Shareholder Activism – The Interaction Between Hedge Funds and Other Institutional Investors

In September 2011, the share price of Canadian Pacific Railway (CPR) dropped to less than $43 — in October, hedge fund Pershing Square Capital Management announced an ownership position in CPR and the share price immediately jumped to $62.50. The fun had just begun. In the ensuing months, Bill Ackman, founder and CEO of Pershing Square, pursued a shareholder activism campaign that included direct communication with CPR directors and executives, an extensive media campaign, and a successful proxy battle that elected seven Pershing Square nominees to the CPR board of directors, ousted CPR CEO Fred Green, and installed Hunter Harrison, legendary in railroad circles, as the new CEO responsible for driving operational efficiency improvements. In April 2013, CPR announced the best quarterly results in its 132 year history and the share price soon exceeded $142. Pershing Square had built up an ownership stake of 24 million shares (14.2% of the outstanding CPR shares worth $3.4 billion). Another high profile campaign occurred when hedge fund, Scout Capital, announced a 5.5% ownership share in Tim Hortons, calling for sweeping changes to enhance shareholder value by optimizing capital structure, altering US expansion plans, and converting company owned restaurants into a real estate investment trust (REIT).

Institutional investors (e.g., pension funds, insurance companies, mutual funds, banks, investment advisors, and hedge funds) are organizations that pool and invest large sums of money on behalf of their stakeholders. The motive for activism is to increase shareholder value by addressing agency conflicts (i.e., the tendency of managers to take self-enhancing actions that are not in the best interest of shareholders). Typical hedge fund activism includes challenging bad strategies, removing poorly performing executives, and ensuring that mergers and other management activities make sense for the shareholders. While hedge fund activism began in US markets, it has become increasingly widespread in Canada. In the 1980s, pension funds emerged as the most common shareholder activists. Today, hedge funds are the most prevalent in the investor activism space. Hedge fund activists are very different from other institutional investors – they begin monitoring targets before acquiring an ownership position and become agents of change with specific goals that depend on the target's unique situation. Hedge funds are more effective in implementing change at target companies because hedge fund managers have the means and incentive to focus on longer term value enhancing activities.

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Support for hedge fund activism is not universal. While proponents argue that activist hedge funds are beneficial, critics hold that the benefits of activism do not accrue to stakeholders equally and deny that activism creates long term value — any shareholder benefit is short term in nature and based on financial manipulation rather than true value creation. To successfully implement activist agendas, hedge funds require support from other shareholders because they typically acquire minority ownership positions in target firms. Given that institutional ownership at publically traded firms was more than 60% in 2005, it is clear that institutional investors collectively control sufficient power to enhance the effectiveness of hedge funds.

The observation that the level of institutional ownership has a significant impact on the probability of being targeted suggests that hedge fund activism creates value — hedge funds

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BIOGRAPHY

DR. ANDREW CARROTHERS is an Assistant Professor of Finance at the Faculty of Business, the University of Prince Edward Island (UPEI). He currently teaches in the areas of corporate, international, personal, and entrepreneurial finance. He holds a PhD in Finance from McMaster University. His primary research interest is corporate governance, with a particular focus on hedge fund activism and executive compensation. He is also active with research on financial literacy. https://www.upei.ca/business/profile/andrewcarrothers

Prior to joining UPEI, Andrew gained extensive work experience as a senior manager at an S&P 500 company. He is a Chartered Financial Analyst (CFA) charter holder and is a member of Professional Engineers Ontario.

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It was a great honour to be the recipient of the prestigious Canadian Securities Institute Research Foundation PhD scholarship. This generous funding helped me to promote the research agenda of the CSI Research Foundation by investigating the interaction at target firms between activist hedge funds and other institutional investors. This topic is important because shareholder engagement by hedge funds has become widespread in Canada and will have significant ramifications for typical Canadians. When shareholder activism is successful, the benefits accrue to all shareholders, not just to the activist.

The CSI Research Foundation PhD Scholarship was instrumental in my obtaining a tenure-track faculty position at a top caliber Canadian university and has produced two 2017 academic journal publications. I have a strong belief that members of academe need to have a personal commitment to three key elements: relevant research (and the ability to make it accessible), educating and motivating undergraduate and graduate students, and academic service. I am passionate about financial markets, corporate governance, and financial literacy. Funding from the CSI Research Foundation made it possible to continue to do what I do best.

prefer high levels of institutional ownership because they expect support for value creating activism. The market responds positively to hedge fund activism — the average abnormal return at target firms in the +/- 20 days surrounding the disclosure of activist intentions is 7.1% and the average abnormal return in the 20 months after the disclosure is 23.0%. The trading behavior of other institutional investors indicates that they have a favorable view of hedge fund activism. By supporting activist hedge fund agendas, other institutional investors play an important role in improving governance, performance and shareholder value at target firms. Overall, the results of my research suggest that activist hedge funds and other institutional investors have compatible goals — *they are friends not foes.*

There are few things more closely linked to the collective Canadian psyche than coffee, donuts, and railroads. Activist hedge funds are here to stay and play, which may well be a good thing for all of us. When shareholder activism is successful, the benefits accrue to all shareholders, not just to the activist. Target firms of activist hedge fund have high levels of institutional ownership – mutual funds, insurance companies and pension funds – and these assets are widely held by Canadians. The financial well-being of typical Canadians depends on the investing success of these institutions.