

Item # 8

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Professors Louis Kaplow, Lucian Bebchuk, and Oliver Hart

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**“Hedge Fund Investor Activism and Takeovers”**

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\*presenting

# **Investor activism and takeovers<sup>\*</sup>**

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## **Abstract**

We examine long-horizon stock returns around investor activism in a comprehensive sample of 13D filings by portfolio investors between 1993 and 2006. Announcement returns and long-term abnormal returns surrounding investor activism are high for the subset of targets that are acquired ex-post, but not detectably different from zero for firms that remain independent a year after the initial filing. Firms that are targeted by activists are more likely to get acquired than those in a control sample. The results suggest that hedge funds' short investment horizons make them better suited to identifying undervalued targets and prompting a takeover than at fixing corporate strategy or tackling long-term corporate governance issues.

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## I. Introduction

It is well known that managers of public companies lack proper incentives to maximize shareholder value, preferring to consume private benefits instead. Without proper oversight, managers may receive excessive compensation and perks, remain in power too long, build corporate empires, or otherwise squander free cash flow.

Grossman and Hart (1980) show that minority shareholders in widely-held firms have little incentive to spend resources monitoring professional managers. Any improvements arising from their oversight of management will have to be shared with other investors, who bear none of the costs. In equilibrium, therefore, shareholders decide not to monitor. Shleifer and Vishny (1986) observe that the minority investor free-rider problem may be mitigated by the presence of a large blockholder. While the blockholder faces costs of monitoring, the size of the blockholder's stake ensures that only some of the rewards are taken by residual shareholders.

The most common form of blockholding in the U.S. is tied to large institutional investors – primarily comprised of pension funds and mutual fund investment companies. Consistent with the predictions from theory, a number of empirical studies show that these investors are more involved in disciplining management than small shareholders. For example, Smith (1996) shows that CalPERS, the California state pension plan, targeted over 70 of its portfolio companies between 1987 and 1993 for poor corporate governance and operating performance. In addition, from their study of all blockholders of U.S. public companies between 1980 and 2005, Cronqvist and Fahlenbrach (2006) find that large shareholders exert measurable effects on firms' investment and financial policies, as well as executive compensation.

While blockholdings are widespread, there is virtually no evidence that institutional shareholders are *effective* monitors, or that their presence in the capital structure increases firm

value. Relatedly, when institutional blockholders make formal demands on management, there is no evidence of their success. Karpoff (2001) and Romano (2001) conclude that institutional investor activism as a whole has little impact on firm performance. Karpoff et al. (1996), Wahal (1996), and Gillan and Starks (2000) report that shareholder proposals have historically done little to improve firms' operations. On the few occasions where investors have attempted to remove management from their jobs, they generally encounter resistance (Brav et al., 2006), are faced with high costs (Black, 1990; Roe, 1994; Bainbridge, 2005; and Kahan and Rock, 2006), and are often unsuccessful (Black, 1998; Karpoff 2001; Romano, 2001; and Bebchuk 2005a, 2005b). Why have institutions tended to be ineffective monitors? Davis and Kim (2005) hypothesize that these institutions have significant conflicts of interest that make them unwilling to advocate for change at a firm they deem a potential money management client. Legal and regulatory constraints also make it difficult for traditional institutions to exercise all their rights as shareholders. Facing these constraints, large shareholders are better off selling the stock of a poorly managed firm rather than advocating for change.

In contrast with the results on traditional institutional blockholders, recent research suggests that hedge funds are up to the task of monitoring management. Hedge fund activists differ from their traditional institutional counterparts by having more concentrated portfolios, fewer dollars of assets under management, and enhanced performance incentives. In addition, hedge funds are faced with fewer regulatory constraints. Kahan and Rock (2006) argue that the combination of increased incentives and fewer constraints makes hedge fund activism less costly and also more likely to be successful than traditional institutional activist investing. Consistent with this, several recent papers show that firms targeted by hedge fund activists between 2004 and 2005 earn abnormal returns upon announcement of their involvement. Brav, Jiang, Partnoy,

and Thomas (2006) find that the announcement of hedge fund activism generates abnormal returns of between 5 and 7 percent in a short window around the announcement. In addition, the authors document modest changes in operating performance around the activism. Klein and Zur (2006) document abnormal returns of approximately 7 percent in a longer window around the announcement of activism. The authors suggest that these abnormal returns are a result of the hedge funds' effectiveness at extracting cash for the equity holders of the target companies rather than from improvements in target operating performance. Becht, Franks, Mayer, and Rossi (2006) also find that activist investments of the UK pension fund Hermes significantly outperformed benchmarks. Clifford (2007) shows that hedge funds earn a significantly higher return on their activist positions compared to their passive positions, suggesting that hedge funds may use these higher returns to counteract the costs of managing and monitoring an activist holding. These results, together with the recent dramatic increase in the number of activist filings (see Figure 1) have led many market participants to reevaluate traditional thinking on the effects of activist investing.

What accounts for these high returns? One hypothesis is that activists improve the firm as a going concern, either by firing management, or by forcing management to institute operational or governance changes. But this hypothesis is difficult to believe given the evidence that hedge funds institute only limited measurable changes (Klein and Zur, 2006). Even when hedge funds are successful at implementing change, it may take several years for shareholders to recognize that these changes were beneficial. Furthermore, a finding that hedge funds were successful monitors of management would be difficult to reconcile with the conventional wisdom that hedge funds have short investment horizons.

An alternate hypothesis, that we suggest, is that hedge funds are effective at identifying undervalued companies, locating potential acquirers for them, and removing opposition to a takeover. Under this alternate hypothesis, the targets of activism earn high returns when investors expect that these firms will soon be acquired at a sizeable premium. From the perspective of the activist, termination via merger or acquisition additionally helps solve the problem of how to exit their sizeable position in the target. The price pressure associated with an exit in the public markets can be considerable, particularly when the target is a small firm and the trading of other investors is likely to be correlated with the trading of the activist.<sup>1</sup> In a merger or acquisition, the activist exits in cash or with stock of a larger, more liquid company. Our hypothesis is consistent with many hedge funds' characterizations of their activism – the activist Robert Chapman, for example, claims to seek companies that are “digestible” in the sense that they are easy to market to bidders as potential takeover targets.<sup>2</sup> Our characterization differs markedly from previous work on investor activism, which tends to attribute high announcement returns to improvements in operational performance or reductions in agency costs.<sup>3</sup>

We construct a comprehensive database of activist SEC filings between 1993 and 2006, focusing on instances where the target is a US firm. Our data, which covers 50 percent to 200 percent more incidents than previous work, allow us to trace the increase in activist activity

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<sup>1</sup> The term “roach motel” is frequently used to describe situations in which several activists hold large illiquid positions in a poorly performing target firm. “Roach motel” refers to the fact that it is easy for the “roaches” to get into the position, but difficult to get out.

<sup>2</sup> As quoted by Marcia Vickers, “Companies Beware...It’s Shark Season,” *BusinessWeek*, June 10 2002.

<sup>3</sup> The technical distinction between our findings and other papers is that other papers have shown the existence of (1) operating improvements, (2) excess returns on activism, typically inferring a correlation between (1) and (2). We show there is a significant selection bias, in that the firms with the largest returns tend to drop out of the sample by way of takeover, and hence the documented operating improvements are on the subset of firms with low excess returns.

between 2005 and 2006 compared to the late 1990s.<sup>4</sup> In addition, the thirteen year time span of our data allows us to analyze the long-run returns to activism.

Our main result is that targets of investor activism earn high returns only for the subset of events in which the activist successfully persuades the target to merge or get acquired (ex-post). The majority of activism targets – firms that do not end up being acquired – earn average abnormal returns that are not statistically distinguishable from zero, though our expectation was that the change in value would be positive. This result applies to both announcement returns, as well as to the long-term returns following the initial activist filing. This does not mean that one cannot identify isolated examples in the data where the activist creates value and the target remains independent – our observation is simply that these cases are the exception, rather than the rule.

Related to our main hypothesis, we consider a related explanation. Suppose that activist investors make no changes, but that the returns associated with their involvement reflect an ability to pick undervalued stocks. These undervalued stocks are probable acquisition targets regardless of an activist intervention, thus potentially providing an explanation for our results linking target performance with the likelihood of a takeover. Put differently, this alternative hypothesis suggests that the path of the target and its ultimate takeover would have been no different absent the activist intervention. Consistent with this hypothesis, activist targets tend to have similar characteristics: they are in the NYSE third size decile or below, have low or no analyst coverage, have low market-to-book ratios, and have underperformed relative to other firms in their industry. All of these characteristics, could, in theory, be associated with higher probability of subsequent takeover.

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<sup>4</sup> For example, Brav et al. (2006) study 374 cases, Boyson and Mooradian (2007) study 418 events, Klein and Zur (2006) study 403 events.

However, we believe this competing hypothesis is not supported by the data. First, it implies that the announcement returns of the target reflect the market's update of the price given the new information that an activist investor believes it is undervalued. But this implies that announcement returns, and long-term post announcement returns, should not vary depending on what the activist demands (since presumably, all activist positions are motivated by undervaluation of the target). On the contrary, we find that returns bear a strong relation to what is demanded by the activist. Second, we propose a test based on the ex-ante likelihood that activism targets are going to be acquired, as follows. We form a matching portfolio based on industry, size, and pre-activism return. We find that matching firms are less likely to be acquired within the next year, compared with firms that are the target of activism. We conclude that the presence of the activist effectively puts the target in play and significantly increases the probability that the target is ultimately acquired. Finally, we construct complete accounts of all episodes in which an activist became involved in a firm and the firm was ultimately taken over. In the vast majority of these cases, the activists play a role in securing the takeover. In fact, some of the most revealing evidence comes from statements made by third parties that ultimately takeover activist targets. Thus, on balance, the evidence supports the hypothesis that activists increase the conditional probability of a takeover event.

Our findings leave us with a narrower view on the role of activist investors in monitoring management. While recent popular accounts suggest that we are in an era of the "imperial shareholder," our results indicate that activism tends to be most successful when there is a high probability of a takeover. Where improvements may take several quarters or even years to realize, the investment horizon of hedge funds makes them unsuitable overseers of management. Firms that would benefit from modest changes in operating policy or governance, or for which a

relatively minor intervention, like a reduction in CEO pay, is desirable, are not likely to hit the radar screen. Of course, hedge funds do occasionally succeed in changing the board, initiating or increasing dividends, repurchasing shares, or even cutting executive pay-- it is simply not clear that these changes increase shareholder value relative to getting the target acquired.

