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From Elliott Management to Pershing Square Capital: The Impact of Activist Hedge Funds on the Global Economy

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Introduction

Activism investing is a complex and fascinating phenomenon in financial markets, as it entails disruption in the management of firms and governments. It can broadly be defined as a shareholder (either an individual or a fund) using his equity stake in a company to push for certain changes and policies in order to increase shareholder value.

Hedge funds have become one of the main drivers of this form of investing, as their financial prowess and ample availability of capital allow them to exert significant influence on the stakeholders of many firms. Activist hedge funds have been on the rise recently, expanding their range of action to reach foreign markets, in addition to targeting larger and more important companies.

Most activist funds launch campaigns against firms, but some daring funds have also set their sights on sovereign states going through financial distress, lured by the opportunity to achieve extraordinary returns. While this kind on investing does not fit the traditional definition of shareholder activism, as there is no company or equity stake involved, it is guided by some of the same principles, such as the willingness to confront the counterpart (in this case, the government) and implement unorthodox methods during the holding period.

This thesis aims to explore how activist hedge funds impact financial markets, by analyzing their interaction with both governments and firms, and the consequences for all parties involved. To achieve this objective, the composition is divided into two main chapters and two case studies, which allow for a complete investigation in the world of activism.

The first chapter introduces activism, looking at its history and development, as well as dealing with the crucial aspect of how to measure the returns for activist hedge funds. The second one explores more thoroughly the interactions between an activist hedge fund and the target firm, going from the strategies implemented by the fund to the ways a company can defend itself when faced with such attacks. Seeing as activist hedge funds will mostly target companies, this chapter is necessary to better comprehend the underlying issues arising from this occurrence.

The first case study reviews the feud between Bill Ackman and Carl Icahn, two of the most famous activists in the business, over the future of Herbalife, a nutrition and weight loss company. The high stakes at play concerning the investments by the two moguls created an uncertain environment for the company, showing how activists sometimes are responsible for the growth or demise of a target firm. The second case study recounts Elliott Management's involvement with Argentina. The world held its breath as the almost fifteen-year long legal battle over repayment of defaulted debt played out in international courts, demonstrating how nations had to deal with the threat of unwanted attentions by activist hedge funds.

Chapter 1 - An Overview on Activist Hedge Funds

1.1 History and Rise of Activist Hedge Funds in the US

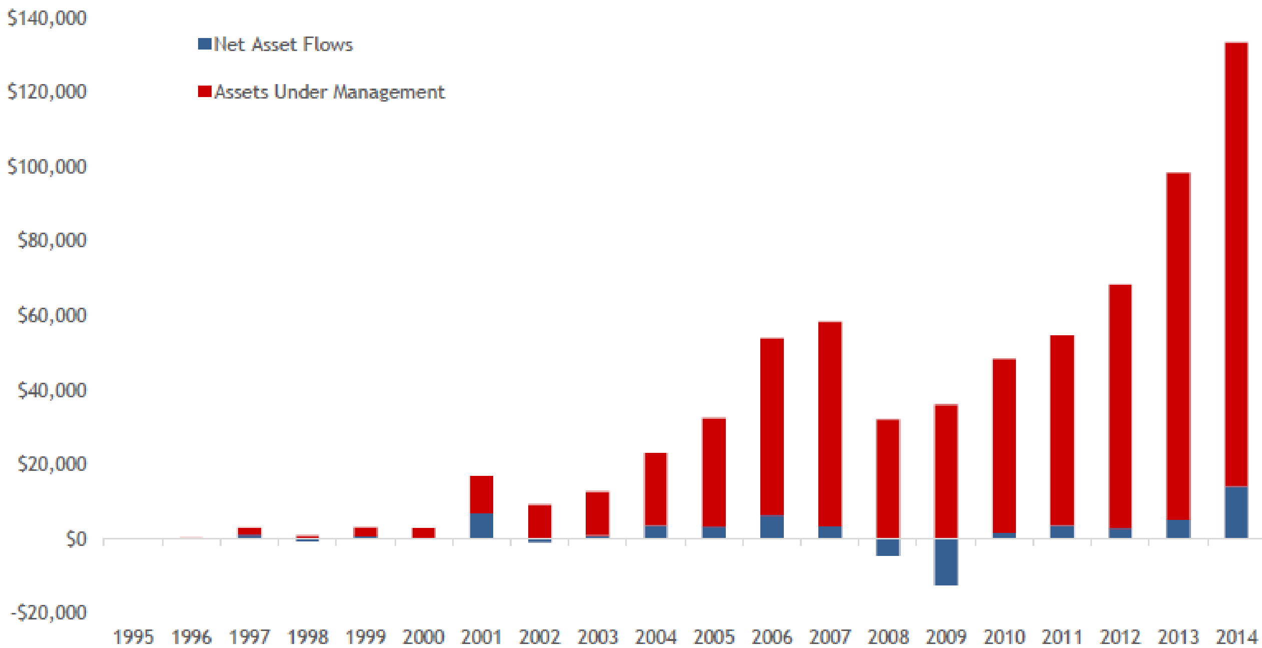
The birth of hedge fund activism can be traced all the way back to the 1950s, when the so-called "proxyteers" (such as Robert Young and Louis Wolfson) began proxy battles against the boards of several US public companies. The following couple of decades were quite tame and saw no major developments in the industry; that all changed in the 1980s, with the rise of corporate "raiders" and their use of aggressive and daring financial tactics to obtain corporate control (exemplified in the media by figures such as Gordon Gekko in the 1987 hit movie, "Wall Street").

This level of financial activity earned the 1980s the nickname of "the Deal Decade" (Cheffins & Armour, 2011) and public companies became the ideal vehicle for raiders to test their influence in the markets. This phenomenon was probably incentivized by the Investment Company Act of 1940, which allowed public companies with less than 40% of its assets invested in stocks to pursue various strategies, some akin to the ones used by modern-day activist investors. Furthermore, during this period some investors began to use private investment funds to carry out transactions; these financiers can be considered the ancestors of activist investors.

The financial data available paints a clear picture of the relevance of hedge funds in the United States in the 1990s, as they had only $40 billion of asset under management, compared to the $1.6 trillion of mutual funds. However, During this period one, of the most prominent activist investors rose to fame; Stephen Gordon, an ex-investment banker who used his own fund to obtain large shares in underwhelming financial companies with the intention to exert his influence, paving the road for the emergence of activist hedge funds.

The 2000s marked the consolidation of activist investors in financial markets, as disappointed shareholders became more engaged with the companies' management in an effort to unlock potential value. This consolidation is further supported by a study conducted by Robin Greenwood and Michael Schor, who performed a year-by-year review of activist hedge fund's operations between 1994 and 2006; in 2002 activist hedge funds managed $23 billion, while in 2006 that number increased almost four-fold to more than $120 billion.

Figure 1.1 Assets Under Management and Net Asset Flows ($ Millions)



Source: Hedge Fund Research (2014)

There are several reasons why activist hedge funds became more relevant during the early 2000s. One useful starting point is to look at the dot.com bubble, which exploded towards the end of the 1990s and led to a severe decrease in stock prices throughout the whole market. Even companies that were not directly involved in the bubble saw their stock prices drop, creating opportunities for value investors and activists to search for bargains.

Activist investors were also "helped" by the financial scandals that took place during that time, such as those involving Tyco and Enron; these events created a wave of distrust in upper management of many companies, opening the door to activist interventions, with the support of public opinion. Activist investors were seen as figures capable of unlocking value and use company resources more efficiently compared to traditional money-managers.

Some of the policies suggested had to do with the recent buildup of cash by Fortune 500 companies, which had amounted to $650 billion by 2005. Activists argued that excess cash had to be returned to investors through dividends and share buy-backs or, in extreme case, by selling the company.

Activist hedge funds operated under ideal conditions, as institutional money managers became more willing to indulge the activists and their campaigns while the ample availability of credit in the market allowed private equity funds to perform many leveraged buyouts. Hedge funds were also helped by new laws in Congress, such as the one which introduced the "qualified purchasers", defined as individuals with over $5 million in investments who did not need the protections created by the Investment company act of 1940; hedge funds could then theoretically have an infinite number of investors, but they never went over 499 to stay within the boundaries set by other financial regulations.

An interesting situation occurred when the 2008 financial crisis broke out; based on the aftermath of dot.com crisis, it would have plausible to assume that the same economic conditions might have applied (mainly the presence of a large number of undervalued stocks), leading to a further boom for activist hedge funds. However, there was a key difference; the 2008 crisis created a credit crunch of unparalleled magnitude in the markets, leaving activist investors with less options to pursue their target companies. This resulted in 2008 being the worst year for hedge fund performance.

This abrupt drop in performance however proved to be only a temporary roadblock, as the bull market that followed paved the way for an even bigger role played by activist hedge funds, suggesting a high correlation with market returns. The bull market, along with other economic factors such as low interest rates and low returns in the fixed income markets, contributed to the surge of these funds, as shown by the AUM increase after 2009 in the previous graph.

Furthermore, starting with the new millennium, activist investors had been able to re-brand themselves as defenders of shareholder value, opposed to the "corporate raiders" reputation they had earned over the previous decades.

1.2 Activism Vs Traditional Investing

While traditional investors tend to buy a stake in a company because they are confident in the ability and vision of current management, activist investors want to intervene directly in the day-to-day operations of the target company, challenging management head-on to allocate resources more efficiently and increase shareholders' return.

The prime example of activist funds are the so called established pure-play activists (J.P.Morgan, 2015), who want to create shareholder value by generating Alpha (risk-adjusted excess returns); these funds exert significant influence on the markets, thanks to their sheer size and the "brand recognition", amplified by their large media following (some examples are Elliott Management, Pershing Square Capital and Icahn's Enterprises, among others).

When an activist hedge fund invests in a firm, different outcomes could occur: the stock price might react in an erratic fashion and increase following the public announcement, or the company's management may start implementing new policies aimed at increasing shareholder value on its own account. If this is the case, the activist hedge fund will not have any reason to pursue a costly battle with the firm, preferring instead to wait for the stock price to increase and sell its stake for a substantial capital gain. This is the typical course of action of more traditional investment funds, which buy low and sell high without challenging management, adapting to the market developments.

