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Summary

Activist Hedge Funds Target Corporate Social Responsibility

Some hedge funds invest in socially responsible companies to change their focus to maximizing value for short-term shareholders, according to an *Academy of Management Journal* article.

As more companies continues to adopt corporate social responsibility (CSR) programs, hedge fund attacks are becoming a growing problem, according to Mark DesJardine of the Pennsylvania State University.

Activist hedge funds view CSR programs—diversity and fair labor practices, charitable giving, community volunteering, environmentally friendly policies—as a sign of "wasteful" spending, in which companies are seen as favoring investments with uncertain returns that typically only pay off in the long term. Hedge funds, however, usually invest in organizations for less than two years.

After analyzing 506 activist hedge fund attacks in the United States between 2000 and 2016, DesJardine and coauthors Emilio Marti of Erasmus University Rotterdam and Rodolphe Durand of HEC Paris determined that companies have an average 3% chance of being targeted by activist hedge funds, but that this probability of attack nearly doubles to 5% for the most socially responsible companies.

"Between 2011 and 2015, one in seven S&P 500 firms experienced at least one hedge fund attack," the authors wrote in "Why Activist Hedge Funds Target Socially Responsible Firms: The Reaction Costs of Signaling Corporate Social Responsibility." They cited this assessment by the bank J.P. Morgan: "No recent development has influenced firms' strategic and financial decision-making as profoundly as the surge in shareholder activism [by hedge funds] following the global financial crisis," making firms "increasingly fearful of becoming the next target of activism."

"Most managers abhor activist hedge funds, because these activists come in and essentially proclaim, 'You managers and board members, you're not running this company properly, so now we're going to intervene, rally other shareholders, and overturn what you're doing,'" DesJardine explained.

"Actions taken by activist hedge funds can be placed into three general buckets: Gaining board representation, cost-cutting or refocusing, and redistributing cash to shareholders. Often these demands coincide, but about half the time, activist hedge funds demand a seat on the board. Other demands may include opposing an acquisition, replacing the CEO or board members, reducing the workforce, or hiking up dividends and buying back shares," he said.

"Two things about CSR programs that are not in line with the typical activist hedge fund model: CSR returns are long-term and uncertain. In many cases, unless you have an investment horizon of at least 3 to 5 years, then CSR doesn't make a whole lot of financial sense. There are corporate actions that can yield much faster returns. The second thing is that the monetary returns to CSR are highly uncertain and can be difficult to directly measure against the bottom line, especially when compared to other types of more conventional investments, such as capital expenditures," DesJardine said.

Substantial costs for firms

"Hedge fund attacks create substantial costs for firms. Some of these costs are easy to measure—for example, advertising costs or the costs of hiring legal experts, public-relations professionals, and other advisors," the authors wrote. "These costs amount to an average of $12.5 million per proxy contest for large capitalization firms. Other costs are harder to measure—for example, the costs that arise when strategic partners or employees engage less with a firm due to the uncertainty created by a hedge fund attack, or when top managers shift their time and attention to the attack."

"A background interview with a former head of investor relations whose firm was attacked by a hedge fund illustrates these costs. As he pointed out, the 'leadership lost sight of the ball and became all-consumed by this battle and lost sight of growing the company'—the top managers 'were constantly on the jets, going across North America and Europe to gauge shareholder support' when trying to fend off the activist hedge fund," they wrote. Even after the firm narrowly won a proxy contest, the former head of investor relations said, "We were all so burnt out. Our CEO looked like he had gone through a war. . . . It took another six months for our ELT [executive leadership team] to recover and get the eye back on the ball of managing the company."

In 2017, Procter & Gamble reportedly spent at least $100 million to counter an activist hedge fund attack, the authors noted.

"After hedge funds exit, the CSR programs of these companies can flatline for up to five years," DesJardine said. "But what is also concerning is that CSR signals a broader potential to cutback spending in other areas where returns are long-term and uncertain. For example, in employee welfare and research and development. And the hedge fund is not responsible for any troubles the company experiences after it sells its shares and is gone."

Noting that activist hedge funds sometimes can hold shares for just a few months, DesJardine asked, "Is it fair that an activist hedge fund gets to go in and demand these changes that are designed to line the pockets of short-term shareholders, and then leave without any accountability to the company, its stakeholders, and long-term shareholders? It would help to see policy makers design a system in which activist hedge funds are held more accountable, for instance, by having to hold shares for longer time periods—minimum holding periods."

