The Agitators

By Mano Mahadeva, CPA, MBA | Column Editor

The prospects of rich rewards continue to keep activist shareholder campaigns proliferating. Just over the past several months, hedge fund managers took positions to demand change at companies such as Apple, Microsoft, PepsiCo, Yahoo, AIG and Sysco. By persuading management, other shareholders or both of the wisdom of their approach, activist funds apply pressure on a company to reduce costs, split up, increase share repurchases, unload a flagging unit or even sell the entire business, due to differing business philosophies.

Within the past year, Trian Fund Management suggested that Sysco has not lived up to its potential and wanted a board seat to push for changes. Carl Icahn, who has taken aim at companies ranging from Apple to AIG, has set his sights on Xerox, arguing that shares of Xerox are undervalued. Pershing Square Capital Management's William Ackman believed Mondelez should cut costs or sell itself, due to inefficiencies. 21st Century Fox nominated Jeffrey Ubben, chief executive of Value Act Capital Management, where ValueAct agreed not to launch a proxy fight against the company for the length of the board term. GM reached a deal with an investor group that averted a proxy fight over its balance sheet. And in a rare move of support, in October, Trian Fund Management said it had taken a stake in GE as its seal of approval on the conglomerate's decision to narrow its focus.

Hedge funds have become an attractive segment of the alternative investment market with appeal to private wealth and institutional investor groups. This loosely regulated investment vehicle takes many forms, which add to their appeal. Initially created to reduce net market exposure as in a typical "hedge," today's hedge funds have broader applications. Each application is based on a strategy to take advantage of specific market opportunities. Activist funds, now boasting more than $100 billion under management, are funds with this type of strategy.

As market returns diminish and other successful strategies get replicated, activist funds have become increasingly active and ambitious in their selection of targets and inventive in their choice of tactics. Large institutional funds hoping to improve their returns are now routinely seen working with activist funds. Sophisticated media campaigns are used to help convince investors of needed change. Even independent board members have been more receptive to activist proposals.

Is hedge fund activism good or bad for the market? Can they change American capitalism for the better? This discourse is certainly heated on both sides of the aisle. Critics say that activists and their funds destroy value by loading up debt, reducing head count, reducing research and development, and pumping up short-term profits. Much has also been said about the use of complex financial engineering to ring up results. Critics call these activists the corporate raiders of old as depicted by the movie *Wall Street*. Supporters argue that corporate governance in companies is dysfunctional and that it is designed to protect the board and management from being accountable. They argue that in most cases, the stocks of companies sought after are undervalued due to mismanagement or the failure of the board or CEO to enhance value. They also state that holding an "active" position does not necessarily involve additional debt, more fees or in premiums to shareholders.

As this rhetoric continues, there have been failures and successes recorded as defined by different constituencies of the activists' performance. Even though these activities have been limited to public companies, it is important for us to learn from them and prepare ourselves and our company in a "prevention versus cure" approach. Toyota used the word "paranoid" in its approach to business years ago. And the word paranoid meant that regardless of how well they performed, they were fearful a competitor would do better than them, so they remained "paranoid" all the time.

Adopting that mindset, a company should remain "paranoid" and on an ongoing basis, review its mission, strategy and governance issues in light of its circumstances and needs, and regularly adjust them to meet changing market conditions. Company leaders should play their part by actively communicating their company's long-term strategy for growth, articulating what capital they seek, defining what real value is, explaining how this value is measured, and determining when the investments will deliver returns.

So rather than being told what to do to make us successful, why not proactively do this ourselves and possibly prevent a crisis? A forward looking, resilient and capable business will help position your company for success into the future. This will also help create a vibrant vision of the future that helps inspire people and make it attractive to those long-term investors who will help lead you to sustained success.

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