However, when an activist fund targets a company it deems appropriate, this is rarely the case, meaning that the fund will have to take a hands-on approach to maximize its return. The activist fund will not sit back and patiently wait for the market to adjust to what it considers the right price for the stock, seeing as this process could take a considerable amount of time or might never happen at all.

It is important to note that activist hedge funds, unlike private equity funds, prefer to buy minority stakes in companies, as they do not need to tutor the company for a long period of time. Activists will then use their minority shareholder's rights to pressure management on certain issues.

When management is not receptive to the new shareholders' demands, the fund can use the media to purse its objectives by criticizing top executives and threatening legal actions such as the "transfer by vote" (Cheffins & Armour, 2011), which is a proxy battle focusing on who actually can serve on the board of the company. These legal battles can be very costly and time-consuming, and success is all but guaranteed, explaining why activism is such a risky financial strategy. Activist funds in fact bear all of the operational and legal costs stemming from the decision to intervene in a firm, so if they are unsuccessful in imposing their views, they could incur in substantial losses.

Compared to traditional investors, activist cannot diversify their investments to a significant extent, as the financing costs required to launch a campaign take up a large part of a fund's resources. Furthermore, activist hedge funds will have to deal with the illiquidity of their investments, since once they buy a stake in a company and announce to the public, it will become impossible for them to sell their position without affecting the market price of the stock.

Other costs associated with an activist intervention, which are not present for traditional investors, are search costs necessary to find a suitable target company and communication costs to successfully engage with the company's management. In addition to all of the financial costs and drawbacks, activists will also have to comply with stringent corporate governance laws and public disclosure obligations.

To better comprehend why activism exists and how it developed into such an impactful strategy, the fact that 20% of activist hedge funds positions start out as passive holdings can provide great insight (Elia, 2018). This phenomenon can be observed by looking at how many 13G filings, which are signed by the firm with the Securities and Exchange Commission when an ownership larger than 5% is acquired (without the intention to exert control), turn into 13D filings, which instead have to be signed when the shareholder wants to take an activist approach with his holdings. By examining these filings, Marco Elia (QUT Business School) studied the factors that determine this switch, starting from the initial purchase price and the impact of financial losses on the fund's strategies. One of the tenants of behavioral finance claims that financial professionals are hesitant to realize their potential losses; hedge funds can react to this issue by changing their investing strategy and pursue an activist intervention, hoping to invigorate the struggling company.

In 66% of cases in which the shift in strategy occurred, this study found that the hedge fund making the shift was experiencing a paper loss. Overall hedge funds tend to prefer passive positions seeing as they are less costly, so when they decide to engage in an intervention, they have to be sure that the potential for value improvement outweighs the total cost of the operation.

Another key difference between traditional and activist investors is the target companies. While the preferred targets for traditional value investors are undervalued companies, the companies which activists deem appealing are not only undervalued but also underperforming, meaning that they offer hidden potential for shareholder value to be unlocked by implementing specific policies and improving efficient resource allocation, creating the perfect scenario for an activist intervention.

Although recently suffering a minor decrease, the percentage of funds under management of activist hedge funds been increasing over the last five years, as shown by the table below.

Table 1.1 AUM ($ Billions) and Percentage Change per Semester

	H1 2013	H2 2013	H1 2014	H2 2014	H1 2015	H2 2015	H1 2016	H2 2016	H1 2017	H2 2017
Activist Funds:										
AUM	$84	$93	$111	$119	$129	$122	$112	$121	$123	$126
% Change	29%	11%	19%	7%	9%	(5%)	(9%)	8%	1%	2%
Other Hedge Funds:										
AUM	$2,330	$2,535	$2,689	$2,725	$2,839	$2,773	$2,785	$2,897	$2,977	$3,085
% Change	7%	9%	6%	1%	4%	(2%)	0%	4%	3%	4%

Source: Review and Analysis of 2017 US shareholder activism. Sullivan & Cromwell LLP

1.3 How to Measure Activist Hedge Funds Performance

The starting points for measuring activist hedge fund performance are Alpha and Beta (Becht, Franks, Grant, & Wagner, 2017), respectively defined as the risk-adjusted excess return, and the coefficient which measures the correlation between the stock's return and the overall market return (if the stock's Beta is equal to 1, its returns will follow exactly those of the market). Alpha refers to the abnormal returns which are not explained by the correlation with the market, and for this reason is the main selling-point for hedge funds, as they have to exploit the market inefficiencies and provide returns which could not be achieved anywhere else in order to attract investors.

In the short-term, there is always a market reaction to the announcement of an activist campaign, demonstrated by a median return of about 3%. In the medium and long-term, returns become much more volatile, making it difficult to forecast the returns of an activist intervention; nevertheless, activist hedge funds have been able to beat the market on several occasions, increasing the inflow of funds into this particular sector.

Mathematically speaking, alpha was introduced in the Capital Asset Pricing Model (CAPM), which represents the security market line:

$$R_{pt} - R_f = \beta_p(R_{mt} - R_f) + \epsilon_{pt}$$

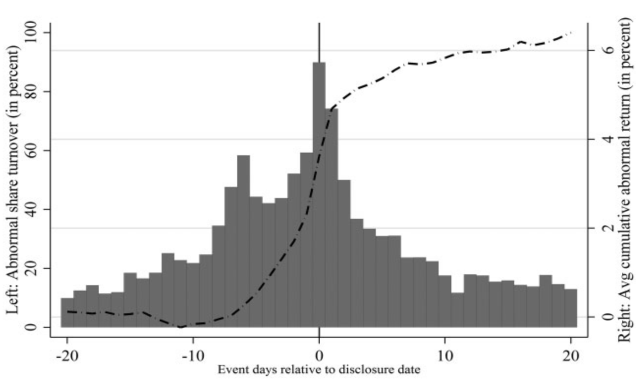
Any deviations from this linear relation are called alpha,

$$R_{pt} - R_f = \alpha_p + \beta_p(R_{mt} - R_f) + \epsilon_{pt}$$

Going more in detail, Cumulative Abnormal Returns (CAR) were used in one of the most thorough studies on activist hedge fund performance, published in 2017 by Oxford University Press, which took a sample of 330 activist funds and 1740 activist engagements across 23 countries, from 2000 to 2010. The study took into consideration several factors when evaluating the performance of these funds, such as the probability of becoming a target for activist investors, the number of requests made by the fund to the company's management, the type of requests and the probability of successful outcomes, among others.

Performance can be measured for the first time around the activist engagement date, by taking as a reference the 20 days before the announcement and the 20 days following the announcement (-20, 20 window). The study found that during this time window, abnormal returns (CAR, monthly alphas) averaged 6.4% across all countries, with some variations across different regions (the US averaged 7% while Europe 4.8%). The returns around the announcement date are important because they influence the holding periods of the various investments.

Figure 1.2 Abnormal Returns Around Disclosure Date



Source: Returns to Hedge Fund Activism: an international study. Becht, Franks

The scope of the study then shifted to the medium and long-term period, when the outcomes of the engagements are announced. The different types of outcomes in the research were defined as: “Board” (referring to the removal of the current CEO or other executives in the company), “Payout” (a change in the buyback strategy or dividend policy) and corporate restructuring, which in turn can be divided into “Takeover” (defined as the target firm being acquired by a private equity fund or specific buyer) and “Restructuring” (spin-offs of non-core assets).

Seeing as alphas in the long-term are heavily linked to the probability of achieving a successful outcome during the negotiation, value-weighted abnormal returns for successful and unsuccessful outcomes were considered, reflecting the profitability of the engagement. Other important factors in assessing the performance of the activist campaigns were the number and type of outcomes being pursued by the fund, with “Takeover” being regarded as the most significant because it deals with the most severe obstacles affecting the target company, which might be negatively influencing the stock price.

When these new factors are taken into account, activist hedge funds which were able to successfully implement multiple outcomes, including “Takeover”, generated the highest abnormal returns at 18.1% during the (-20,20) window of the outcome announcement date. Overall funds with multiple successful outcomes were significantly more profitable than those successful in implementing a single outcome.

The abnormal return of all outcomes at engagement outcome date averaged 6.42%, with Europe being the region with the highest rate at 8.77%.

Furthermore, the study differentiated between single activists and “wolf-packs”, with the latter occurring when multiple funds target the same “prey”, often coordinating their attacks. The results showed that wolf-packs were much more likely to successfully achieve at least one outcome compared to single activists, with a probability of 78% for the former against 46% for the latter. However, it is important to note that this higher probability did not necessarily translate into higher abnormal returns for wolf-packs.

Finally, the study assessed the overall performance of engagement over the holding period of the investment, from the disclosure of engagement to the announcement of the exit from the company. To achieve this goal, the analysis used the Four-Factor Carhart model (which expands on the three-factor Fama and French, in turn based on the CAPM). The formula of this model is written below:

$$R_{p,t} - R_{f,t} = \alpha_P + \beta_{P,RMRF}\left(R_{m,t} - R_{f,t}\right) + \beta_{P,SMB}SMB_t + \beta_{P,HML}HML_t + \beta_{P,MOM}MOM_t + \varepsilon_{P,t}$$

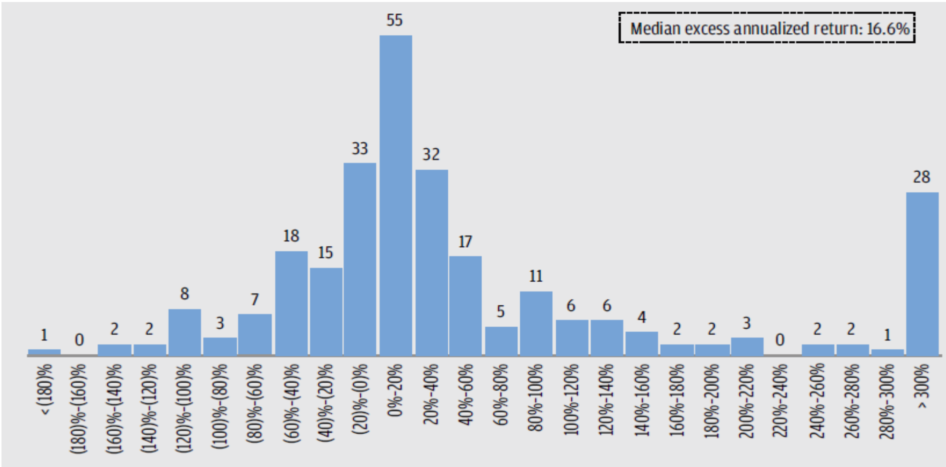
Where SMB refers to the difference in returns between a portfolio of small and big stocks, RMRF to the excess return of the market, HML to the difference in returns between portfolios with different levels of book-to-market values and MOM to the difference of portfolio with high and low-momentum securities.