An important question, that we do not answer here, is whether the shareholder activism associated with takeovers creates long-term value for acquiring company shareholders. In principle, activists could create value by identifying assets whose value is not being maximized by current management. In this case, the takeover premium represents the present value of the synergies (or some fraction of this value) gained by having the assets under a different roof. The other possibility, however, is that activists are good at identifying firms for which potential acquirers might overpay. A long tradition of papers in corporate finance, starting with Roll (1986) and including Shleifer and Vishny (2003) and Stulz, Moeller and Schlingemann (2005) argues that firms overpay, on average, for public market acquisitions.<sup>5</sup> In this case, the function of the activist is primarily to market the stock, rather than identify acquirers with true synergies. We doubt that this characterization is appropriate in our sample, however, as takeovers initiated by activists are usually cash rather than stock transactions (stock transactions are usually associated with low subsequent returns, e.g., Shleifer and Vishny 2003). Yet, given enough data on the future performance of the takeovers in our sample, it should be straightforward to distinguish between these possibilities.

The paper proceeds as follows. The next section summarizes the construction of our data. Section III summarizes short- and long-run returns around activist activity, confirming results from previous work in our expanded dataset. Section IV relates these returns to the theories

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<sup>5</sup> See also Asquith, Bruner and Mullins (1983), Ang and Chen (2003), Malatesta (1983), Mitchell, Pulvino and Stafford (2004), Morck, Shleifer and Vishny (1990), Travlos (1987).

outlined above and analyzes the data in light of our alternate hypothesis. This section also examines the incidence of takeovers in our sample of events. The final section concludes.

## **II. Data**

We construct our sample by merging all Schedule 13D and DFAN filings from the SEC EDGAR database for the thirteen year period between the third quarter of 1993 and the third quarter of 2006. 13Ds are filed with the Securities and Exchange Commission within 10 days of an entity's attaining 5% or more in any class of a company's securities. The filing documents the size of the purchase as well as a summary of the investor's intentions. Starting in 2000, activists occasionally attach a letter to a target firm's management or board in their SEC filing. 1993 is the earliest year for which company filings are available electronically; however we do not find any activist 13Ds until 1994.

13Ds must be filed by institutional money managers, hedge funds, as well as for crossholdings formed when two firms merge or form business alliances.<sup>6</sup> Several papers, starting with Mikkelson and Ruback (1985) note that mergers and takeovers are often preceded by the acquisition of a minority stake in the target. As a result, the authors find that the market reacts favorably to 13D filings announcing interfirm investments. Since our focus is on portfolio investment, we restrict our sample by cross-referencing the 13D filings with a list of investment managers that have filed a Schedule 13F institutional holdings form at some point with the SEC. This limits our data somewhat, because only institutions with \$100 million or more file 13F

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<sup>6</sup> We thank Nick Panos at the SEC's Office of Mergers and Acquisitions for pointing out that even though the Schedule 13G exists for passive investment in 5 percent or greater interests in a security, the Schedule 13D is the default filing. A filer has to petition the SEC to receive permission to file as a passive investor with regards to a particular holding. If a filer chooses not to go through this effort, it will simply file a Schedule 13D, and not a Schedule 13G, even if, for all intents and purposes, it has no activist intentions. This also helps to explain the large number of 13D filings in the SEC database relative to the total number of activist events.

reports. However, this step is necessary to facilitate the separation of the activist filings from the larger universe of Schedule 13D filings – a total of 173,078 for our period of this study.

We add to our sample of 13Ds by including all definitive proxy statements filed by non-management (DFANs). DFANs are filed with the SEC by investors who intend to or are engaged in a proxy fight with a firm’s management. A proxy fight may be initiated with a stake in a company’s securities that comprises less than 5 percent of shares outstanding, although the mean for our sample is 10.8%, implying that these activists usually show up on both filings.

Our initial sample includes a total of 20,771 filings. From these, we exclude targets that are closed-end funds, and firms that are not identifiable on CRSP at the time of the initial filing. To arrive at a list of events, we read the 13Ds “Purpose of Transaction” section of each filing to identify whether or not the filer is pursuing an activist strategy. While in the initial 13D the activist may signal its belief that the target firm is “undervalued”, further amendments to the initial 13D (these amendments are known as 13D/As) elucidate the steps the activist is taking, or the concessions demanded by the target, to increase shareholder value. The overwhelming majority of transactions are for the purposes of “investment” only, and we exclude them from our sample. However, these “non-activist” filings serve as a useful control group in some of the tests that follow. We also exclude several hundred events from Gabelli Investments in which the 13F states the firm’s intention to “engage management.” Our reasoning is that Gabelli appears to file identical 13Fs when acquiring large stakes, thus we have no reason to believe that these filings indicate activist intentions.<sup>7</sup>

For each activist-target pair, there are typically multiple filings. These result from small changes in the activist position, or from formal communication between the investor and

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<sup>7</sup> However, when press releases or further clarifications on the 13D spell out specific activist demands, then we do include the Gabelli event. Our final dataset includes 70 Gabelli events (including filings from Gabelli Funds, GAMCO Investors, and Gabelli Asset Management).

management. Repeat filings are more prevalent in the later sample years. We exclude repeat filings for an activist-target pair for which the purpose of transaction is essentially unchanged. This often occurs when an activist exchanges several letters with management over a topic (e.g., whether it is prudent for the firm to use its cash to repurchase shares). If, however, there is a meaningful change in the purpose of transaction over the course of several 13D filings for the same target-investor pair, we code these as two or more separate activist events. For example, in Pardus Capital Management's initial filing of its 6.4% holding of Bally Total Fitness in September 2006, Pardus described its intention to "communicate with management of the company." Two weeks later, Pardus filed an amended 13D to report that it had proposed certain independent candidates for election to the board of directors. Thus, these are coded as separate events. Our results are not much affected by whether we throw out these follow-on events, which we throw out in some of our tests. The case described above also highlights the difficulty of classifying activist events as "hostile" or "friendly": Potentially friendly attempts to engage management can become hostile if the stock price drops, or if management resists activist demands.

Following the process described above, we find a total of 990 activist events. We use company websites and newspaper articles in addition to the CISDM hedge fund database to determine whether or not the activist is a hedge fund or a non-hedge fund (i.e. mutual fund, pension fund or investment management company).<sup>8</sup> If the activist is not one of these four types

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<sup>8</sup> Some of the activists classified as non-hedge funds may indeed have a hedge fund, but the fund is not its main product offering to investors. For example, Gabelli Asset Management is a publicly traded investment management company that offers mutual funds to retail investors in addition to a number of investment advisory services and products to institutional and high-net worth individual investors, including hedge fund investments. Since the 13Ds filed by Gabelli (or any filer in general) do not indicate whether the activist investment is being made either by and for its hedge fund, mutual fund, or other account, we classify these filers as non-hedge funds, as they are generally not identified as hedge funds in news articles or on the company websites.

of institutional investors. This is done so as not to confuse corporate crossholding and acquisitions with activism from portfolio investors.

Table 1 summarizes our sample. 784 events were initiated by 139 unique hedge funds, and 196 events were initiated by 38 unique non-hedge funds. Over the same 13-year period, almost four times more hedge funds engaged in activism using 13D filings than did other institutional investors. We suspect that one reason non-hedge funds are less likely to show up in our sample is that they tend to negotiate privately with management (Kahan and Rock, 2006). Most of the non-hedge fund filings can be traced to Ontario Teachers Pension Plan Board, Franklin Mutual Advisers and Franklin Resources, and Gabelli Asset Management, who each participated in ten or more events. There are considerably more hedge funds that have been involved in several activist events. From this group of hedge funds, filings by Farallon Capital, Steel Partners, VA Partners, Wynnefield, Blum Capital, Carl Icahn, Chapman Capital, Newcastle Partners, JANA, Third Point, and Pirate Capital constitute over two thirds of the sample.

The temporal trend in hedge fund filings is evident in Figure 1, which shows that annual activist filings by non hedge funds remains relatively fixed between 1996 and 2006, while hedge fund filings increase dramatically. More than half of the hedge fund activist events occur in 2003 or later, yet close to one-third of the hedge fund activist sample comes from the years between 1994 and 2000. Thus, hedge funds appear to have taken over the domain once occupied by pension funds and mutual funds.

### ***Classification of activist demands***

Every Schedule 13D filing includes a “Purpose of Transaction,” Item 4 of the filing. In this section, the filer must disclose any plans or proposals that could relate to or result in a significant change at the company, whether this is a call for the election of an independent

director, or a bid to acquire the target. This section can signal to the market what plan the investor intends to follow with regards to its position. Often, the investor has no activist plans, but files a Schedule 13D to reserve its right to engage in future activism.<sup>9</sup> Any subsequent change in holdings or intention is then reported in an amended 13D filing.

In addition to the information contained in the “Purpose of Transaction” section, the SEC allows investors to file additional materials as exhibits - often press releases or letters to the management or board of the target company. These materials, along with the formal remarks in Item 4 of the 13D, provide the market with detailed, if at times undiplomatic, explanations of the course of action the activist wants the firm to take.

Our reading of the 13D statements suggests that activist demands fall into a few well-defined categories. We classify the events into the following nine categories: (1) intention to engage with management, (2) capital structure issues, (3) corporate governance issues, (4) business strategy issues, (5) strategic alternatives, (6) calling for the sale of part or the entire target, (7) blocking a proposed merger or acquisition because of unfavorable pricing, (8) financing and bankruptcy issues, and finally, (9) intention to engage in a proxy contest (for instances where the activist files a DFAN). In recent years, “strategic alternatives” appears to be a synonym for calling for a spinoff or acquisition. Activist classifications are based on what is stated in the 13D filing, and not by the target company response.

While a more detailed explanation of activist categories is given in the Appendix, a few comments are in order. First, activism categories are non-exclusive: if an activist calls for the election of an independent director while also suggesting that the company spin-off an underperforming division, this event will fall under both the corporate governance and business

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<sup>9</sup> If the filer has no activist intentions, the SEC also allows for the filing of a Schedule 13G (instead of a 13D), which indicates that the large shareholder is engaged in passive investing.

strategy categories. Second, event dates correspond to the filing date of the 13D that announced the activist intentions. The exception is for proxy contests: proxy dates are aligned to the earliest filing date of SEC documents DFAN14A, a PREC14A, and a PREN14A for the activist-target pair.

