



Portfolio PERFORMANCE

Lost in Translation?

Skeptics question whether shareholder activism translates into tangible returns

BY LORI PIZZANI

Does shareholder activism really lead to tangible returns—real dollars and cents that boost investors' portfolios? The answer is: Maybe. It seems to depend on whom you ask and what policies and agendas are being pushed by whom.

"Many corporations may look at activists as thorns in their sides," says Bryan Armstrong, CFA, partner at Ashton Partners, a Chicago investor relations/corporate communications firm. "Proxy battles can cost millions of dollars on both sides, and if the activist wins, the company has to absorb the cost."

Shareholder activism *does* boost returns, says Richard Cohen, partner with the law firm of Lowey Dannenberg Bemporad Selinger & Cohen in White Plains, NY. After two years of miserable performance, the largest shareholder of a publicly traded closed-end venture capital fund, a hedge fund, took action. It sued the two advisers to recover excessive compensation, fought an NYSE policy that allowed the firm to block the advisory contract renewal, sued the directors for breach of duty, and together with another activist, successfully sponsored its own slate of directors. The new board hired a new CFO, cut costs, cut executive and director compensation, and overhauled policies. Four years after the changes, the fund is consistently profitable, has boosted its share price and net asset value, paid hefty dividends, and just completed a secondary offering.

"Frankly, people invest to make money. When management becomes holier than thou about someone looking to make a buck, they're living in a glass house," Cohen says.

The CalPERS Effect

Since 1992, the California Public Employees' Retirement System (CalPERS), which now manages US\$230 billion in assets for 1.5 million California state and local employees, has issued an annual Focus List of publicly traded companies that the pension manager has invested in but that are underperforming and have resisted CalPERS' pressure to bolster governance practices. The CalPERS Focus List is a warning to the listed companies and, in effect, the equivalent of a public flogging.

Companies that are unresponsive to CalPERS' call to reform governance practices, which may include declassifying a board (removing staggered boards so that all directors must be elected annually), removing supermajority voting requirements for bylaw changes, axing overly generous severance packages, and instituting a "claw-back" policy (which allows the recapture of executives' bonuses and incentive pay in the event of fraud or misconduct) can find themselves facing CalPERS-led proxy proposals or even litigation.

On 15 March 2007, the newest list of 11 companies was formally released. These companies are "the poster children for bad performance and bad corporate governance," says Rob Feckner, president of the CalPERS Board of Administration, in announcing this year's targets. The goal is to facilitate real corporate reform among these companies. "Studies have shown that good corporate governance improves the bottom line," he added.

CalPERS reiterated this long-standing position via a study it conducted to prove the "CalPERS Effect"—the link between good corporate governance and good operating results. The study demonstrated the wealth-enhancement effect of CalPERS' attention for the

KEY POINTS

- Studies show that targeted shareholder activism can improve shareowner value, thereby boosting returns to investors.
- Skeptics point to flaws in how returns are measured and fuzzy links that do not clearly show a direct correlation to shareowner activist initiatives.
- Social activists point to the value proposition of being a good corporate citizen.

short-term (via an almost immediate spike in stock prices for those companies publicly identified as Focus List targets from 1997 through 2002) and for the longer term. It found that over a one-year period "on average, a public company that is placed on the CalPERS Focus List earns a return over and above its risk-adjusted rate of return that is 59 percentage points greater than the risk-adjusted rate of return that shareowners would normally expect to receive for their investment."

A July 2006 study by long-time CalPERS' consultant Wilshire Associates analyzed the return of 122 companies from the CalPERS Focus List and showed that the CalPERS effect can linger five years after initial targeting.

"CalPERS' pursuit of reforms at Focus List firms has created an estimated total wealth creation of US\$3.1 billion between 1992 and 2005," estimates Brad Barber, professor of finance in the Graduate School of Management of the University of California at Davis and also director of the Center for Investor Welfare and Corporate Responsibility. In his April 2006 report, "Monitoring the Monitor: Evaluating CalPERS' Shareholder Activism," Barber pointed out that such wealth creation translates into US\$224 million annually over the 14-year period and could be as large as US\$89.5 billion through December 2005 "if abnormal returns are even casually linked to the CalPERS Focus List."

CalPERS Caution

Others are more cautious about connecting the line of improved company

performance to CalPERS—or any investor's—activism.