Value-weighted abnormal returns for engagements with successful outcomes averaged 11.3% across the total sample, while engagements which failed to achieve any outcomes still exhibited positive abnormal returns (4%) for the entire holding period.

The Oxford Press Study provided a detailed breakdown of the methods used to measure the performance of activist campaigns worldwide, but in order to analyze the recent trends in the industry, other studies and reports have to be taken into account. Activism has been growing ever since the bull market following the 2008 financial crisis, and recently there has been an increase in activist campaigns launched on large-cap companies, totaling 21% of all campaigns in 2017. This increase has been possible thanks to the ever-growing support of institutional investors for activist investing, who have recognized the benefits that can result when such investments are successful.

A report on activist investors published in 2015 (JP Morgan, 2015) showed how over the previous five years (2010 – 2015), activist hedge funds had a median excess annualized return of 16.6%, allowing them to outperform the market; looking more closely however, the high volatility in the distribution of these excess returns over different funds becomes evident, as shown in the graph below.

Figure 1.3 Distribution of Excess Returns over the S&P 500



Source: The Activist Revolution. JP Morgan

Another trend highlighted by this report, apart from the stronger focus on large-cap companies mentioned above, is the smaller stake taken by funds when launching a new activist campaign. The reference ownership stake has always been 5%, but recently activists have been able to exert significant influence on target firms with stakes sometimes smaller than 1%. This has been possible thanks to the reputation that certain activist funds have been able to develop over the years, which has allowed them to use unconventional tools (social media and other venues) to make their vision known to market.

1.4 Activism Outside of the US

Activism has expanded gradually from the US to other countries and is now present in almost all the developed economies of the world, especially in the European Union, Switzerland and Japan. While many similarities can be found across nations, the effects that activist hedge funds have on financial markets and the way they are perceived by participants varies according to the regulatory environment and company governance culture.

Furthermore, the global scale of activism has allowed domestic funds (mostly American) to bridge the geographical gap and directly intervene in foreign companies. An example of this phenomenon was the recent feud between the US based Elliott Management activist hedge fund and the Dutch chemicals and paint company Akzo Nobel, which sparked a prolonged legal battle culminating in the joint support for the appointment of a new CEO to lead the company in addition to the spin-off of the chemicals branch (New York Times, 2017).

In 2017, 52% of all activist campaigns worldwide targeted non-US companies (Activist Insight, 2018), marking the first year during which global campaigns were more frequent than US ones. This trend is likely to continue as institutional investors embrace activism as a viable option to unlock shareholder value; these investors are now able to support campaigns all over the world, meaning that every company is a potential target.

As activist hedge funds become more global, they also tend to target bigger companies (market capitalization greater than $10bn), as demonstrated by Third Point's campaign against the Swiss conglomerate Nestlè and Elliott's involvement with the Korean giant Samsung, to name a few. This phenomenon might be explained by the fact that large US companies have been subject to activist interests for some decades by now, while non-US companies have been fairly immune to these kinds of pressures, leaving a lot of room for potential interventions.

Historically speaking, Asia has been characterized by a culture of passive investing, supported by complex ownership structure, lack of transparency and government interference in certain companies (J.P.Morgan, 2018); these features used to protect firms from investor's pressure but are now used by activist hedge funds as leverage to gather support when launching new campaigns. Activists are being hailed as disruptive forces within the static Asian financial markets, forces able to "attack" the pillars on which companies have based their governance culture. Furthermore, regulators are embracing activism as well because of its potentially beneficial effects on accountability and dialogue between management and shareholders.

Some of the reforms being enacted deal with transparency on pay packages and shareholder's voting process, in addition to promoting a dynamic and ongoing exchange of ideas among all the stakeholders in a company. These reforms are being brought forward in all major economies in Asia, such as South Korea, Singapore, India, Taiwan, Japan and Hong Kong, with the last two accounting for almost 60% of total activist activity in Asian countries.

These recent developments have led to an increase in the total number of activists' interventions in Asia, representing 31% of all non-US campaigns in 2017, up from 12% in 2011. Once again, a strong example comes from Elliott Management and its 1.5% stake in the Hyundai conglomerate (South Korea). The fund is trying to make the firm more efficient and diverse, by implementing new policies regarding excess cash and board structure.

A peculiarity about activism in Asia is the even distribution of industries being targeted, as no industry accounts for more than 11% of total activity. This is very different compared to what happens in other regions, where a single sector can represent more than 40% of total market activity. Domestic funds are the main drivers of activism in Asia, initiating 62% of total campaigns in the continent, implementing a softer approach compared to American funds, presenting themselves as supportive shareholders instead of opponents.

Activism has been increasing in Europe as well, 2017 being a strong year for activist campaigns, with over 100 companies being initiated by September, mostly concentrated in the U.K, Switzerland, Germany, France and Italy. Furthermore, the number of companies being targeted worth more than €1bn has increased from only 6 in 2009 to 40 in 2016 (Activist Insight, 2017).

The fragmentation of the European financial market, marked by the overlap between local regulations and EU directives, presented some initial challenges for investors, but at the same time allowed for some countries to stand out and capture the attention of activists, favored also by the region-wide economic growth following the crisis. To that regard, the European Parliament recently passed a new Shareholder Rights Directive, to be fully implemented by mid-2019, aimed at promoting long-term shareholder engagement, possibly leading to an increase in the frequency of activist campaigns.

The objectives of European campaigns are usually in line with the American ones, but similarly to what happens to Asia, these campaigns tend to be less eye-catching (although there are some strong exceptions) as activist prefer to be seen as "constructivists" and conduct private negotiations with their counterparts, without the media getting involved.

The UK is the country which witnessed the most campaigns, about 30% of the total in Europe (although activity has been flat lately). The influence on the activist approach coming from the US has been increasing, as demonstrated by the use of media as a vehicle for gathering support and running a more effective campaign. The future of activism in the UK nevertheless is heavily linked to Brexit, as reforms regarding corporate governance proposed by Theresa May are on hold and the trust placed in the British financial markets is being put to the test.

Germany and France both offer strong protections to minority shareholders, allowing them to exert notable influence on management. The main issue tackled by activists in these countries is M&A, which occurs within a solid regulatory framework. France is the second biggest activist market in Europe, and it has some of the highest focus on companies valued at more than $10bn, comprising about 30% of total campaigns launched.

In Italy the intervention of foreign funds is limited by a less-forgiving regulatory system, but that hasn't stopped institutional investors from demanding a more hands-on approach from certain funds. An interesting case has been the ongoing feud between Elliott Management and the French media conglomerate Vivendi over the composition of the Board of Directors of Telecom Italia.

As is the case with Asia, activism in Europe is becoming less stigmatized and the potential benefits are starting to surpass the perceived threats. Activism is now seen as less of a shock compared to some years ago, as targets are more prepared and willing to implement substantial changes on their own, reducing the need for public feuds between funds and companies. However, this also signals the consolidation of activism as a viable option to approach investing all over the world.

Chapter 2 - How Activist Hedge Funds Interact With Firms

2.1 Target Companies

Since their inception, Activist hedge funds have identified their targets focusing on five main issues affecting the company: underperformance by the target compared to competitors, sub-optimal capital allocation, corporate governance structure, involvement in M&A operations and importance of different divisions and assets within the firm (JP Morgan, 2015). To increase the likelihood of a successful engagement and generate considerable alpha, most of the time activists will look for deficiencies to exploit in multiple areas of the target company.

Looking at the targeting process more in detail, the main driver for an activist intervention is the firm's underperformance, as shown by the statistic that the target company, on average, lags 10% behind the market during the year prior to the public disclosure of the campaign and by 21.6% expanding the analysis to three years prior. If the firm is underperforming, activists will then seek to evaluate other core weaknesses and decide whether to intervene or not.

The targets will often have strong Returns On Assets (ROA) and lower growth compared to peers in the market, indicating a strong operational structure generating sound cash flows. The statement that best exemplifies this strategy comes from Trian Partners, which described their targets as "best in class" (AIMA, Simmons & Simmons, 2014) and market leaders within their respective industries.

One instance of an important company being involved in a dispute with an activist occurred in 2014 when Carl Icahn (one of the most notorious activist investors) wrote an open letter to Apple's CEO Tim Cook, explaining how he thought that the company was trading below its real value; according to Icahn, the solution was to accelerate and expand the share repurchase by Apple, using the significant cash reserves held by the company at that time.

The focus on underperformance by activists is a trait shared with value investors, who look for profitable, stable companies with a higher book value compared to the market value and then buy stakes in the firm, hoping that the market will eventually recognize the true value of the company. However, while valuation is the only component for value investors, for activists it is only a part of a more comprehensive strategy, aimed at analyzing thoroughly the target company by comparing the existing business plan to an alternative plan elaborated by the fund. When the alternative business plan in likely to yield higher alpha, the activist hedge fund might intervene.