Table 2 breaks down the number of events for the different classifications by type of activist. Because the categories are non-exclusive, the number of events in each category sum to more than 990. However, the vast majority of events are assigned to only one category.

Table 2 reveals important differences in the demands of hedge fund and non-hedge fund investors. Aside from making general “undervalued” statements or expressing an intention to engage with management, hedge fund activists frequently demand that the target sell off all or part of its assets. In practice, activists who declare the target to be undervalued often try to locate a buyer for the firm, creating some overlap between the two categories. Governance related activism is also fairly common and targets policies relating to poison pills, confidential voting, or board structure.

Relative to hedge funds, non-hedge funds are more likely to target corporate governance issues than any of the other categories. Karpoff et al. (1996) finds that shareholder proposals targeting these issues are ineffective in increasing shareholder value and improving a firm’s longer-term operating performance. In addition, non-hedge funds have traditionally chosen to engage in private activism and negotiation with management at the target firms, rather than publicly express their disapproval through filings with the SEC or various press releases (Kahan and Rock, 2006). Indeed, the fact that the activist hedge funds, many of which have only been in business for a few short years, have to publicly agitate for change might actually be evidence of

their relative lack of influence compared with the more experienced and better known mutual and pension fund activists.

### ***Activist and Target Characteristics***

We collect detailed information on the activist portfolio, summarized in Table 3. CDA/Spectrum makes available quarterly holdings information for institutional investors, compiled from their 13F filings with the SEC. These filings include all holdings of domestic equities for funds that manage \$100 million or more.

Kahan and Rock (2006) argue that hedge funds may cause firms to sacrifice long-term positive NPV projects because of their short investment horizon. The third line of Table 3 presents some evidence consistent with this: the median position at hedge funds is held for only 1.5 quarters, in comparison with 7 quarters for non-hedge funds. It is also important to note, as the table shows, that the activist holding constitutes a more sizable portion of the overall portfolio for hedge funds.

The bottom panel of Table 3 summarizes characteristics of the target, as well as the importance of the target as a piece of the activist portfolio. Both hedge funds and non-hedge funds tend to target small firms, although hedge fund targets are even smaller than non-hedge fund targets.

The final rows of Table 3 summarize the past performance of the target firm. Controlling for its loadings on SMB, HML, and the market return, the median target firm underperformed slightly in the year prior to activism. More interestingly, the target firm significantly underperformed the other firms in its industry, which we suspect is one of the reasons the activism took place initially. These results are consistent with Bethel et al. (1998) and Becht et

al. (2006) who find that activism targets underperforming firms with the intention of increasing shareholder value.

We also find that the activist targets are small stocks with low or no analyst coverage in addition to low market-to-book ratios. Finally, in unreported results, we observe a fair amount of industry concentration of these events, perhaps consistent with the notion that activists are good at picking industries where the prospect for consolidation is high.<sup>10</sup>

### III. Announcement and long-term abnormal returns around investor activism

#### *Announcement Returns*

Abnormal daily returns around the announcement of the 13D filing are the difference between the daily return on the target stock and the return on a matching portfolio:

$$AR_{it} = R_{it}^{\text{Target}} - R_t^{\text{Match}} \quad (1)$$

Ideally, we would identify matching stocks for each target based on size, industry and the book-to-market ratio. Compustat accounting data is only available for about half of the firms in our sample, however. We consider cutting the sample size down to only include Compustat firms, but one problem with this is that it systematically removes smaller activism targets. Therefore, we form a surrogate matched portfolio as follows.

We start with 100-days of returns in the interval  $[T-110, T-10]$  where  $T$  denotes the date of the initial 13D filing, and estimate loadings of target firm returns on the Fama and French (1993) HML, SMB, and market return factors

$$R_{it}^{\text{Target}} - R_t^F = a_i + b_i HML_t + c_i SMB_t + d(R_t^M - R_t^M) + u_{it} \quad (2)$$

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<sup>10</sup> Tabulation of events by industry available from authors upon request

Our matching portfolio return in  $t+1$  is then the factor loading weighted return on the HML, SMB, and market portfolios.

$$R_{it+1}^{\text{Match}} - R_{t+1}^F = \hat{b}_i HML_{t+1} + \hat{c}_i SMB_{t+1} + \hat{d}(R_{t+1}^M - R_{t+1}^M) \quad (3)$$

Where  $\hat{b}$ ,  $\hat{c}$ , and  $\hat{d}$  are the estimates from the first stage regression in (1). In the few occasions where there is insufficient pre-event return data to estimate factor loadings, we substitute the CRSP value-weighted market for the match portfolio instead.<sup>11</sup>

The final step is to cumulate daily abnormal returns from (3) starting 10-days before the 13D filing. These results are shown for the full sample in the left-hand-columns of Table 4 and are plotted in Panel A of Figure 2. The table reveals that returns to activism are large – approximately 3.5 percent in the 15-day event window.

One observation from Table 4 is that announcement returns accrue starting a few days before the filing date. We attribute this to the fact that investors are allowed a period of up to 10 days from the time they acquire the 5% or greater stake in the target and the time they are required to file with the SEC.<sup>12</sup>

The remaining columns of Table 4 show announcement returns by activism category. Returns are positive when the activist indicates a desire to “engage management,” when the activist requests an asset sale or tries to block a merger, and when the activist wages a proxy fight. In contrast, returns are not significantly different from zero when the activist targets capital structure issues, corporate governance, corporate strategy, or proposes a spinoff.

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<sup>11</sup> One drawback of our procedure is that it is inappropriate if factor exposures are changing quickly over time (a problem that does not arise if we assign matched firms to each stock). We are less concerned with this because we track performance for a fairly short window after the event.

<sup>12</sup> Nick Panos of the SEC’s Mergers and Acquisitions Office has informed us that there is no legal restriction on the activist that would prevent him/her from talking to the press or others before the 13D is actually filed.

The top row of the table shows the number of events in each category, as well as the fraction of events for which the target was acquired within eighteen months of the activism. There is a loose positive correlation between the fraction of targets that get acquired and the CAR for each category, suggesting the possibility that prices rise on announcement of the 13D because investors anticipate a possible acquisition.

### ***Monthly Returns***

We next calculate monthly returns surrounding investor activism, following a similar methodology as before. We start with 24-months of returns in the interval  $[T-25, T-1]$  where  $T$  denotes the month of the initial 13D filing, and estimate loadings of target firm returns on the Fama-French (1993) HML, SMB, and market return factors, as in (2). Our matching monthly return is the factor loading weighted monthly return on the HML, SMB, and market portfolios. As before, where there is insufficient data for calculating these factor loadings, we substitute the value weighted return for the match portfolio return instead.

Table 5 shows cumulative abnormal monthly returns for the period starting one month before the activism and ending 18 months later, while these results are plotted in Panel B of Figure 2. Following Brav, Geczy, and Gompers (2000), Table 5 shows cumulative abnormal returns (CARs), rather than buy-and-hold returns (BHARs) because of preferred statistical properties.<sup>13</sup> If the target firm is acquired at any point after the event, abnormal returns are set to zero thereafter.

For the full sample of events, abnormal returns for the 18-month period are significant and just over 10 percent. A large portion of these returns accrue in the [+3 months, +18 months] window. Put differently, only a modest portion come from the period around announcement,

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<sup>13</sup> One of the few advantages of BHARs, however, is that it is less subject to bid-ask bounce, which might be a concern for smaller firms in our sample. We have replicated our main results using BHARs, reaching the same qualitative conclusions. This table is available from the authors.

suggesting that the market underreacts, on average, to the announcement of activism. Another possibility is that the long-term abnormal positive returns reflect general undervaluation of the target, which reverts to fundamentals over the subsequent months.

The remaining columns of Table 5 break down returns by activism category. Firms targeted for a sale, or firms for which the activist tries to block a merger earn the largest abnormal returns. For the remaining categories, abnormal returns are positive, but insignificant.

In the appendix, we also show that a calendar-time portfolio of stocks purchased directly following an activist announcement significantly outperforms the market during the 1995-2006 period. It is interesting to note that the bulk of this outperformance occurs after 2000, during a time when value-stocks performed well. The calendar time portfolio has positive loadings on HML and SMB, but has an annualized 3-factor alpha of approximately 12 percent during our 11-year sample period.

#### **IV. Interpretation and Analysis**

The results so far show that announcement abnormal returns and monthly abnormal returns are positive, and tend to be significant only when the activist requests a sale or steps in to oppose a merger, often asking for a higher price. But what activists ask for, and what they accomplish, may diverge. Thus, in this section, we try to establish whether our hypothesis is complete – whether activists tend to create value only in cases where they manage to secure a takeover. Alternately, we check whether (a) hedge fund activists make operating or governance changes that are reflected in shareholder value even when the target is not acquired, or (b) whether hedge funds simply pick undervalued stocks, which are more likely to get acquired irregardless of activist intervention.

The analysis is organized as follows. We first document the results of investor activism, focusing on both qualitative accounts based on press articles as well as more formal quantitative accounts based on Compustat accounting data. We next attempt to identify a correlation between the result of the activism and stock market performance, finding that the outcome most strongly associated with high stock returns is that of a takeover. Finally, we try to shed light on the question of whether the activist investor *caused* the takeover, or whether the activist was simply effective at picking a stock that was likely to be taken over in the first place. Again, we use a combination of qualitative accounts (including the steps taken by the activist to secure a takeover) as well as a more formal statistical account in which we try to identify whether activists increase the conditional probability of an acquisition relative to a matched sample of firms.