"Virtually all studies of long-term performance have reported no statistically significant changes in operating performance of targeted companies," noted a shareholder activism report released jointly in January 2007 by Stuart Gillan, Jerry S. Rawls Professor of Finance at Rawls College of Business of Texas Tech University in Lubbock, TX, and Laura Starks, Charles E. and Sarah M. Seay Regents Chair in Finance and Finance Department Chair at the University of Texas, Austin. After reviewing myriad past studies of activist efforts, they found, "Even in cases of activism that lead to significant improvements in operating performance or stock appreciation over the next several years, it is difficult to ascertain whether it was activism, *per se*, that caused the changes." The uncertainty about the link between cause and effect is exacerbated by the long term performance measures used in the studies.

One problem with linking activists' efforts with higher stock values, according to Professor Starks, is that shareholders often exert pressure on managers and carry on dialogue with them behind the scenes. With hedge funds taking a much more activist role these days, perhaps we will see more concrete evidence, she adds. Right now, lack of transparency in hedge fund trading makes any clear cause and effect difficult to analyze.

"Hedge funds are definitely in the more active part of the continuum," says Professor Gillan. "We are only now starting to see some study of this." Hedge fund managers have become more aggressive and are asking for many more specific details in their negotiations with companies. But hedge funds, he warns, fall into two camps: those with short-term motives and those with long-term designs.

"There's an interesting dichotomy; hedge funds pushing for a financial return are often viewed suspiciously by other investors," notes David Chavern, chief operating officer of the U.S. Chamber of Commerce, which represents the interests of U.S. businesses.

The questions, he adds, are: What is the appropriate time horizon for gaining financial returns, and can short-term investors get on the same page as long-term shareholders?

On the negative side, although CalPERS may have the Midas touch, Professor Barber notes in his report that it targets value companies, not growth companies, which may account for some of the boost the CalPERS study found. On the positive side, the CalPERS effect may also offer "deterrence benefits," he adds. If companies are aware of monitoring and possible public castigation, they may be less likely to engage in certain practices that reduce shareholder value.

Advancing Social Causes

Investment managers must tread carefully where social issues are concerned, Barber cautions. Although they may believe such issues as environmental sensitivity, carbon emission disclosure, or human rights issues for non-U.S. laborers are important for company management to address, investment managers should ensure that their actions on any issue are aligned with the interests of plan beneficiaries or clients, offer a real benefit, and do not simply represent the social ideology of the manager.

In 2000, CalPERS divested of US\$365 million in tobacco company holdings. But, Barber notes, that action may have been a financial flub. From October 2000 through June 2006, a dollar invested in tobacco stocks grew to US\$2.77 while that same dollar invested in the S&P 500 Index shrunk to 98 cents.

More and more activists are pointing to the three-legged stool called ESG—for environmental, social, and governance issues. "Social factors are harder to grasp. The moral and the ethical is important to us and as important to our investors as financial performance," notes George W. Rue, CFA, chief investment officer with New Covenant Trust Company, a religiously and socially active investment manager in Jeffersonville, IN. The biggest client of New Covenant Trust is the Presbyterian Foundation. "Becoming a good corpo-

rate citizen is another form of insurance," echoes Anita Clemons, vice president of investments for the firm.

Proving that socially enlightened or environmentally aware companies provide better overall returns is difficult, although shareholder activists pushing social policy changes abound. Right now, the hot issue is climate change and the array of environmentally related issues, notes Tim Smith, president of the Social Investment Forum (a coalition of socially active investors) and senior vice president of Walden Asset Management in Boston. "Those with a better environmental record are a proxy for a better managed company," he says. Addressing social and environmental issues, Smith adds, is key to reducing companies' risk and enhancing their reputation, which enhances shareholder value.

"There is a major divide between shareholder activists and social activists," says Steve Milloy, principal of Action Fund Management of Potomac, MD, which runs the Free Enterprise Action Fund, a probusiness mutual fund. Milloy often locks horns with socially responsible fund managers who, he argues, push corporate managers to address social ills by undertaking costly initiatives that reduce shareholder value. "Shareholder activists are more interested in seeing the business succeed. We want to make sure management runs the company the way it should," he criticizes. "Social activists are more interested in hijacking the company for their own social agenda." ■

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RECOMMENDED RESOURCES

The Shareholder Wealth Effects of CalPERS Focus List
CFA Digest (February 2004)
(cfapubs.org)

The Social Responsibility of the Investment Profession, Research Foundation of CFA Institute monograph (July 2006)
(cfapubs.org)

"The Evolution of Shareholder Voting for Executive Compensation Schemes"
Abstracted in the CFA Digest (November 2006)
(cfapubs.org)