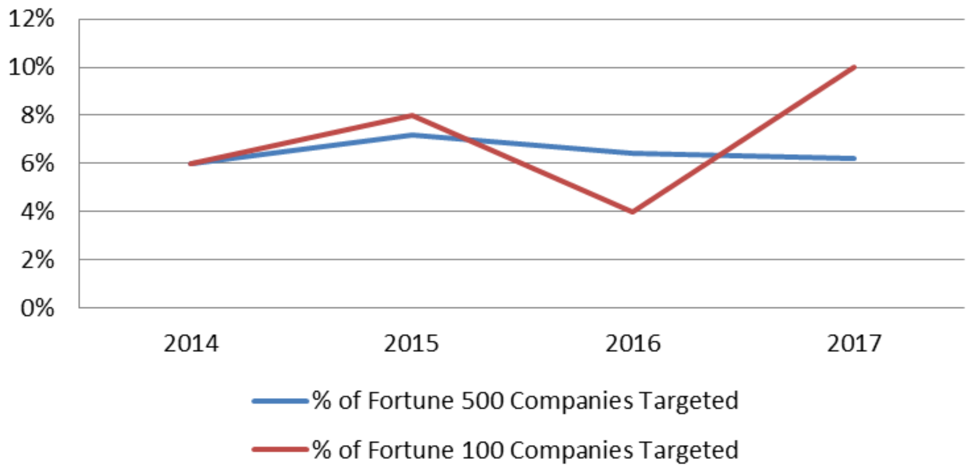
Furthermore, activists will not limit themselves by targeting only underperforming firms, seeing as underperformance is often considered a sufficient but not necessary condition for the existence of locked shareholder value. To that regard, it is interesting to note that one third of the targeted firms were actually outperforming the market before becoming publicly involved with activists.

Other than the raw performance of companies, activists also focus on less technical aspects, such as the behavior of management on certain issues. In the constantly evolving, globally connected and environmentally conscious world we live in, issues such as pollution and shady employment tactics can become sources of unwanted attention for the offending companies. These new issues are summarized by the ESG acronym, which refers to the Environmental, Social and Governance aspects of a firm’s conduct, considered to be just as important as economic performance by investors when evaluating a company and its management. A 2014 study found that of all shareholders proposals, 28% came from investors motivated by religion, social and environmental policy (Hoffmann, Fieseler, 2017).

If a company employs child labor or disposes of waste in a non-environmentally safe manner, investors might begin to investigate further and eventually start asking for changes. In this scenario, activists can use these findings as leverage to launch a new campaign and directly target the unethical management responsible for implementing such policies. If the issue in question is particularly troubling, the activist hedge fund will probably be able to gather more support, both financial and commercial, greatly increasing the odds of a successful outcome.

The scope of the campaigns has moved from mainly small and mid-cap companies to targeting bigger and more established firms, as demonstrated by the drastic increase in the number of Fortune 100 companies involved in disputes with activists from 2014 to 2017 compared to those of the Fortune 500.

Figure 2.1 Percentage of Fortune 100 and Fortune 500 Companies Targeted by Activists

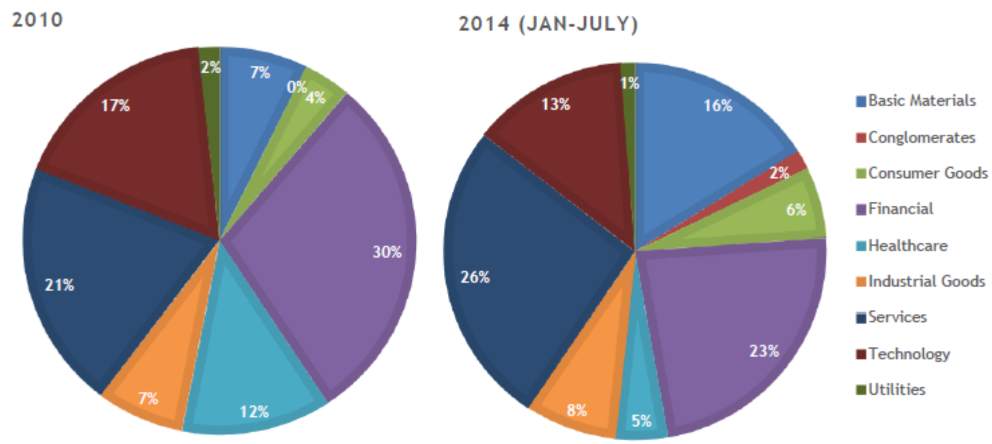


Source: Review and Analysis of 2017 US Shareholder Activism. Sullivan & Cromwell LLP

This trend is easily explained by the ever-increasing inflow of capital in the activist world, based on the successful outcomes of past campaigns. This increased availability of funds, together with the reputation built over the years, has enabled activist hedge funds to put their sights on companies previously thought to be immune from activists' pressures. The increasing involvement of institutional investors, such as public pension funds and mutual funds, and proxy advisory firms has allowed activist funds to face the exceptional idiosyncratic risk that comes when trying to acquire significant stakes in large companies.

When it comes to what industries are targeted by activist hedge funds, no clear favorite emerges, demonstrating how different industries at different times might exhibit the characteristics which are appealing to activists. In general, the financial, services and technology industries have captured the most the attention of these investors, as shown in the pie chart below, analyzing the percent of new campaigns launched in several industries in 2010 and 2014.

Figure 2.2 Distribution of Targeted Firms in Various Industries



Source: Unlocking Value. AIMA / Simmons & Simmons

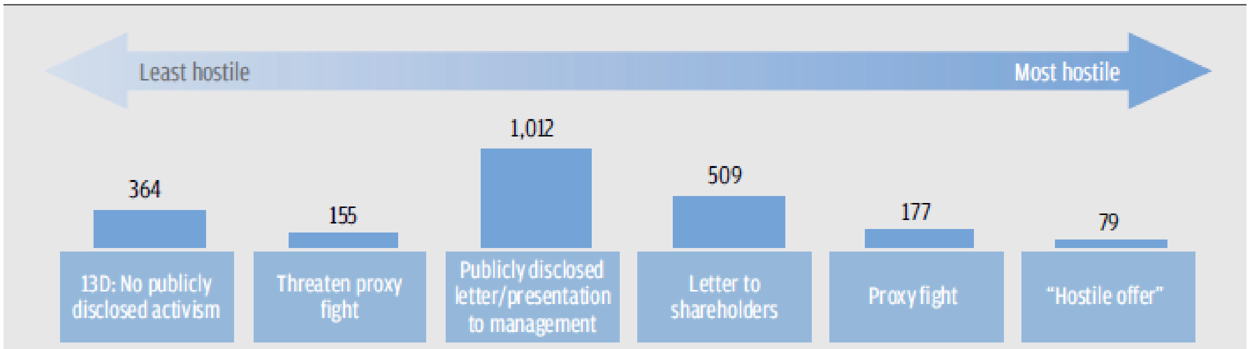
From a geographical point of view, the largest market remains by far the United States and Canada, with the majority of activist engagements involving companies listed in North America. Then we find Europe (especially the UK) and Asia, with the latter accounting for a small percentage of global activist campaigns, although it is likely to increase in the following years, as the financial market adapts and regulation becomes less stringent.

2.2 Strategies Used by Activist Hedge Funds to Exert Influence

Activist hedge funds want to generate alpha by challenging the target company's management on pressing issues regarding capital efficiency, corporate governance structure and proposed M&A. They try to achieve this goal by acquiring sufficient power in a company using various strategies, ranging from peacefully cooperating with management to launching a full-blown proxy war against the firm. Activist funds can also decide how to interact with management, via a private conversation with the board hoping to successfully implement the changes without public disclosure or by announcing the engagement to the public to gain leverage during negotiations.

The engagement tactics used by funds in the past, other than the ones mentioned above, also include making formal shareholder proposals, publicly shaming the target company's management, mounting a litigation case and proposing a takeover bid. A constructive activist fund manager, preferring to engage in a private negotiation, might meet several times with the executives from the target company and visit the operational facilities, proposing medium and long-term measures to increase shareholder value. The graph below shows the number of times each engagement tactic was used by activist funds between 2009 and 2014.

Figure 2.3 Frequency of Engagement Tactics Used (2009 - 2014)



Source: The Activist Revolution. JP Morgan

The most hostile and extreme tool that an activist hedge fund has at its disposal is to launch a proxy fight, defined in the Cambridge dictionary as "*a situation in which a group of investors that wants to take control of a company tries to persuade shareholders of that company to vote at shareholders' meetings in a way that helps the investors achieve what they want*". Activists mount proxy fights to put pressure on management by convincing board members to vote for their proposal to unlock shareholder value. Proxy fights are very costly and do not guarantee victory for the fund, which is why they are viewed as a last resort and not pursued often. However, 67% of definitive proxy fights (about 14% of total fights) in 2013 resulted in activists receiving at least one seat in the Board (JP Morgan, 2015).

Although hostile engagements (proxy fights, takeover bids, etc) get more press coverage, they are, at least initially, far less common compared to non-hostile ones (private emails, formal proposals), as the former occur in slightly more than 20% of activist campaigns, with some variation depending on the geographical area. Activists in the US tend to be more aggressive compared to their European counterparts, who prefer instead to cooperate with management.

The prevalence of non-hostile engagements can be attributed to the lower cost associated with these types of campaigns, as hostile tactics on average end up costing some $20 million more than non-hostile ones. For this reason, activist funds must be cautious in waging proxy and legal fights against companies, as they must generate a higher alpha in a shorter period of time compared to a constructive approach.

With the increased focus on large-cap stocks, activist have been changing their ownership stakes to exert their influence. Contrary to what one might expect, smaller stakes are becoming more common among activist hedge funds, as these funds are becoming more widely accepted by financial markets all over the world.

The 5% ownership stake has generally been considered the minimum required to influence a company's management, as it is compliant with the SEC 13D disclosure rule. However, smaller stakes (meaningful minority stakes) are proving to be the preferred option for many activists, as they find that they are still able to exert significant power by controlling as little as 1% of the target company, thereby reducing their exposure to risk.

This has been possible also thanks to the use of the media by the more established funds, who use their reputation to turn public opinion in their favor and force management to listen to their proposals, reducing the need for a large stake. A study by JP Morgan found that in 60% of campaigns initiated between 2009 and 2014 against firms worth more than $25 billion, the activist stake at the time of the announcement was less or equal to 1%.

Most activists might build a stake in the company over time, using outright share purchases, stock options, convertible debt, derivatives and other instruments to consolidate their position of power within the target company. Some funds might start out as passive shareholders but then realize that an activist approach might be better suited for the situation.

The use of financial instruments to consolidate power is difficult to quantify because funds are not required to disclose them; a study in 2008 reported that 16.1% of activist campaigns had disclosed derivatives holdings (AIMA/Simmons & Simmons, 2014), but the true number is likely to be higher.