***When targets are not acquired, what are the effects of investor activism?***

Our starting point is to understand what actions the target firm takes in response to the activist's requests. We collect data on what happened after each event, by reading the subsequent 13D filings and communications between management and the activist, as well as searching the newswires for information on the outcome. To identify whether the firm merged or was acquired in the year after activism, we look at the CRSP delisting code and delisting date and check whether it falls within 18 months of the initial complaint.<sup>14</sup>

Table 6 shows the results of this classification. We classify the outcomes into the following sixteen categories: (1) no news of an outcome, (2) merger or asset sale completed, (3) merger or asset sale announced (4) third-party merger called off or bid increased (5) spinoff completed or announced (6) activist takes over target (7) target hires investment bank or begins

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<sup>14</sup> CRSP delisting codes indicate whether the security is still trading, or, if not trading, the reason for delisting. We treat as "merged" all firms with a delisting date within eighteen months of the initial filing, where the delisting code has a first digit of 2 (Mergers) or 3 (Exchanges).

auction (8) share repurchase or special dividend, (9) greenmail of the activist, 10) removal or amendment of a target's poison pill, 11) the resignation(s) of the target's executive officer(s), 12) board seats granted to activist, 13) activist proxy proposal defeated, 14) activist cuts position in target below 5% without any other outcome, 15) the activist and target complete a financing or bankruptcy agreement, and finally, 16) the target announces significant changes to its business or operating strategy (i.e. layoffs, plant closings, etc.).

Some of the outcome classifications are non-exclusive: for example, if a target repurchases shares and gives board seats to the activist, this event will be categorized with two outcomes. Table 6 gives the number of exclusive classifications (i.e. where no other outcome was recorded) in parenthesis to the right of the non-exclusive outcome number.<sup>15</sup>

These sixteen outcomes can be organized into four broad categories: asset sales and spinoffs, capital structure, corporate governance, and other. We cutoff our searches eighteen months after the first filing, under the presumption that if the investor cannot get managers to make changes within a year and a half, they never will.

For nearly half of the activist events, we find no additional news following the first filing. Not surprisingly, these events tend to be concentrated among smaller targets. This raises the concern that these firms are less newsworthy than larger firms, generating less search results from the newswires. However, in the 18 months subsequent to filing, these events earn average abnormal returns close to zero suggesting that our classification is probably accurate.

The first group of outcomes for which we find news comprises events in which an asset sale or spinoff was announced or completed. In 178 cases, the target is acquired. In 48 cases, a merger or asset sale is announced. The other outcomes in this category include completion of a

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<sup>15</sup> The two classifications "no news of an outcome" and "merger or asset sale completed" are exclusive; that is, this outcome classification will not be accompanied by another classification. As a result, the non-exclusive number and the exclusive number in parenthesis for these two outcomes will be the same in Table 6.

spinoff (7 events), the activist taking over the target entirely (7 events), and the target hiring an investment bank to solicit potential buyers (14 events).

Our main question is whether the returns to activism depend on if the target is eventually acquired or not. These results are shown in Table 7 and plotted in Figure 3. The left-hand columns show average returns following the initial 13D filing for the 226 events for which an acquisition was announced or completed within eighteen months of the initial 13D filing. The table shows that these events earn abnormal announcement returns of over five percent. The rest of the table sorts the remaining non-takeover events by outcome. The average announcement return, over all of these events, is 2.4 percent, about half of that earned by firms that are eventually taken over. The right-hand columns further separate these events into categories based on the outcome. Events that result in changes to the board or a share repurchase do not cause significant positive returns. Events that result in a spinoff earn significantly positive announcement returns of 6.4 percent.

The results in Panel B are more interesting, as they show the long-term returns to activism, conditional on the outcome. Events for which an acquisition was announced or completed earn post-filing abnormal monthly returns of over 25 percent, reflecting the takeover premium paid by the acquirer. For the full set of events that are not acquired, post-13D filing returns are not significantly different from zero. These returns do not seem to depend on what actually happened – events for which there is no news do not have significantly different monthly returns than events for which good news was announced (i.e., board resignations or a spinoff). The possible exception is the few events in which the firm agrees to repurchase shares. Monthly returns here are positive, but not significant.

***When targets are not acquired, do activist investors create value?***

Another way to track the operating performance of firms post-activism is to study accounting measures before and after the activist request (see for example, Brav et al (2006), and Klein and Zur (2006)). We believe this is problematic for a few reasons. First, the most significant outcome for a target firm is a takeover, in which case it is dropped from Compustat. Second, almost 100 firms in our sample do not even supply Compustat data before the event. This reflects a selection bias in that Compustat does not cover many small firms. These caveats in mind, Table 8 shows changes in operating performance following activist filings *for the subset of targets that were not acquired*.

Changes in performance are measured as the difference between the fiscal year after the 13D filing and the fiscal year before the filing. The accounting variables are constructed as follows: *Capital Expenditures* is capital expenditures (Compustat item 128) over lagged net property, plant, and equipment (item 8); *Cash flow* is the sum of earnings before extraordinary items (item 18) and depreciation (item 14) divided by lagged net property, plant, and equipment (item 8); *Dividends/earnings* is the ratio of the sum of common dividends (item 21) and preferred dividends (item 19) over earnings before depreciation, interest, and tax (item 13); *Leverage* is long-term debt (item 9) plus current liabilities (item 34) divided by long-term debt plus current liabilities plus book value of common equity (item 60); *Operating return on assets* is the ratio of operating cash flow (item 308) over lagged total assets (item 6); *Return on assets* is the ratio of EBITDA (item 18) over lagged total assets;  $\Delta A/A_{t-1}$  denotes the percentage change in balance sheet assets;  $\Delta S/S_{t-1}$  denotes the percentage change in adjusted shares outstanding. We winsorize all scaled variables at the 1% level to reduce the influence of outliers.

The table shows that for the full sample of events, there is no significant change in ROA, operating ROA, cash flow, the payout ratio, asset growth, or share growth. We do find, however,

that firms reduce investment levels – capital expenditures scaled by property, plant, and equipment falls from 36.5% to 22.1% for the average firm in the sample. The table also shows that surviving firms dramatically increase their leverage ratio – by nearly 40%<sup>16</sup>.

While there appears to be no significant changes on average (except for reductions in capital expenditures and increases in leverage), the more important question is whether any of these operating changes are associated with high stock returns. In our data, there are several examples in which management agrees to the demands of the activist and yet, the stock price drops as a result. One such example is Pirate Capital’s activist intervention at James River Coal Co. in November, 2005. Although it was able to win three board seats at the company and successfully lobbied the firm to hire an investment bank to explore strategic alternatives, the stock lost nearly 75% of its value before it reduced its position below 5% in December, 2006. More broadly, we seek to find evidence of stock price appreciation for targets that executed operational or financing changes demanded by activists, yet ultimately remained independent.

Table 9 takes a look at this claim. We again focus on the subset of firms that did not merge within eighteen months of the initial activist filing, and for which Compustat data is available before and after the initial filing. For each measure of changes in operating performance, we sort firms into groups depending on whether they fall above or below the median. For example, in the sample of firms that survive, the average change in ROA is approximately zero (Table 9). Firms that fall below the median experienced reductions in ROA that averaged minus 9 percent, while firms that fall above the median experienced increases in ROA that averaged 8 percent. The table shows that average eighteen-month abnormal returns for the bottom group were 2.8 percent, compared with 16.5 percent for the top group. However, as

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<sup>16</sup> Interestingly, this effect is far more pronounced when the activist initially targets “capital structure” issues in its initial 13D filing. In these instances, targets more than double their leverage ratios from one year before the activist filing to one year after.

the last column of the table shows, the difference between the average returns of these two groups is not significant. Thus, even if we were to accept the premise that the increase in ROA for the high ROA group was a direct result of the investor activism, there is no evidence that it is associated with significantly higher stock returns. We repeat the procedure above for each of the measures of operating performance. In each case, the result is the same. We find little evidence linking changes in a target's operating performance and long-run returns following activism.

***Do activists increase the probability that firms are taken over?***

While the evidence thus far is consistent with our hypothesis that activists primarily create value in instances where they can bring about an acquisition of the target, it is also consistent with another explanation: that the returns associated with their involvement reflect activists' ability to pick undervalued stocks that are inherently more likely to be acquired (with or without an activist intervention). And to the extent that the activists ask target firms to make operating changes, these are changes that were apt to happen anyway. Consistent with this alternate hypothesis, activist targets tend to have similar characteristics: they are small stocks with low or no analyst coverage, low market-to-book ratios, and have underperformed relative to other firms in their industry.

To test this alternate hypothesis, we consider two approaches. The first is to assemble chronologies of each activist-target pair in cases where a takeover was completed, with the objective of identifying the steps taken by the activist in pursuit of a takeover. The second approach is to perform a matched sample analysis, asking whether firms with similar characteristics as the activist targets had similar outcomes.

***Takeover Chronologies***

For the subset of firms that are eventually acquired, we construct detailed chronologies of each event. We draw on press reports, activist SEC filings, and target firm SEC filings between the first 13D disclosure and the ultimate takeover.<sup>17</sup> Our objective in constructing these chronologies is to get a sense of whether the actions of the activist investor increase the probability of a subsequent takeover, or alternatively, that the activists simply act as witnesses to the takeover and corresponding increase in stock price.

We start with a few examples that are typical in our data. Consider activist Southeastern Asset Management (SEA)'s holdings of Vicorp Restaurants. On February 8, 2000, SEA reported a 14.5% stake (1.28 million shares) in Vicorp Restaurants. The activist also stated that "it may talk with outside parties interested in transactions involving the company." The following day, activist Franklin Resources Inc. also filed a 13D with the SEC, reporting its 7.3% stake. It revealed it had been approached by an unnamed Vicorp shareholder regarding Vicorp's Board. Vicorp's management owned 59% of the company at this time. On February 15, 2001, a newly formed affiliate of BancBoston Capital and Goldner Hawn Johnson & Morrison Inc. agreed to buy Vicorp for a 38% premium, \$25.65 a share in cash. Shareholders approved the transaction on May 2. While there is nothing in this account to *prove* that the activist caused the takeover, the chronology is suggestive.

Another type of event that appears frequently is one in which the activist opposes a merger agreement, asking for improved terms. Consider activist Heartland Advisors 19.8 percent stake in MDT Corporation. On May 17, 1996, Getinge Industrier AB filed a 14D1, a tender offer statement for 6,769,431 shares of MDT at \$4.50 per share, a total transaction of \$30,462,000 in cash. Heartland rejected this offer on June 6. In a July 11 letter, it advised Getinge to raise its offer by \$1 to \$5.50 per share. Heartland also expressed that it may contact other parties about

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<sup>17</sup> We have made these entries available on one of the authors' website.

purchasing MDT. Getinge agreed to Heartland's recommendation for the now \$37,232,000 transaction, revising its offer the next day. At this point, Getinge had effective control of 40.6 percent of the shares. In this example, it is not clear whether the activist increased the *probability* of the takeover; however, the presence of the activist appears to have increased the eventual sale price.