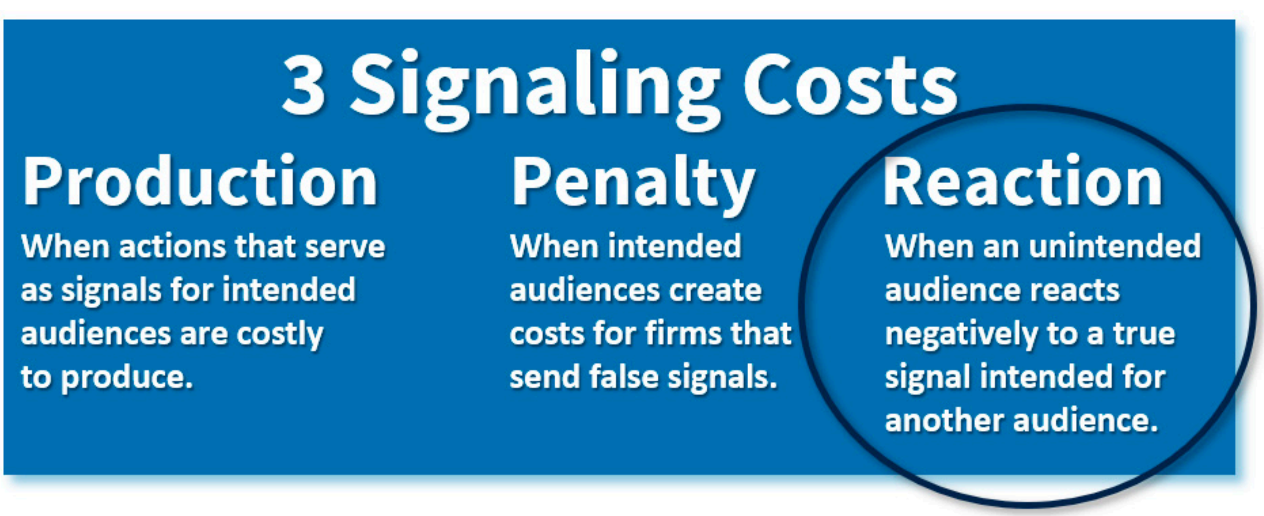
Social and environmental costs

"**For policy makers**, our study indicates that protecting firms targeted by activist hedge funds could relieve pressures that ultimately undermine the CSR activities of firms," the authors wrote. DesJardine said revising regulations to increase transparency related to hedge fund activities could help companies better engage activists in productive conversations and counter attacks when warranted.

"**For socially responsible firms**, our findings highlight the importance of attracting socially minded and long-term shareholders who can potentially moderate the profit-centered interventions of activist hedge funds," the authors wrote. "**For investors who care about sustainability**, hopefully our paper encourages reassessing whether investments in activist hedge funds align with their values. Today, many individuals and organizations are invested in activist hedge funds through their pension funds and endowments, which have been a major driver of growth for activist hedge funds since 2009. Ultimately, policy makers, firms, and investors need to weigh the potential efficiency gains that activist hedge funds bring to corporations against the negative effects that those funds tend to create for corporate social responsibility."

"For managers, if you aim to build a company with a social purpose, then you need to be aware that there's a cost in doing that because some activist hedge funds out there will try to take advantage of it," DesJardine said. "But there are ways to mitigate that cost. If you want to become more socially responsible, then you need to tie that objective into the broader business purpose of your company. And you need to communicate to markets what the value of being socially responsible is and what the broader agenda is on this front. That way, the company can develop a supportive base of like-minded and long-term shareholders whose values align with those of management. If an activist comes knocking, then it's important to communicate how the activist's agenda might conflict with the objectives and values of existing shareholders."

"Clearly there are questions to be asked of the hedge fund activism model in this time of social unrest: Is this disciplinary governance mechanism worth the social and environmental costs, as well as long-term economic costs, that it imposes on business and society?" he asked.



Reaction costs

In their article, the authors explained how companies' CSR activities send "signals" to external audiences about the priorities of management.

"For example, by hiring a female board member (an observable action) a firm can signal to job-seekers that it is both willing and able (its unobservable intentions and capabilities) to support women in their careers. Similarly, by engaging in CSR activities (an observable action), a firm can signal to governments that it would be a trustworthy partner (an unobservable intention) for a government procurement contract," they wrote.

The authors noted that previous researchers have "only explored the signaling costs associated with **intended audiences**, such as job-seekers and governments, but overlooked the costs that unintended audiences may create for signal senders. There are two types of signaling costs associated with intended audiences: **production costs**, which arise from producing observable actions that serve as a signal for intended audiences, and **penalty costs**, which arise when intended audiences penalize firms that send false signals."

The authors coined the term **reaction costs** for when **unintended audiences**, activist hedge funds, in this case, create unexpected costs for organizations. "Reaction costs are the costs that signal senders incur when unintended audiences react negatively to a true signal that was intended for another audience. Reaction costs matter because they may render signals costlier for signal senders than previously assumed."

"Companies with stronger CSR signal they have more 'wasteful' spending and ambitions that can be eliminated to unlock more 'value' for short-term investors," DesJardine said.

"While CSR activities may build goodwill among stakeholders who draw positive conclusions about a firm's 'moral character,' they also expose that firm to attacks from stakeholders who draw negative conclusions about its 'business character,'" the authors wrote.