One of the most creative and unconventional methods to gain more power is the share loan agreement, used to acquire voting rights while giving up economic ownership, allowing the activist to increase his influence around key dates during the course of the whole engagement. The process of separating voting rights and economic rights has been called "decoupling" and has been criticized by some regulators and market participants for creating shortcuts around disclosure rules and conflicts of interest within the shareholder community.

Activist hedge funds are typically short-term investors, with the same study by JP Morgan showing how about two thirds of activist campaigns are shorter than one year (half being shorter than six months). That is a huge difference compared to institutional investors who have an average holding period of three years. This focus on the short term is a good indicator of how activist hedge want to maximize short term shareholder value, without having much consideration about the long-term effects of their policies.

Analyzing the activist hedge fund trading behavior, a study by Gantchev and Jotikasthira between 2000 and 2007 found that on average funds acquired a 4.25% stake in the target company before the public announcement and an additional 2% until the disclosure of the engagement.

When an activist hedge fund is satisfied with the performance of the firm it has invested in, it will implement its exit strategy by selling the shares in the open market. This is the most common type of exit strategy, occurring in 64% of activist campaigns, followed by the acquisition or merger with a third party, which account for around 30% of all exits (AIMA/Simmons & Simmons, 2014). Other possible scenarios involve a private equity fund taking the firm private and delisting it from the exchange or, on rare occasions, the activist fund buying the company.

2.3 Long Term Effects on Targeted Firms

While activist hedge funds focus on the amount of alpha that they are able to generate in the short and medium term, the long-term consequences on the companies subject to activist interventions are the topic of heated debated within the financial world. While consensus has been reached on the short-term positive effects of an activist campaign, many claim that it is not the most relevant aspect to consider, as it may hide negative long-term consequences that might make the shareholders worse off.

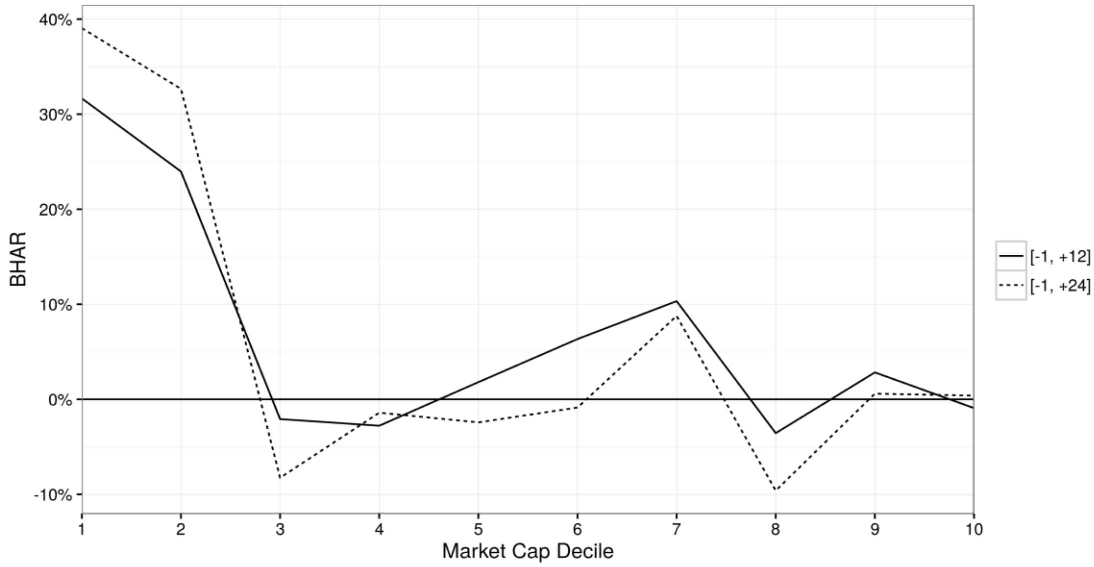
Supporters of activism believe that shareholder engagement reduces the risk of agency problems by increasing efficiency and reduces moral hazard in the market, while opponents reject this view, asserting that activist might distract management by focusing only on short-term returns, preventing the implementation of valuable long-term policies, such as investments in research and development. Among this ongoing debate, some activist hedge funds have begun a lobbying coalition to protect their interests.

A research published by the European Corporate Governance Institute in December 2018 (DeHaan, Larcker, McClure. 2018) set out to elaborate the real long-term effects of an activist campaign by examining more closely the equal-weighted returns compared to the value-weighted returns, the letter being the best representation of the impact of these funds on the economy. The study considered 1964 Schedule 13D filings between hedge funds and the SEC from 1994 to 2011.

A value-weighted approach is preferable to an equal-weighted one because the latter does not capture the effect of the intervention for the average investor. Seeing as 91% of total market value in the US is comes from the top 20% of companies in terms of market capitalization, investors will be affected to a greater extent by a campaign targeted at a large company instead of a small one; for this reason, an analysis on the distribution of value-weighted long-term returns could result in a more accurate portrayal of activism’s long-term consequences.

When using equal-weighted abnormal returns, the study found that the two-year average returns were significantly positive at 5.9%. This number on its own however is deceiving, as a more thorough analysis reveals that most of those returns are accounted for by the 20% smallest companies, with an average market cap of $22 million, while the largest 80% of companies have statistically insignificant (-1.6%) abnormal returns after two years.

Figure 2.4 Equal-weighted buy-and-hold abnormal returns for different size deciles



Source: Long-Term Economic Consequences of Hedge Fund Activist Interventions. deHaan, Larcker, McClure

On the other hand, when using value-weighted returns, the long-term returns are insignificantly different from zero. Less than half of the targets exhibit positive returns and overall the impact of an activist intervention on shareholder wealth is negligible. These results indicate that the empirical evidence found in this study does not support either long-term benefits or losses for shareholders of a firm subject to an activist campaign, so the creation or destruction of value has to analyzed for each individual firm.

Table 2.1 Value-Weighted Mean Abnormal Returns

		(1) VW Mean Abnormal Returns		(2) Abnormal Change in Market Value (in Millions)
Days [-10,+10]	VW Mean	0.024***	Mean	18.8***
Months [-1,+12]	VW Mean	0.018	Mean	3.4
Months [-1,+24]	VW Mean	0.019	Mean	13.2

Source: Long-Term Economic Consequences of Hedge Fund Activist Interventions. deHaan, Larcker, McClure

The same study also examines the long-term operating performance of the companies (except for the firms that delist over the years), focusing on a sample of matched control firms for different attributes such as size, industry and ROA (defined here as operating income before depreciation and amortization over total assets) pre and post activism. When the ROA level and growth is matched across the samples, no significant differences can be found between companies, as activism does not influence the target's ROA using neither the value-weighted nor the equal-weighted approach.

When considering even more performance metrics, such as ROE, EPS growth, profit margin and spread over borrowing, among others, once again no empirical evidence can be found to suggest a significant impact of an activist endeavor.

However, the study does find noticeable differences when looking at the various types of outcomes achieved at the time of exit by the activist hedge fund. Firms which spin off assets or change upper management (including the CEO) are prone to slightly negative long-term abnormal returns while those that increase payout through dividends or share buybacks tend to experience slightly positive returns.

The most noteworthy post-activism long-term returns occur when looking at the 26% of firms which delist after an activist intervention. The companies which are subject to a merger or acquisition at the hands of another firm (about 73% of the delisted firms) have average significant abnormal long-term returns of 26.4% using the value-weighted approach after two years; these results clearly show how a successful M&A operation is the source of the greatest returns and the most beneficial for shareholders.

Table 2.2 BAHR for Acquired and Nonacquired Firms

		Acquired versus Nonacquired			Nonacquired: Delist versus Survive		
		(1) Acquired	(2) Nonacquired	(3) Diff. (1) – (2)	(4) Nonacquired: Delist	(5) Nonacquired: Survive	(6) Diff. (4) – (5)
	N	380	1,584		129	1,455	
Short-term							
[-10,+10]	EW Mean	0.076***	0.049***	0.027**	0.073***	0.047***	0.026
	VW Mean	0.052***	0.018**	0.034**	-0.021***	0.018***	-0.040
	% > 0	69%	61%		55%	61%	
Long-term							
[-1,+12]	EW Mean	0.245***	0.025	0.220***	-0.506***	0.072***	-0.578***
	VW Mean	0.182***	-0.016	0.198***	-0.596***	-0.009	-0.587***
	% > 0	66%	42%		15%	45%	
[-1,+24]	EW Mean	0.254***	0.012	0.241***	-0.830***	0.087***	-0.917***
	VW Mean	0.264**	-0.032	0.295***	-0.797***	-0.023	-0.774***
	% > 0	65%	37%		11%	40%	

Source: Long-Term Economic Consequences of Hedge Fund Activist Interventions. deHaan, Larcker, McClure

A purely empirical approach to evaluating the long-term consequences of activism is too narrow and fails to capture other non-statistical elements, such as the psychological impact on market participants (management and board members) and policy makers, in addition to other externalities.

2.4 Protection Against Activist Hedge Funds

While we have been mainly focusing on the activist hedge funds and their numerous engagement tactics, it is interesting to analyze how the targeted firms can protect themselves and respond to activist pressures. The most effective way to prevent becoming a subject of an activist campaign in the first place is to have strong financial performance recognized by all market participants; this will close the door for many activists who begin their target identification process by looking at the underperformance of the company relative to its market peers.

Investors may interpret underperformance as a sign of weak management and overall lack of direction by the company, suggesting that a revamped strategy could potentially unlock shareholder value. Activists might insinuate that the current management is incompetent and present themselves as beacons of hope for the existing shareholders.

However, as we have seen, performance is not the only metric used by activists, as lately larger and healthier firms have become involved in several campaigns. The management of an outperforming company will have to allocate excess capital in an efficient manner and monetize assets to fend off the possibility of an activist intervention.

In the past an activist campaign was not considered a threat by the target company until the activist stake was below 5%, and management used to refuse to talk or completely ignore the attacking fund. As we have seen, this conviction is outdated; activist funds today can disrupt management with holdings of less than 1%. For this reason, companies must be prepared to engage with activists and try to cooperate, keeping the dialogue peaceful instead of responding coldly.

This change in strategy has also been supported by the role of media, transforming these once private negotiations into carefully orchestrated public relations competitions, trying to win over the shareholders of the company. Furthermore, activism is costly not only for funds but also for firms, so there is mutual interest to settle the dispute as quickly as possible. In 2014, about 75% of all activist demands were satisfied by the target company.