Relative to most of the activist events in our sample, the two examples above are among the more straightforward, in that they can easily be broken into four parts: (1) initiation of the activism, (2) methods used during activism, (3) intermediate results of these methods, and (4) a final outcome. In what follows, we use judgment to classify each event into these four parts, recognizing that some events do not fall as neatly into this framework.

We start with (1), the initiation of the activism. In the data, there appear to be four alternatives: (i) the activist bids on the company, putting it in play, (ii) an activist bids on the company after the company has already received an offer, (iii) a third party offer is made after the activist has become involved with the target, and (iv) a third party bid is made before the activist gets involved with the target. In case (iv), we allow for the possibility that the activist owned shares prior to the bid, yet did not make any public statements regarding the activist's intentions. Table 10 shows that (iii) and (iv) are by far the most common.

We next tabulate steps taken by the activist in pursuit of a takeover. We consider whether (i) board seats are granted or requested, (ii) the activist files a lawsuit at some point, and (iii) the activist asks for an amendment or reconsideration of an existing merger proposal, or pushes for a higher offer than an offer that is currently outstanding. Out of 177 cases, we identify 51 events in which at least one of the four steps above applies. The most common demand is that an existing takeover agreement is amended.

Third, we tabulate the results of these intermediate steps, namely, that the third party increases her bid for the target, or that the activist comes back with a higher offer for the entire firm (rare, as the activist is rarely the ultimate buyer of the company).

Fourth, we tabulate the outcomes. This task is straightforward, as our sample conditions on the firm being taken over! In a small minority of cases, the activist itself takes over the company. In the vast majority of cases, the third party bidder succeeds in the acquisition, possibly at a higher price, and again in a small minority, a fourth party (neither the activist, nor the initial third party bidder) purchases the target company.

A broad brush impression from these chronologies, and their tabulation in Table 10, is that activism that succeeds in causing a takeover tends to be of two types. In the first, the activist buys a piece of the firm and “markets” it to potential buyers, whether strategic or private equity. In the second, the firm is already “in play” and the activist gets involved to ensure that the target is sold at a suitable price. In all, the activist is successful at putting the company in play or sweetening an outstanding offer for the target in almost two-thirds of all the cases where the target is ultimately acquired.

### *Matched sample analysis*

We now use matched sample analysis to identify whether activist investors increase the probability that a firm is acquired. To do this, we compare the probability that target firms are acquired with the counterfactual probability that they would have been acquired in the absence of activism. We obtain a counterfactual by matching each activism target with a firm in the same industry, which is of similar size and has experienced similar past returns. The premise of our matching procedure is that the matched firm was also a candidate for investor activism. We then track each of these firms for a period of one year (or eighteen months) following the initial

activist filing, keeping track of whether the firm is delisted or acquired, or still trading at the end of this window. Table 11 shows these results. In our sample, 22.6% of firms are delisted within a year of the first filing. Of these, 18.1% are acquired by another firm and stop trading. In contrast, in the matched sample, only 10.6% of firms are delisted within a year, and 7.2% are acquired. Thus, activists seem to have a significant effect on whether an undervalued target is ultimately acquired or not.

One drawback of our matching procedure is the potential omitted variable bias: perhaps activists select targets on unobserved characteristics that do not enter our match. Put differently, we cannot control for some heterogeneity between the firms that the activist actually targeted and firms, that albeit similar, were not ultimately targeted. While there is no way to fully rule out the importance of unobserved characteristics, we try another matched sample that is based on 13D filings in which no activist intentions were stated. Thus, this represents a group of firms that also become large positions in the activist investors' portfolios, but in which no formal complaints were raised. The table shows that for this sample, 15.4% of firms are delisted, and 12.6% are subsequently acquired, within a year of the first activism complaint.

Finally, for purposes of comparison, we calculate the probability that stocks in the same size cohort as the target stocks are delisted. The table shows that only 7.4% of small stocks are delisted in a given year, with 4.7% of these being acquired.

To sum up, based on a variety of control samples, activists increase the probability that a firm will be acquired. Panel B shows similar results, but extends the window in which we track the target firm and its control firm from one year to eighteen months.

There are a few other reasons to think that activists increase the probability that firms are acquired. First, announcement returns are strongly related to the specific requests of the activist.

As we showed earlier, announcement returns are particularly high when the activist requests that the target look into the sale of all or some of the business. Since presumably all activist positions are motivated by undervaluation of the target, it would follow that those positions that specifically call for the sale of the target should see higher announcement returns only if the market believes that the activist will be able to follow through on their demands. Thus, the market rationally bids the price of the target stock up in anticipation of a takeover premium.

Finally, there is often revealing evidence in the statements made by third party buyers of activist targets. As Thomas H. Lee, a private equity fund manager, acknowledged in a speech in 2007, “I’d like to thank my friends Carl Icahn, Nelson Peltz, Jana Partners, Third Point [all activist investors or hedge funds] for teeing up deals because [...] many times [activist targets] are being driven into some form of auction.”<sup>18</sup>

## **V. Conclusions**

Activism that calls for an asset sale generates the highest returns, both at the announcement date and in the long run, while other types of activism have almost no effect on a target’s returns after the short period around the filing of a 13D. Furthermore, activism actually seems to increase the likelihood that an undervalued target is ultimately acquired; the returns to activism thereby reflect this enhanced probability of a future takeover premium.

Activism is mainly focused on small firms. These companies have little analyst coverage and have underperformed relative to other firms in their industries, making them potentially strong candidates for future takeovers. The activists need to acquire at least a 5% stake in order to most effectively push for a takeover with the public filing of the mandatory 13D. This last

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<sup>18</sup> As quoted by Andrew Ross Sorkin, “Will Credit Crisis End the Activists’ Run?”, *New York Times*, August 27, 2007.

point suggests that if hedge fund assets continue to grow, these investors may become increasingly successful at implementing takeovers at ever larger firms in the future

One implication of our work is that the scope for hedge fund activism to have pervasive effects on corporate governance is somewhat limited. In our view, hedge funds invest in small undervalued companies with the ultimate goal of seeing those targets bought out. With the returns highest for targets that are acquired within 18-months of the activist filing, it follows that the activists are largely focused on bringing about such a result and less interested in making significant corporate governance changes. A longer term advisory relationship with the target resulting in outcomes other than a takeover, although potentially value-increasing, will be less attractive to hedge funds that need to post high returns for their investors in a relatively short amount of time.

A related implication of our work is that the announcement returns to investor activism should depend on the overall takeover interest in the market. Anecdotal evidence from the credit crunch of August and September 2007 appears to confirm our intuition. During this time, private equity interest in debt financed buyouts declined dramatically due to spikes in interest rates. Many activists saw corresponding drops in the value of their portfolios – many of the firms they had targeted had been purchased in the hope of a takeover, the probability of which declined when rates fell. Activist investor Carl C. Icahn made this especially clear when he told *The New York Times* in August 2007 that the credit crunch was going to make it more difficult to generate high returns using activism.<sup>19</sup>

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<sup>19</sup> As quoted by Andrew Ross Sorkin, “Will Credit Crisis End the Activists’ Run?” *New York Times*, August 27, 2007.

## Appendix A1: Classification of Activist Categories

*Engage Management:* The activist intends to engage or discuss issues with management to increase shareholder value or makes a general statement that shares are “undervalued” without including any specific plans or proposals. This is the least aggressive form of activism. (45.54% of hedge fund sample, 22.45% of non-hedge fund sample).

*Capital Structure:* The activist targets capital structure issues. This type of activism relates to a recapitalization, stock or debt issuance, restructuring of debt, dividends or a stock buyback. (10.08% of hedge fund sample, 6.12% of non-hedge fund sample).

*Corporate Governance:* The activist targets corporate governance issues. This type of activism can include a call to declassify the board, remove a poison pill, elect activist-selected directors, or fire a company officer or board member. The corporate governance classification also applies to activism that targets issues of board or executive compensation, corporate fraud, and lack of transparency. (21.94% of the hedge fund sample, 48.47% of the non-hedge fund sample).

*Business Strategy:* The activist critiques excess diversification and the level of investment in some business lines or cites poor operating strategy at target. (4.59% of the hedge fund sample, 6.12% of the non-hedge fund sample).

*Asset Sale:* The activist calls for the target to sell itself or certain assets in order to maximize shareholder value. This classification can also represent an offer by the activist itself to takeover the target. (18.11% of the hedge fund sample, 13.27% of the non-hedge fund sample).

*Block Merger:* The activist blocks a proposed merger, usually because it deems the terms of the deal unfavorable to target shareholders. Often, the activist will demand a higher price. (5.61% of the hedge fund sample, 10.20% of the non-hedge fund sample).

*Financing/Bankruptcy:* The activist provides financing for a target in bankruptcy or financial distress. (1.40% of the hedge fund sample, 2.04% of the non-hedge fund sample).

*Strategic Alternatives:* Activist requests that the target pursue various strategic alternatives for the firm, including a spinoff of an underperforming division. (2.42% of the hedge fund sample, 5.10% of the non-hedge fund sample).

*Proxy:* The activist files under Schedule 14A with the SEC, signaling an intention to solicit proxies from shareholders either to elect its own proposed director(s) or to adopt a shareholder proposal that the activist has submitted or plans on submitting. (9.06% of the hedge fund sample, 3.06% of the non-hedge fund sample).

Events may have more than one classification. For example, if an activist calls for the election of an independent director while also suggesting that the company spin-off an underperforming division, this event will fall under both the corporate governance and business strategy categories.

There are two categories however for which any other classification is mutually exclusive: *Engage Management* and *Proxy*. If an activist announces that the target is “undervalued” and intends to engage with management to increase shareholder value, the event

will only be classified under Category 1 and no others. The same is true for the proxy contest category – if an activist announces its intentions to engage the target in a proxy contest, the event will only be classified as *Proxy*.

## **Appendix A2: Monthly Returns in calendar time portfolios**

One drawback of the event-time methodology, pointed out by Schultz (2003), is that if events are clustered in time (such as IPO waves, for example), the researcher may find abnormal performance when there is none. A simple remedy is to examine the performance of a calendar-time portfolio that purchases stocks following investor activism. This approach has the additional advantage of determining whether the abnormal returns to activism are implementable.

