markets, but also CEOs. If boardrooms continue to become increasingly hostile to innovation and radical thinking, it is likely that the best talent and CEOs will not want to work at public companies where they are constrained (Lee, 2015). The pressure these companies face represents an unsustainable and systemic threat that activism presents to the American economy.

Chapter 5: Conclusion

Summary of Findings

Shareholder activism, and in particular activism by hedge funds, can deliver mixed results to corporations. On the positive sides, its effects include bringing greater accountability and transparency to managers and boards, and improving a firm's discipline when it comes to capital allocation. The claim that activists are only short-term focused, as is popularized in the media, is debunked by their ongoing and growing support from large passive funds and the long-term financial success of some companies following activist investments. More frequently in recent years, funds managed by Fidelity, Vanguard, and the California State Teachers Retirement System, for example, have supported activists for board seats or backed an activist-sponsored proposal (Toonkel & Kim, 2013). Indeed, even Warren Buffett has a bit of a shareholder activist streak in him. Buffett recently told CNBC that Berkshire Hathaway voted its nearly 30 percent stake against the director slate put forth by USG, a major building company, because in Buffett's words, "We did not think the [USG's] directors were essentially doing their job" (Kim, 2018). Buffett went on to say that he could not think of a time that he ever voted against a board of directors slate before now. Following Buffett' move, the board of USG authorized management to explore the possible sale of the company to Knauf KG of Germany, which had offered to purchase the company only to have USG unwilling to negotiate with the bidder.

In some notable cases, shareholder activism has been shown to be produce better operating performance and stock price increases. However, the authors of this paper find that the cost frequently stifles long-term drivers of a company's success by taking actions such as slashing R&D that curtail innovation, or cutting back on marketing campaigns that can reduce future sales. The incentives of activists to raise funds and establish their firms' reputations creates a situation in which their demands are geared toward enhancing immediate value, not taking risks or promoting outside-the-box thinking. Furthermore, even if activists may deliver accountability, their actions frequently encourage financial moves that can distract managers from the core operational areas in need of attention. These actions collectively limit a manager's ability to invest in the future and innovate, representing a threat to customers, employees and communities. We find that activism's prioritization of financial returns threatens the culture of innovation and creativity that is central to the well-being of the American economy.

Implications and Areas for Further Study

There are a number of important implications that arise from the growth of shareholder activism and consequential threat to innovation. One of the most salient issues, as discussed in chapter 3, is the issue of directors' accountability to shareholders, which has precipitated the rise of shareholder activism. It is clear that U.S. corporations must improve their corporate governance practices and prioritize the appointment of strategic actors to boards. Recent exposures of excessive and wasteful spending make this issue particularly relevant today. For example, it was recently revealed that Jeff Immelt, when he was CEO of General Electric, used two private jets during his travels, with one of them empty but still following behind (Muoio, 2017). Wasteful actions such as these represent the abuse of shareholders' money and interests. To solve this issue, corporations must demand stricter governance standards and greater transparency in how a company is using its capital. Boards should become more proactive in displaying prudent spending and the benefits and capital allocation policies. In addition, they should hold more frequent meetings, retain only committed individuals with valuable expertise, and be held accountable to performance standards themselves to determine compensation.

Shareholder activism, in theory, presents a way to solve this corporate accountability issues. However, in practice, activism threatens corporate innovation and consequently the strength of the national economy, making it too big a tradeoff. Companies such as Uber, Airbnb, and WeWork are waiting longer to IPO and enter the public markets. This reality not only limits companies by denying them an important access to capital, but also exacerbates income inequality in the U.S. As more companies remain in the hands of fewer private investors, typical Americans are offered fewer chances to invest and profit when these companies grow (A. Westbrook & D. Westbrook, 2017, p. 690). Furthermore, forcing companies to remain private in order to innovate opens the door to even lower accountability and the potential for abuse, as evident from the exposure of Uber's abusive workplace under former CEO Travis Kalanick (Isaac, 2017).

Neither of the current alternatives—remaining complacent to sleepy boards or allowing activism to threaten American ingenuity—is a good option. It is necessary for policymakers and economic leaders in the United States to work together to improve corporate governance. In order for the United States to remain at the forefront of innovation and economic output, this improvement is critical.

Appendix

List of Interviews Conducted:

Barry Rosenstein, JANA Partners

Ellen Kullman, Former Chairman and CEO, DuPont

Jeffrey Smith, Managing Member and the Chief Executive Officer & Chief Investment Officer, Starboard Value

Kim Castellino, Strategic Government Advisors

Martin Lipton, Founding Partner, Wachtell, Lipton, Rosen & Katz

Michael Goldstein, Former CEO ToysRUs, former Chairman Charming Shoppes

Ron Shaich, Founder & Chairman and Former CEO, Panera Bread

Suraj Srinivasan, Harvard Business School

Vice President of Investment Stewardship at Large Investment Manager (Requested Anonymity)

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