The other important aspect that management has to keep in mind when running the business is to establish and maintain a pristine reputation, by engaging in regular discussions with shareholders and rendering the company activist-proof and avoiding any agency conflicts. The reputation enjoyed by the company directly influences shareholders' loyalty during harsh times, when a good reputation will decrease volatility and a subpar one will make the share price more exposed to swinging conditions in the market, amplifying shareholders' dissent and criticism.

If a company is inadvertently damaging its own reputation by taking advantage of cheap labor in under-developed countries or not complying with environmental norms, activist shareholders might use general meetings to speak up and galvanize other participants, eventually having repercussions on the stock price.

A company's reputation will always influence market performance, seeing as it takes years to develop, by building strong relationships with all stakeholders, offering quality products and excellent customer support and promoting the welfare of society, not only of the individual firm. For this reason, public shaming by activist investors can prove to be extremely efficient in planting the seeds for an overall loss in confidence in the company's management.

When a company falls prey to an activist fund, it can respond by implementing various policies and change its stance on a number of issues, either trying to carry out some of the suggestions or creating obstacles for the activist. These strategies can be divided into three major categories: substantive, governance and tactical, which range from hiring financial advisors to adopting a so-called "poison pill", a strategy aimed at making the target company more unattractive in the wake of an activist intervention, thereby increasing the cost of engagement. The most common first response by the company is to return excess cash to shareholders, via stock buybacks and an increase in dividends, as shown in the following table.

Table 2.3 Strategies by Target Companies in Response to Activists

	2013	2014	2015	2016	2017	Five-year average
Substantive Actions						
Act to Increase Shareholder Value (e.g., buybacks or dividends)	17%	8%	21%	12%	10%	14%
Hire Advisors to Evaluate Strategic Alternatives	6%	3%	8%	7%	5%	6%
Governance Changes						
Amend Advance Notice Requirements	8%	2%	4%	3%	1%	4%
Other Charter/Bylaw Changes	9%	5%	10%	3%	7%	7%
Corporate Governance Enhancement	8%	1%	3%	4%	1%	3%
Tactical Actions						
Increase Size of Board	8%	5%	17%	10%	5%	9%
Adopt Poison Pill	6%	7%	1%	2%	2%	4%
Adjourn Meeting	4%	0%	1%	2%	1%	2%
Postpone Meeting Date	2%	1%	3%	2%	1%	2%
Amend Poison Pill	1%	0%	1%	1%	0%	1%
Decrease Size of Board	1%	2%	3%	2%	3%	2%
Call Special Meeting	1%	1%	1%	1%	0%	1%

Source: Review and Analysis of 2017 US shareholder activism. Sullivan & Cromwell LLP

When a company is faced with the prospect of a proxy battle, it risks being subject to a shake-up in the board of directors, losing seats necessary to lead the company according to the existing vision. To avoid this scenario, the company may settle with the activist fund and award it with minority board representation, preferring this outcome to a no holds barred public fight. In 2017, 28% of proxy contests went to vote, while in 38% of the cases the company settled and gave some concessions (Sullivan & Cromwell LLP, 2017).

Chapter 3 - Clash of the Titans: Ackman Vs Icahn over Herbalife's Fate

3.1 Carl Icahn and Bill Ackman's Rise to Prominence

When talking about shareholder activism and powerful hedge fund managers in the industry, the names of Bill Ackman and Carl Icahn will be mentioned quite often; they are the founders of Pershing Square Capital Management and Icahn Enterprises respectively, two of the most revered investment funds.

Carl Icahn rose to fame in the 1980s as a corporate raider, later transforming himself into an aggressive activist investor. In the early years of his career he acted as a "lone wolf" (Cheffins & Armour. 2011), without the backing of outside investors. He purchased large stakes in companies throughout the 80s with the help of some undisclosed "silent partners", but records show that Icahn always had a much bigger stake in the investments, accounting for 80% of net profits. His reputation grew over the years and finally in 2004 he founded his own activist hedge fund, Icahn Partners, managing to raise over $1.6 billion. Given his high net worth (currently at about $16 billion, making him the 31st richest person in America, according to Forbes), Icahn is still able to act as a "lone wolf" in pursuing his targets, without the need of further funding and support.

Carl Icahn is the current chairman of Icahn Enterprises, a holding company listed on NASDAQ stock exchange that controls the hedge funds Icahn Associates and Icahn Capital. One of Icahn's trademarks is to target firms which he perceives as being mismanaged and trying to gain seats on the board, in order to increase efficiency and accountability by removing substandard managers. He tends to buy large stakes in companies whose management is unable to cope with fundamental flaws in corporate structure and governance, such as Yahoo's failed acquisition attempt (Lee & Schloetzer. 2014) or companies who are not using their assets to their full potential, reducing profitability, such as Apple's significant cash reserves.

Furthermore, Icahn relies heavily on the media to spread his message, ranging from sending open letters to giving interviews on television and writing on social media. By effectively using these multiple communication channels, he is usually able to solicit a reaction from every shareholder of the company.

Bill Ackman is the founder and CEO of Pershing Square Capital Management, an activist hedge fund with almost $8 billion of assets under management as of late 2018 (Bloomberg, 2019). Ackman implements a hyper-aggressive hands-on approach with his investments, buying significant stakes in undervalued companies.

He often conducts negotiations with the aim to revolutionize the target company by acting on its management and board of directors, in an effort to revamp profits, corporate strategy and unlock shareholder value.

However, Ackman, compared to Icahn, is also willing to short companies he deems as being overvalued and fundamentally flawed. For this reason, he is prone to initiating high stakes public activist campaigns by incessantly attacking the target's management, trying to drive down the share price and overcome any type of resistance by the firm's executives. His attacks are often sudden, leaving little time for companies to prepare a counter strategy.

One instance of such a strategy being implemented in the market occurred when Ackman set his sights on the financial services firm MBIA. He publicly questioned the company's AAA rating in 2002, as he thought that it was too leveraged because of its reliance on off-balance sheet financial instruments for raising funds. In 2007, MBIA's use of Collateralized Debt Obligations ensuring Mortgage Backed Securities (of which many based on sub-prime mortgages) created some serious headaches for the company, as the mortgage market begun to crumble. By October the shares had dropped over 40% YTD, as Ackman ramped up the pressure on the company and its hazardous exposure to subprime mortgages. He exited his position in 2008, making about $1 billion, or 26% return on investment, in six years (Lee & Schloetzer 2014).

3.2 The Herbalife Saga

Herbalife Nutrition Ltd is a holding company specializing in the production of nutrition and weight management solutions, listed on the New York Stock Exchange (HLF). It has been at the forefront of many controversies regarding its business practices, in particular the use of Multi-Level Marketing (MLM). This sale strategy relies on a network of independent distributors, instead of traditional stores, to sell the company's products and recruit new members to reach a wider customer base; this creates a hierarchal structure among the distributors, with those ranked higher receiving a share of the profits from everyone they have recruited, resembling a classic pyramid scheme, and thus drawing the ire of many regulators and investors. The main difference between MLM and a pyramid scheme (which is illegal) is that in the former the products are sold primarily to consumers, while in the latter they are sold to new members, which in turn have to recruit even more distributors to keep selling the products and make any meaningful income.

Among the disgruntled investors was Bill Ackman, who in December 2012 publicly announced that he had taken a short position in the company worth over $1 billion, entering at about $45 per share. He explained his motives in a presentation called "Who wants to be a Millionaire?", claiming that the MLM model was actually a pyramid scheme in disguise, and that Herbalife products were sold to members, not customers.

The stock plummeted over 40% after the disclosure, closing at $26.06, demonstrating how Ackman's menacing reputation as an activist investor had become a driving force in the market, powerful enough to influence many of the company's top shareholders (Lee & Schloetzer 2014).

However, some investors did not agree in the slightest with Ackman's pessimistic view of Herbalife, among which was Carl Icahn, who called then CEO Michael Johnson a couple of days after the news broke out, expressing his disagreement with Ackman on this issue and general lack of respect for him. Icahn pledged to fight him by taking the opposite side and going long on Herbalife stock.

There was bad blood between the two activist hedge fund managers, as they had previously spent years in court over a small payment resulting from Icahn's sale of Hollywood Realty's shares in 2003. When referring to Carl Icahn, Ackman said: "for whom I have no respect" to which Icahn replied: "any criticism from Bill Ackman I consider a compliment." (Chung, Wall Street Journal, 2013).

Carl Icahn acquired a 16.5% stake in Herbalife, becoming the company's biggest shareholder, and in January 2013 a vehement feud ensued between the two investors, with Icahn announcing his bullish view and reinforcing his commitment to the company's business strategy.

During a CNBC news segment in 2013, the two financial heavyweights appeared simultaneously live on air, firing up a heated debate about the future of Herbalife and their opposite bets. The public spat was filled with strong language a high tension, giving birth to what Business Insider claimed was: “The greatest moment in financial tv history.” (Business Insider, 2013)

This show of support (Icahn was not the only investor taking a long position) reinvigorated the stock, so Ackman once again tried to influence the share price. He targeted Herbalife’s auditor, PWC, warning about the potential trouble it could encounter if the company went bankrupt; the stunt move did not provoke a strong enough response by the market, and instead portrayed Ackman as getting desperate about his investment, as Herbalife accused him of market manipulation.

During October 2013, Ackman had to restructure his position due to the increasing stock price, which caused him to incur in a potential $500 million loss. The break-even point for the short position was estimated to be around $31 per share, taking into account transaction and restructuring costs. With pressure mounting from his investors, he attacked the company again, claiming that it unfairly targeted economically disadvantaged minorities to recruit as distributors and saying that he would take this battle “to the end of the earth (Bloomberg, 2014).

Furthermore, Ackman resorted to more unorthodox methods, lobbying politicians, organizing protests and donating to civil rights movements, particularly those involved in the Hispanic community.

The battle was creating quite a few headaches for Herbalife, as in 2015 it recorded a $18.7 million expense referring to “allegations and other negative information put forward in the marketplace by a hedge fund manager," (Farrell, Wall Street Journal, 2016).