Figure A1 shows cumulative profits from an equal-weighted portfolio that purchases stocks one day after an initial 13D has been filed (that expresses activist intentions, and thus is in our sample). Stocks are held for a period of one year. To ensure that the portfolio has a suitable number of stocks, we start tracking performance at the beginning of 1995. At this time, there are six stocks in the portfolio. As activist activity grows over the course of the sample, the number of stocks in the portfolio fluctuates, to a maximum of 118 stocks in August 2006. In the figure, cumulative profits are shown net of the risk-free return. For comparison, the figure also shows excess returns on the value-weighted market portfolio.

There are two main impressions from the figure. First, the activist portfolio significantly outperforms the market during the 1995-2006 period. Second, the bulk of this outperformance occurs after 2000, during a time when value-stocks performed well. The apparent correlation with value-growth returns seems consistent with activists' own accounts of their activities—they seek asset rich companies that are being undervalued by the market.

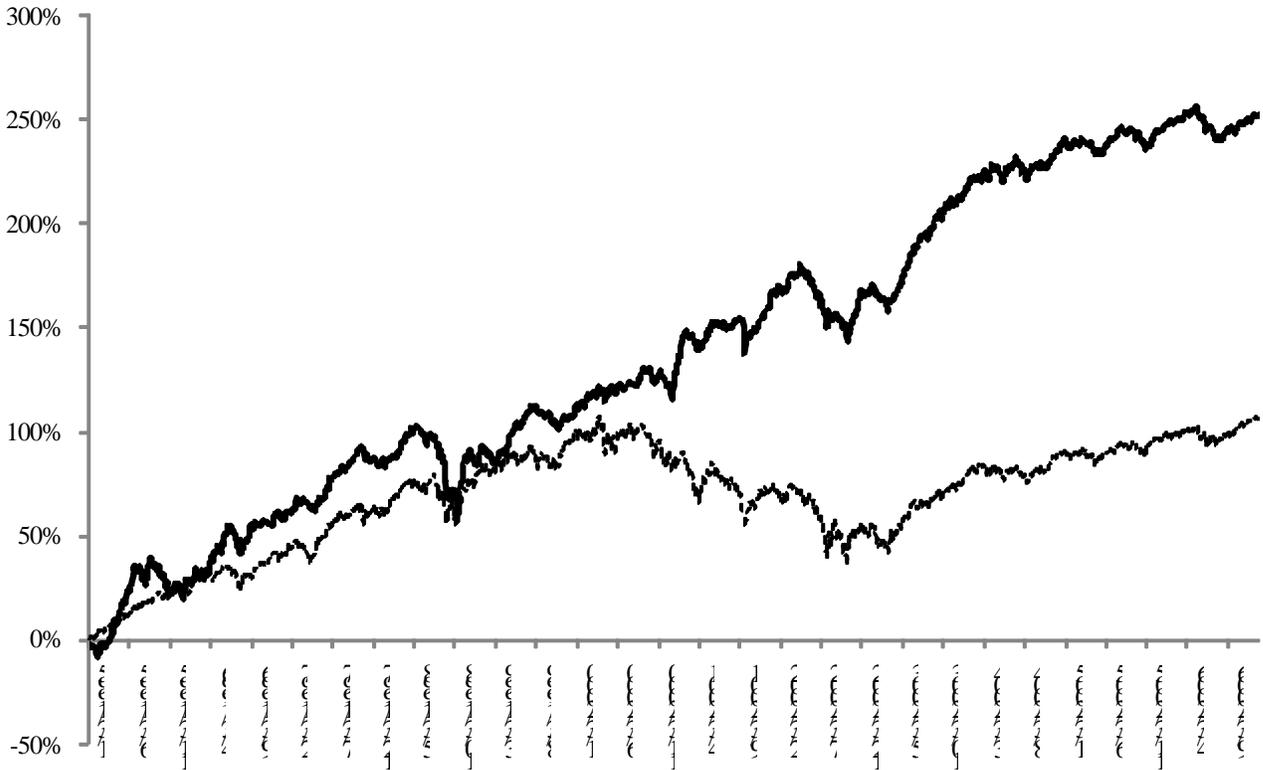
Appendix Table A1 summarizes the returns to this portfolio. The activist portfolio had annualized returns of approximately 21 percent, and three-factor adjusted returns of approximately 12 percent. The adjusted returns are considerably lower than raw returns due to the high loadings of the activist portfolio on SMB and HML factors, both of which performed

well during the second half of the sample. The loading on SMB is not surprising in light of the results in Table 3, which show that activist positions tend to be in smaller stocks. And the loading on HML is not surprising given the low market-to-book ratios of most activist positions.

Table A1 also shows the performance of activist portfolios with different holding periods. Shorter holding periods tend to be associated with superior performance, but long-term performance is high, consistent with the results in Table 5.

The second panel of Table A1 shows the performance of value-weighted activist portfolios. Mean returns are positive, but 3-factor alpha is only significantly different from zero in the case where the holding period is one month. The underperformance of the value-weighted portfolio, relative to the equal-weighted portfolio, stems from the fact that activism tends to generate higher returns in smaller firms.

**Figure A1. Excess calendar-time portfolio returns.** The portfolio purchases all stocks for which a 13D filing has been filed expressing activist intentions, and holds each stock for a period up to one year. Stocks are equal-weighted in the portfolio. The solid line denotes cumulative returns of this activist portfolio in excess of the risk free rate. The dashed line denotes cumulative returns of the value-weighted market portfolio in excess of the risk free rate.



**Appendix Table A1. Calendar time portfolio returns to investing in investor activism 1994-2007.** The portfolios purchase stocks targeted by investor activism one day after the first filing, and hold for a period of one month, three months, one year, 18 months, or two years. The table shows average returns, 3-factor alphas, and factor loadings on SMB, HML, and RMRF for both the equal and value-weighted portfolios. Mean returns and alphas are shown in annualized percentage terms by multiplying the daily averages by 250.

Holding Period:	Equal-weighted portfolios							Value-weighted portfolios						
	Mean(R) %/yr	[t]	3-factor $\alpha$ %/yr	[t]	SMB	HML	RMRF	Mean(R) %/yr	[t]	3-factor $\alpha$ %/yr	[t]	SMB	HML	RMRF
1 month	38.25	[3.97]	29.25	[3.17]	0.53	0.40	0.70	27.25	[3.06]	17.25	[2.04]	0.37	0.41	0.88
3 months	20.75	[3.29]	12.50	[2.25]	0.54	0.31	0.66	9.75	[1.51]	0.75	[0.11]	0.40	0.34	0.81
1 year	20.75	[4.67]	12.00	[3.63]	0.53	0.36	0.71	9.25	[2.10]	-2.00	[0.64]	0.44	0.48	0.95
2 years	19.25	[4.68]	10.50	[3.78]	0.55	0.35	0.72	7.75	[1.79]	-3.25	[1.21]	0.42	0.42	0.98

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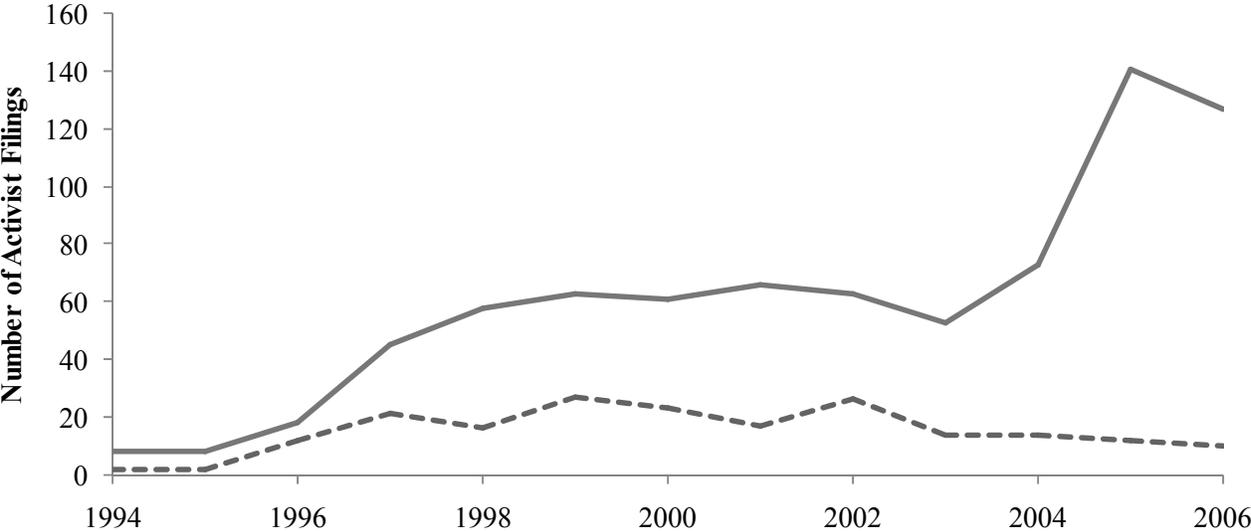
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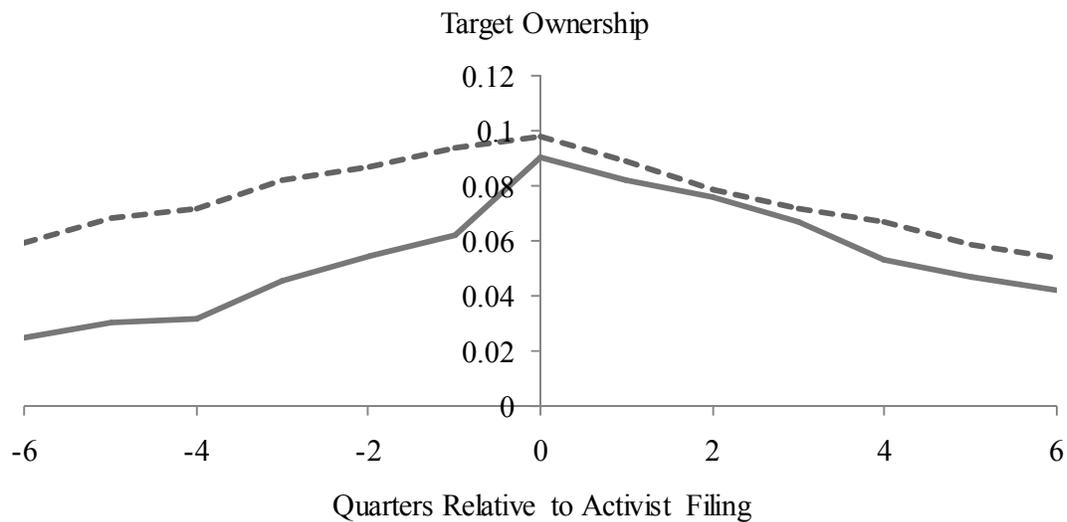
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**Figure 1. Number of 13D Activist Filings by Year and Type of Activist (solid – Hedge Fund Activist, dash – Non-Hedge Fund Activist).** The figure plots the number of activist 13D filings in each year, by activist type. Activist events are culled from 13D filings with the SEC. Repeat filings with the same purpose of transaction are ignored for the purposes of the annual count.