Some congressmembers close to Ackman begun pressuring federal agencies, while Pershing Square Capital conducted some private investigations into any wrongdoings by the company. On the 12th of March 2014, Herbalife announced that it was being investigated by the Federal Trade Commission, followed by a probe launched by the FBI; these events severely affected the share price, giving Ackman breathing room and good odds of a successful outcome.

The investigations went on for a couple of years and eventually in July 2016 the FTC concluded its inquiry into the company, fining the company $200 million as settlement for misrepresenting earnings prospects for distributors (Benoit, Wall Street Journal, 2018). The agency urged the company to implement some changes to its business model in addition to the fine, but most importantly did not classify the firm as a pyramid scheme, dealing a major blow to Ackman and his short position.

Carl Icahn acquired several board seats during the dispute, as his directors collaborated with the firm's management to fend off the short sellers and increase shareholder value. He gained five seats before the settlement with the FTC, which proved to be of great assistance to the company during the negotiations (Celarier, Fortune, 2016).

Immediately after the settlement, Icahn considered selling a part of his stake to cash in on his long position, and in a strange turn of events Ackman came up as one of the potential buyers, as Pershing's CEO thought that weakening the largest shareholders influence would have an adverse effect on the stock price, helping his short position.

The company promptly implemented the changes following the ruling, such as increasing the number of certified sales to customers (which became 90% of total sales) (Herbalife. 2017), leading to a rally in the stock price and shares buybacks. This trend went on for the following years, leaving Pershing's position looking quite bleak.

Furthermore, the company fought Ackman on every level, such as in 2016 when the documentary about Herbalife' dealings "Betting on Zero" by Ted Braun premiered in Washington. The firm's lobbyists bought 173 tickets, not showing up for the movie and leaving the theater half-empty. (Benoit, Wall Street Journal, 2016).

3.3 The Aftermath

Ackman confirmed on CNBC that he had exited his position in February 2018, with the stock trading about $92, conceding defeat to Herbalife and its shareholders, including Icahn. After a five-year battle his fund suffered tremendous losses (almost the entirety of its initial investment), as the share price continued to increase, registering a 35% increase in the early months of 2018 and reaching a record-high $96 per share after Ackman's exit (La Monica, CNN, 2018)

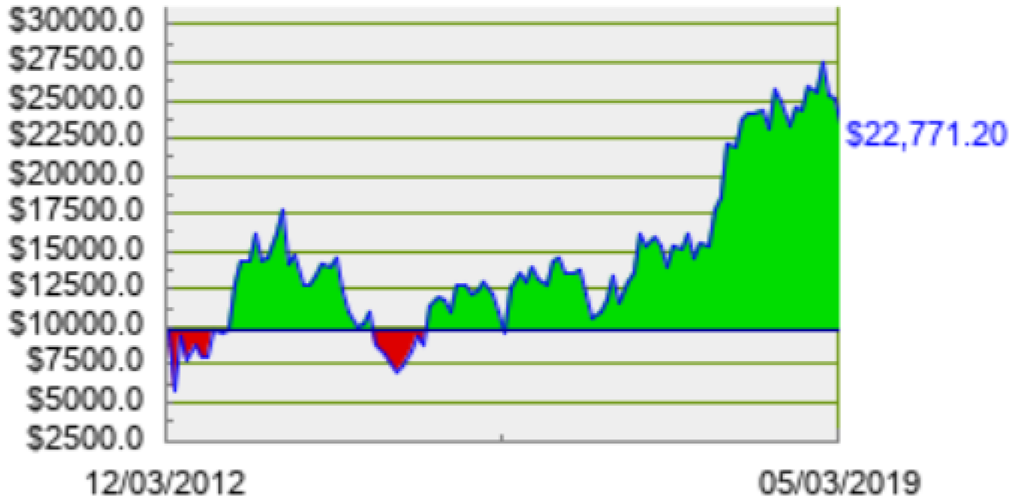
Icahn, on the other hand, increased his holdings in the company throughout the dispute (at one point owning over 26%) and in May 2018 sold about 10 million shares, still leaving him as the largest shareholder with a 21% stake and locking in over $500 million in profit from his long position. The announcement however created some turbulence in the market, as the stock fell 9% following the dilution by its largest shareholder (Lombardo, Wall Street Journal, 2018).

The Chairman of Icahn Enterprises had this to say about the feud with Ackman: "*Bill Ackman put up a great fight and while I really enjoy a great fight, especially when I believe I'm 100% in the right, and I'm certainly happy we won, much more importantly the company is much better off without this distraction*" closing with: "*I wish Bill well*" (Benoit, Wall Street Journal, 2018).

Pershing Square Capital in 2015 had total AUM od $20 billion, but the losses resulting from Valeant and Herbalife took a dent out of Ackman's reputation and financial performance, going in the red for three years in a row and forcing him to rethink his investment strategy as investors started fleeing from the fund. The revamped strategy has somewhat paid off, as the fund returned 24.7% in the first two months of 2019.

Following Ackman's exit, Herbalife announced a series of measures aimed at increasing shareholder value; it changed its name to Herbalife Nutrition Ltd, refinanced its debt, increased its buybacks and most importantly announced a stock split to increase liquidity levels. Herbalife investors approved these changes in the April annual shareholder meeting and on the 15th of May the company implemented a 2 for 1 split to reach a wider investor base. The split proved to be successful, and a comprehensive (split-adjusted) summary of the Compound Annual Growth Rate from 2012 to 2019 of an hypothetical investment can be observed below. The total return would have been 127.69%.

Figure 3.1 Growth of $10.000,00 (Dividends Reinvested) Invested in HLF



Source: *TickerTech.com*

Herbalife currently has $4.89 billion in revenues, with the level of sales increasing 10.48% compared to a year ago and the net profit margin increasing by 6.36% (trailing twelve months) (WSJ market data). These and other performance metrics show the financial health of the company and its potential to continue creating value for shareholders.

Figure 3.2 Herbalife's Stock Price

Source: *WSJ Market Data Group*

Chapter 4 – How Nations Fall: Elliott Management Vs Argentina

4.1 Elliott Management: The Epitome of a Vulture Fund

One of the most influential and feared activist hedge funds in the industry is Elliott Management, founded in 1977 by the ex-corporate lawyer Paul Elliott Singer, with an initial capital of $1.3 million. Singer’s legal background greatly influenced the strategy of the fund, not shying away from lengthy and costly court battles with its targets. Combining this characteristic with a very vocal and confrontational style, Elliott Management focused its efforts on distressed debt operations, targeting both countries and firms.

The addition of Singer’s protégé Jesse Cohn (now head of US equity activism) in 2004 to the firm consolidated the focus on activist investing, characterized by a very aggressive pursuit of shareholder value in many companies, from small tech firms to large global conglomerates such as Samsung and Hyundai. Elliott Management has been by far the most prolific activist hedge fund in 2018, launching 24 publicly disclosed campaigns (Carl Icahn, the second on the list, initiated 9).

The focus on distressed debt makes Elliott Management one of the most peculiar hedge funds, allowing it to tackle not only firms but also countries facing debt problems, demonstrated by its engagement with Argentina and Peru. This tactic has garnered many criticisms, with the fund being accused of unethical behavior and being compared to vultures, taking advantage of countries in financial peril. Singer has always stated that his fund does not create or exploit these problems, it exposes them to the public and incentivizes sound financial performance, by keeping management and government officials in high alert.

Furthermore, the ripple effects of an activist intervention in a company can be felt by nations as well, as demonstrated by Elliott’s (unsuccessful) engagement with Samsung, which pushed its opponents to bribe government officials, eventually contributing to the criminal investigation which resulted in the impeachment and jailing of South Korea’s president Park Guen-hye (Kolhatkar, The New Yorker, 2018).

With $35bn of assets under management and a strong reputation built through consistent returns (the fund has averaged 14% annual returns since its inception, losing money in just two years out of 42), Elliott management is now able to study financial markets and invest in companies without the need of an investment partner, giving it greater freedom in choosing its targets and engagement strategies. According to Paul Singer, on the The David Rubenstein show in 2017, a dollar invested at the inception of the fund would be worth over $160, making him one of the most successful hedge fund managers in the business (Bloomberg, 2018). Elliott generally looks for companies with great products who have experienced strong growth but then suddenly reach, in Singer's own words, an "inflection point", after which the growth stops. This may be caused by, or lead to, poor management choices, such as getting involved in inadequate M&A transactions, being too leveraged and building an inefficient capital structure, among others, ultimately reflecting poorly on the stock price and shareholder value.

4.2 Distressed Debt

Paul Singer's strategy during the first decades of activity of the fund focused on companies in debt and unable to make interest payments; Elliott bought the junk bonds of these companies at very low rates, hoping to be among the first creditors to be paid back in case of bankruptcy of the firm, a process which could take decades spent in various courts (earning the practitioners the nickname "rogue creditors").

Following on some successful stints in this line of business, Elliott turned its attentions to sovereign debt of developing countries, particularly Argentina, influenced also by trader Jay Newman. What ensued later would go down in history as one of the most enticing legal and financial battles involving a private investment fund.

The involvement of private creditors in the sovereign lending market started in the 1970s with the introduction of the United States' Foreign Sovereign Immunities Act of 1976 and Great Britain's State Immunity Act of 1978, which not only allowed nations to participate in the debt market of developed economies, but also gave foreign creditors a claim on the assets. The 1986 Brady Plan (named after Nicholas Brady, US Treasury Secretary) instituted an exchange between the US and the International Monetary Fund involving dollar loans for dollar bonds issued by indebted nations. The purchase of US treasury bonds acted as collateral for the principal, protecting foreign creditors in case of a default, and as a result sovereign bonds started to be traded in secondary markets (Kamenis, 2014).

The shift in strategy by the fund was favored by the situation unfolding in fragile developing economies, such as the ones in South America, where often corrupt governments borrowed more than they could repay, eventually defaulting on their debt. Elliott used this right set of circumstances to purchase defaulted debt from struggling countries (paying a very low price) and negotiate, through litigation in courts, for full repayment according to the original terms.