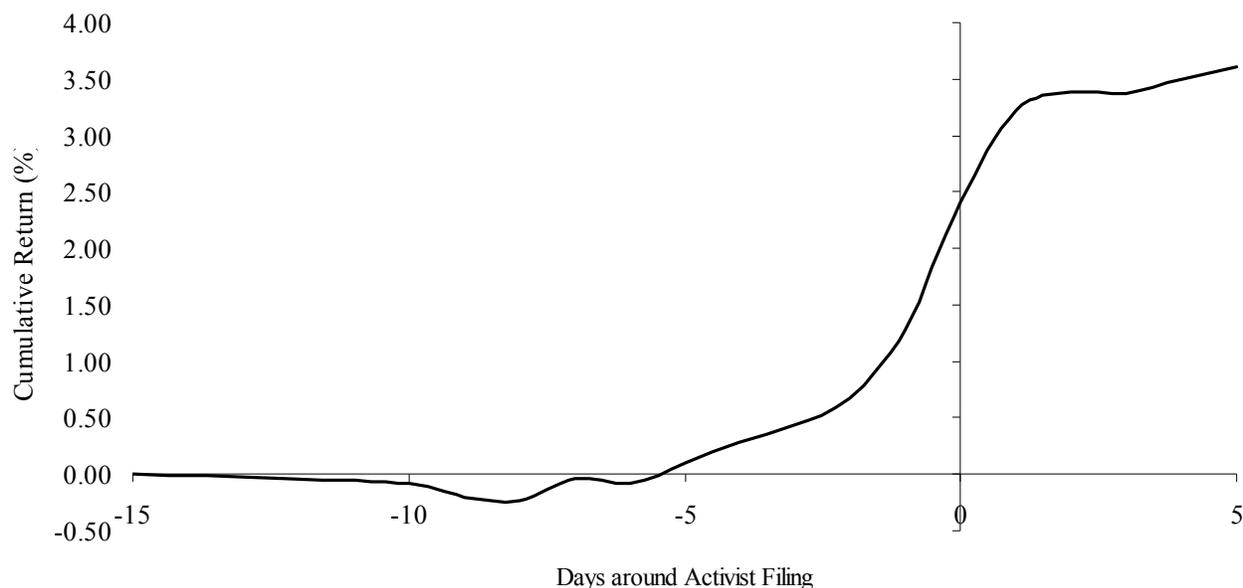


**Figure 2. Activist holding periods.** The sample is constrained to activist events in which the first filing was made in 2005 or earlier, to ensure that complete portfolio holdings are available. We also require that a 13F was filed within three months of the initial filing. Hedge fund holdings are denoted with a solid line, while non hedge fund holdings are denoted with a dotted line.

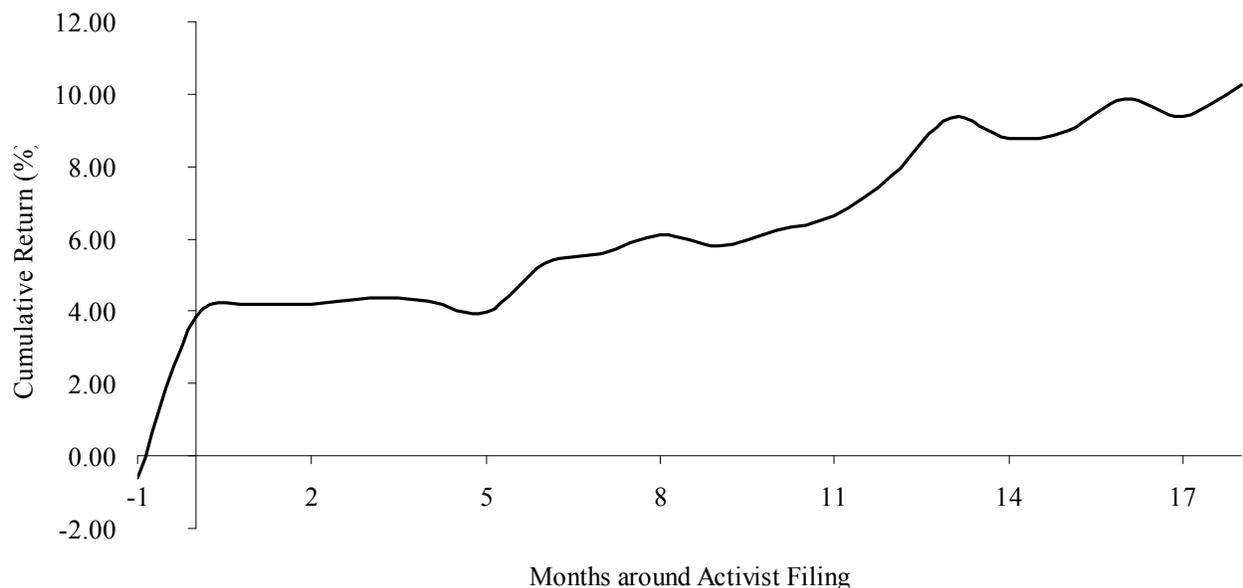


**Figure 3. Abnormal Returns around Activist Filing.** Returns are computed as follows. We first estimate factor loadings on HML, SMB and the market excess return using 100 days of returns prior to the first filing of the 13D. We form a matching portfolio as the factor loading weighted return on the HML, SMB and market portfolios. Abnormal returns are the difference between the target return and the return on the matching portfolio. Cumulations of daily abnormal returns starting 15 days before the event are shown in the Panel A, and cumulations of monthly abnormal returns starting one month before the event are shown in Panel B.

Panel A. Short-Term Cumulative Abnormal Returns

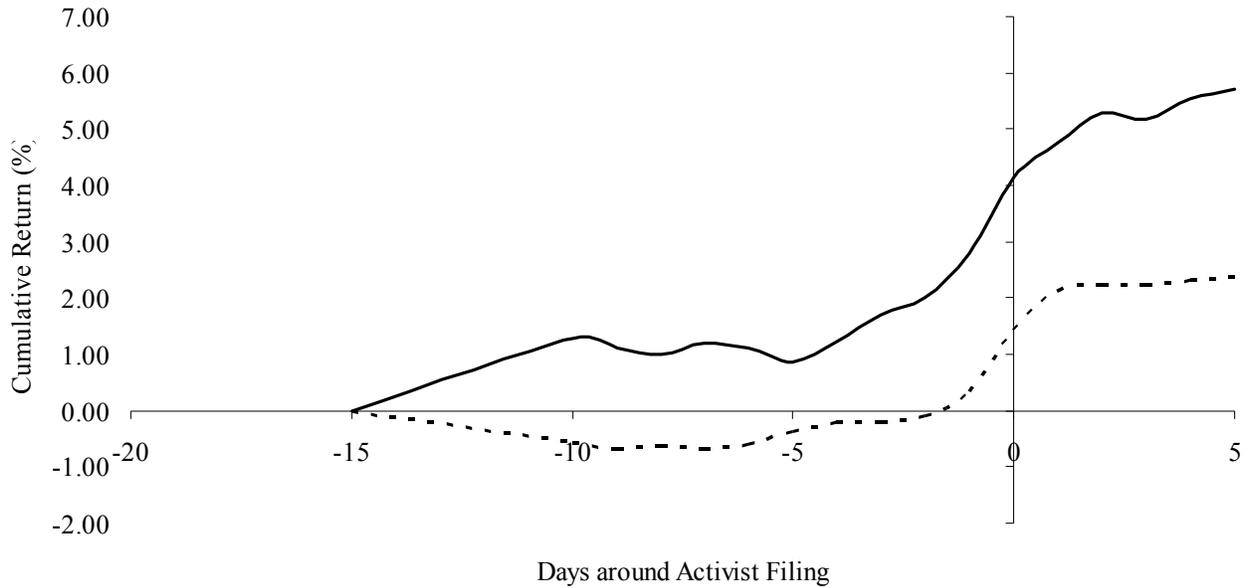


Panel B. Long-Term Cumulative Abnormal Returns

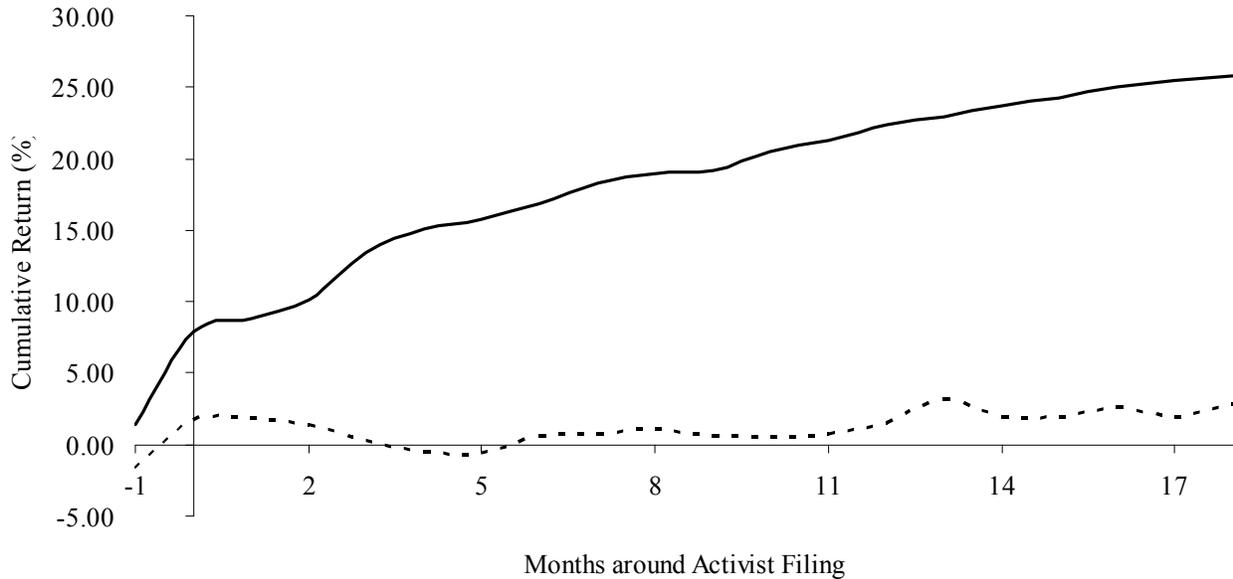


**Figure 4. Abnormal Returns around Activist Filing by Outcome.** We first estimate factor loadings on HML, SMB and the market excess return using 100 days of returns prior to the first filing of the 13D. We form a matching portfolio as the factor loading weighted return on the HML, SMB and market portfolios. Abnormal returns are the difference between the target return and the return on the matching portfolio. Outcomes apply to news announced no later than 18 months after the initial 13D activist filing. The sample is restricted to initial activist filings.