Before getting involved with Argentina, Elliott tested this strategy with Peru, which had defaulted in 1984. Elliott bought $11 million worth of defaulted bonds in 1996 and immediately waged a legal battle to obtain full face value plus interest. After various mishaps, the fund won the legal battle and received from Peru the full value it requested, totaling almost $60 million, earning an impressive return on the investment. This event showed the world how a determined and savvy hedge fund could directly intervene in a country's financial wellbeing and borrowing strategies. Elliott exploited loopholes in financial markets and bankruptcy courts but did not break any laws and acted within the existing legal framework.

Elliott management went on record stating that "*The poor in developing countries are poor because the political and economic systems in their countries have failed them*" (The New Yorker, 2018), and that the fund exposed corrupt politicians and their dealings, preventing moral hazard in the markets, in addition to incentivizing sound fiscal policy by sovereign states.

4.3 The Argentine Saga

After his involvement with Peru, Singer set his sights on Argentina, which was going through similar problems but on a much bigger scale. The country had been suffering from a recession since 1998, and being involved in exchange rate parity regime (tied to the US dollar), it was unable to implement any meaningful monetary policy. In a final effort to fend off the risk of capital flight, then president Fernando De la Rùa froze bank deposits, causing riots to arise and leading to his resignation shortly after. By the end of 2001 Argentina's GDP had fallen almost 20% compared to 1998 (Guzman, 2016).

After missing a substantial interest payment, Argentina defaulted on its $81.3 billion sovereign debt with private creditors between December 2001 and January 2002 and immediately abandoned the convertibility regime. According to conservative some estimates, the cost of servicing the debt would have been about $12 billion a year, making it difficult to sustain the debt. A strong depression ensued: the unemployment rate reached new highs at 25%, extreme poverty became widespread, affecting 45% of the population, and the Argentine peso depreciated more than 40% against the dollar, increasing the debt burden (as it was denominated in dollars).

This crisis came as a shock to the international community, as by 1998 Argentina had become the poster child for the International Monetary Fund and its policies regarding trade liberalization and privatization. However, these policies were also responsible for some of the economic hardships which would eventually lead to the recession, as the unskilled labor force became more marginalized, contributing to an increase in unemployment and a decrease in the level of consumption.

As the crisis unraveled, and civil unrest broke out in the streets, Elliott Management, through a subsidiary known as NML Capital (headquartered in the Cayman Islands), bought $100 million worth of Argentine bonds at extremely low prices (10 cents on the dollar) in the years following the recession. It hoped to replicate the success it had achieved with Peru, seeking full payment (including interest linked to the country's high risk premium and compensatory annual interest rate of 9% for no repayment in due date.). The purchased bonds differed in terms of maturity and interest rates, and also included some bonds with variable interest rates (due in 2005) linked to the country's risk, which increased substantially after the default. After many short-lived president's tenures, the socialist Nèstor Kirchner was elected (and succeeded by his wife Cristina in 2007), vowing to tackle vulture funds and their shady tactics.

Figure 4.1 Spread on Argentine Bonds

Source: *An Analysis of Argentina's 2001 Default Resolution. Guzman*

Argentina continued to suffer from subpar fiscal policy decisions, as Kirchner "cooked up" inflation levels, forbid Argentine citizens from purchasing foreign currency and implemented various questionable policies during her tenure (Rosenheck, The New Yorker, 2014). Following the litigation with Elliott, Argentina was banned from issuing debt securities, in practice rendering it unable to borrow from foreign markets.

The government tried in several occasions to restructure the nation's debt, proposing several offers to bondholders, claiming that accepting these offers would be the only way that they could eventually be repaid. The offer by the Argentine government would give the old lenders new bonds valued at 35% of the original bonds, and in some cases, it would issue warrants linked to future GDP levels (so that if the GDP grew, bondholders would be compensated accordingly). Eventually 92% of the bondholders complied with these new terms but Elliot was not among the ones who signed the new agreements, continuing to rely on court hearings in New York. The fund was able to litigate in American courts because most of the Argentine debt had been issued in the US, which weakened Argentina's sovereign immunity. The pool of remaining bondholders (holdouts), which included Elliott and other funds, was so small compared to the rest that there was a concrete chance that the government could repay them in full.

The negotiations stalled for many years, deteriorating the nation's credit lines, as Kitchener (involved in many corruption accusations) and Elliott refused to compromise, irritating Thomas Griesa, the judge involved. Paul Singer began to think of creative ways to gain any leverage, trying to seize control of different government-controlled assets to be used as collaterals; the assets he had in mind were usually subject to sovereign immunity laws and nobody seriously considered the remote possibility that a hedge fund could have this kind of power.

After the unsuccessful attempts to seize the central bank reserves and satellite launch contracts, an opportunity presented itself to Elliot, as the Argentine warship "Fragata Libertad" docked in the Port of Tema in Ghana during a training session. The one hundred plus meter long vessel carried 69 members of the Argentine Navy and 220 crew members. Elliot seized the opportunity and hired one of the most prominent Ghanaian lawyers to make sure that the ship did not leave the harbor, gaining the upper hand during the negotiations; this stunt did not last long, as the ship sailed away two months later. Nonetheless, it had a significant impact on the negotiations and the public awareness of the whole dispute.

In November 2012, a ruling by judge Griesa created an injunction based on the Pari Passu clause that effectively barred Argentina from paying interest to the new bondholders, a majority of the country's creditors, until it had paid in full the investment funds. The Argentine government appealed the ruling, but the court upheld its decision and the US Supreme Court declined to review the case. Furthermore, the ruling affected every jurisdiction and prohibited any foreign institution from assisting with the debt servicing, as the complicit institutions could be found in contempt with the American courts.

In June 2014, while the talks were still ongoing, Argentina refused to pay Elliott and the other funds, defaulting once again (for the eighth time in history), adding fuel to the fire of an already dire situation. Cristina Kirchner, after calling Paul Singer "the Vulture Lord" and unsuccessfully attempting to circumvent the court's decision, stepped down in 2015 (and was later indicted for corruption), being replaced by the conservative Mauricio Macri, who tackled the negotiations with a new spirit and determined to resolve the issue with the fund in the shortest time possible.

Judge Griesa was pleased with Macri's appointment and considered the possibility of lifting the infamous injunction if the Argentine government decided to repeal the national laws (such as the Lok law) which were preventing payment to the holdouts.

4.4 Aftermath

After a strenuous fourteen-year legal battle, Argentina conceded defeat, as it had to necessarily regain access to the markets to borrow capital and fend off the risk a new recession, which, according to some financial analysts, could have been devastating, as both foreign investments and the Argentine peso would have suffered tremendously. The injunction was lifted and in March 2016 the government chose to compensate the funds, among which was Elliott Management, which won the case and received $2.4 billion as payment (including legal fees), earning a 1,270% return on investment.

The vulture funds' victory provoked bitter discussions among several financial institutions, including the IMF, UN, the US Treasury, among others. Furthermore, the ruling demonstrated the changing power relations between sovereign states and private investment funds, as the International Capital Market Association (ICMA) and the IMF have both proposed to change sovereign debt contracts, to discourage "vulture-like" behavior by investors. The UN vowed to create an international sovereign debt restructuring network, encountering resistance from countries with strong financial markets such as US, UK, Germany, Japan and Canada.

Conclusion

The aim of the present study was to provide a comprehensive overview of activist investing, specifically its use by hedge funds. Using studies published by scholars, in addition to several articles from reputable sources, the work was structured to streamline the main literature on the topic and give readers the tools to understand the implications of an activist hedge fund intervention.

While the impact on firms subject to an activist hedge fund campaign has been analyzed thoroughly, the long-term consequences for the targeted companies are still disputed, as the results vary drastically according to which policies are pursued by the fund and which are successfully implemented.

The role of activists in the market is very controversial, as most participants view them as a negative influence on companies, preferring short-term profits to sustainable long-term policies, while others consider the added benefits of increased accountability for managers and executives as a positive force.

The Herbalife dispute between Ackman and Icahn showed how in some cases a company's whole existence is on the line when it becomes a target of an activist hedge fund. This case study in particular was chosen because it directly involved two activist funds with opposite bets concerning the same company. Ackman's $1 billion short position was matched by Icahn's $1 billion long position, creating a historical confrontation between the two. Pershing Square Capital considered the company to be worthless, as it was built on an illegal business practice; if Icahn had not come to Herbalife's rescue, gaining seats on the board and guiding its strategy, it is likely to assume that the company (now with a market cap of $6.13 billion) could have been wiped out, making Ackman an even richer man but hurting shareholders and workers alike.

However, studying the impact on firms is not sufficient to comprehend the global scale and reach of activist hedge funds, as sovereign states can be targeted as well, giving rise to even more consequential disputes, influencing citizens instead of stakeholders in a company. The impact of a fund on the country's public finances can be devastating, as demonstrated by the Elliott Management Vs Argentina case study, which summarizes the whole conflict, highlighting the negative effects on Argentina's borrowing framework. While the fund certainly did not create the economic crisis, it contributed to making it more complex and lengthier by litigating in court over full repayment of the debt it had purchased. The episode regarding the "Fragata Libertad" navy ship is the most dramatic episode of the whole dispute, baffling the international as to how an American hedge fund was able to seize control of an Argentine vessel and use it during negotiations.

While it is easy to criticize and dismiss Elliott Management and the other funds that participated in the sovereign debt markets, one has to keep in mind that these funds were actually dealing with often corrupt governments, as demonstrated by Cristina Kirchner's indictment on corruption charges, forcing them to be more diligent in their spending and overall conduct.

Activism by hedge funds will remain a controversial subject, as the benefits and damages of an intervention are not purely quantitative, making them extremely difficult to measure and study. Their importance in financial markets, however, cannot be denied, as countless campaigns have proven that even the slightest possibility of an activist intervention needs to be taken into account by firms and governments alike.

The following quote by Paul Singer himself gives a great insight into the philosophy and decision-making process of an activist investor: "*What I came to feel relatively early on in my career is that manual effort—making something happen, getting on the committee, becoming part of the process, try to control your own destiny, not just riding up and down with the waves of the financial markets—was actually not only a driver, an important driver, of value and profitability but an important way to control risk, dig yourself out of holes when you slip into a ravine*," he has said. "*These things don't arise out of my desire to fight with people*." (Rosenheck, The New Yorker, 2014)

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