Panel A. Short-Term Cumulative Abnormal Returns by Outcome (solid – acquisition announced/completed, dash – all other outcomes)



Panel B. Long-Term Abnormal Returns around Activist Filing by Outcome (solid – acquisition announced/completed, dash – all other outcomes)



**Table 1. Activist Events by Year 1994-2006.** The number of activist events, by year. An event is defined as an instance which an activist files a 13D filing announcing 5 percent ownership and an intention to influence the management of the company. Events are separated by hedge fund and non-hedge fund activists, where a hedge fund is defined as any 13D filer that does not operate open-ended mutual funds or a pension. The table also shows the number of unique activists.

	<b>Hedge Fund</b>	<b>Non-Hedge Fund</b>	<b>Total</b>	<b>(First Filings)</b>
1994	8	2	10	6
1995	8	2	10	9
1996	18	12	30	28
1997	45	21	66	59
1998	58	16	74	62
1999	63	27	90	74
2000	61	23	84	69
2001	66	17	83	68
2002	63	26	89	76
2003	53	14	67	59
2004	73	14	87	74
2005	141	12	153	120
2006	127	10	137	107
Total	784	196	990	811
Activists	139	38	177	177

**Table 2. Activist Events by Classification 1994-2006.** Number of activist events, sorted by the type of activism and according to the type of activist (hedge fund / non-hedge fund). Hedge funds are defined according to CISDM data. Event classifications are as follows: *Engage management*: The activist intends to engage or discuss issues with management to increase shareholder value or makes a general statement that shares are “undervalued” without including any specific plans or proposals; *Capital structure*: The activist requests a recapitalization, stock or debt issuance, restructuring of debt, dividends or a stock repurchase. *Corporate Governance*: Activist seeks to declassify the board, remove a poison pill, elect activist-selected directors, fire a company officer or board member, or target issues related to executive compensation, corporate fraud, or lack of transparency. *Business strategy*: The activist critiques excess diversification and the level of investment in some business lines or cites poor operating strategy at target. *Strategic Alternatives*: Activist requests that the target pursue various strategic alternatives for the firm, including a spinoff of an underperforming division. *Asset Sale*: The activist calls for the target to sell itself or certain assets in order to maximize shareholder value. *Block merger*: The activist tries to block a merger with another firm or seeks to increase the bid made for the target. *Financing/Bankruptcy*: The activist provides financing for the target during bankruptcy or financial distress. It may also include an offer to finance the target’s growth or acquisition strategies. *Proxy contest*: The activist files under Schedule 14A with the SEC, signaling an intention to solicit proxies from shareholders either to elect its own proposed director(s) or to adopt a shareholder proposal that the activist has submitted or plans on submitting.

	<b>Hedge Fund</b>	<b>Non-Hedge Fund</b>	<b>Total</b>
Engage management – “undervalued”	357	44	401
Capital structure	79	12	91
Corporate governance	172	95	267
Business strategy	36	12	48
Strategic Alternatives	19	10	29
Asset sale	142	26	168
Block merger	44	20	64
Financing/Bankruptcy	11	4	15
Proxy contest	71	6	77

**Table 3. Activist Portfolio Positions 1994-2006.** The table presents statistics on the activists including assets under management in millions, the mean duration that positions in the activists' portfolio are held, and the total number of positions in the activists' portfolio. All data for the activists comes from the quarter during which the activist filing took place. The table also includes statistics on the activist positions in the target, including market value in millions, the percent of the target firm's shares outstanding represented by the activist positions, the percent of the activists' assets under management represented by the activist position at the 13D filing date, the rank of the activist positions in terms of size in the activists' overall portfolio, the size decile of the activist targets, the number of analysts covering the target as measured by the number of I/B/E/S estimates for the year prior to the activist filing, the target's market-to-book ratio in the year prior to the activist filing, and the 12-month abnormal return of the target up to one month before the activist filing. Monthly abnormal returns are computed as follows. We first estimate factor loadings on HML, SMB and the market excess return using 100 days of returns prior to the first filing of the 13D. We form a matching portfolio as the factor loading weighted return on the HML, SMB and market portfolios. Abnormal returns are the difference between the monthly return and the return on the matching portfolio.

	Hedge Funds		Non-Hedge Funds		All	
	Mean	Median	Mean	Median	Mean	Median
Portfolio Statistics:						
Assets under management (\$m)	1,775	838	24,200	9,230	6,793	1,104
Mean Position Duration in Quarters	2.33	1.53	8.01	7.35	4.23	2.67
Number of Positions	118	43	777	675	266	61
Position Statistics:						
Market Value of Stake (\$m)	59.2	16.4	81.7	30.7	63.7	18.6
Percent of Target Shares Outstanding (%)	9.83	7.80	12.97	9.88	10.47	8.30
Percent of Activist Portfolio (%)	7.66	3.64	1.32	0.00	4.89	2.35
Position Ranking in Activist Portfolio	22.5	9.0	174.0	64.0	56.6	12
Mean Size Decile of Positions	2.71	2.00	3.23	3.00	2.82	2.00
Number of Analysts Covering Target	3.79	2.00	3.29	2.00	3.69	2.00
Target MV/BV ratio t-1	1.54	1.24	1.29	1.15	1.49	1.22
Prior Returns:						
12-Month Abnormal Return Prior to Activism (%)	-3.83	-1.08	4.60	-0.26	-2.15	-0.72
12-Month Buy-and-hold industry abnormal return (%)	-6.24	-15.54	-6.16	-11.00	-6.23	-14.57
24- Month Buy-and-hold industry abnormal return (%)	-13.13	-28.76	-23.56	-20.66	-15.12	-27.29

**Table 4. Announcement returns.** Daily abnormal returns are computed as follows. We first estimate factor loadings on HML, SMB and the market excess return using 100 days of returns prior to the first filing of the 13D. We form a matching portfolio as the factor loading weighted return on the HML, SMB and market portfolios. Abnormal returns are the difference between the daily return and the return on the matching portfolio. Cumulative averages are shown for the full sample and for the various types of activism, classified at time of the 13D filing. These classifications are defined as follows: *Engage management*: The activist intends to engage or discuss issues with management to increase shareholder value or makes a general statement that shares are “undervalued” without including any specific plans or proposals; *Capital structure*: The activist requests a recapitalization, stock or debt issuance, restructuring of debt, dividends or a stock repurchase. *Corporate Governance*: Activist seeks to declassify the board, remove a poison pill, elect activist-selected directors, fire a company officer or board member, or target issues related to executive compensation, corporate fraud, or lack of transparency. *Business strategy*: The activist critiques excess diversification and the level of investment in some business lines or cites poor operating strategy at target. *Strategic Alternatives*: Activist requests that the target pursue various strategic alternatives for the firm, including a spinoff of an underperforming division. *Asset Sale*: The activist calls for the target to sell itself or certain assets in order to maximize shareholder value. *Block merger*: The activist tries to block a merger with another firm or seeks to increase the bid made for the target. *Financing/Bankruptcy*: The activist provides financing for the target during bankruptcy or financial distress. It may also include an offer to finance the target’s growth or acquisition strategies. *Proxy contest*: The activist files under Schedule 14A with the SEC, signaling an intention to solicit proxies from shareholders either to elect its own proposed director(s) or to adopt a shareholder proposal that the activist has submitted or plans on submitting. T-statistics are in brackets.

	All events		Engage mgt		Cap. Struct.		Corp Gov		Strategy		Asset Sale		Block Merger		Fin/Bankruptc		Alternatives		Proxy	
N	980		401		91		267		48		168		64		15		29		77	
% Acquired	26.1%		23.7%		20.9%		15.7%		20.8%		35.7%		78.1%		26.7%		31.0%		18.2%	
	CAR	[t]	CAR	[t]	CAR	[t]	CAR	[t]	CAR	[t]	CAR	[t]	CAR	[t]	CAR	[t]	CAR	[t]	CAR	[t]
-10	-0.08	[-0.3]	0.43	[1.1]	-1.95	[-2.2]	-1.14	[-2.1]	-1.48	[-0.9]	-0.21	[-0.4]	2.80	[1.8]	4.68	[0.6]	-1.71	[-1.5]	0.55	[0.8]
-9	-0.20	[-0.6]	0.27	[0.6]	-1.86	[-1.8]	-0.91	[-1.5]	-2.51	[-1.2]	-0.18	[-0.3]	2.97	[1.9]	0.37	[0.1]	-2.35	[-1.9]	0.98	[1.3]
-8	-0.23	[-0.7]	0.20	[0.4]	-1.68	[-1.5]	-0.76	[-1.1]	-2.67	[-1.2]	-0.13	[-0.2]	3.09	[2.1]	0.97	[0.2]	-2.24	[-1.7]	0.58	[0.6]
-7	-0.04	[-0.1]	0.20	[0.4]	-1.30	[-1.0]	-0.25	[-0.3]	-3.29	[-1.2]	0.68	[1.0]	2.32	[1.4]	-1.81	[-0.4]	-1.19	[-0.8]	1.17	[1.1]
-6	-0.08	[-0.2]	0.57	[1.0]	-2.05	[-1.5]	-0.51	[-0.7]	-3.38	[-1.3]	-0.02	[-0.0]	2.46	[1.4]	-1.67	[-0.4]	-1.07	[-0.9]	0.98	[0.9]
-5	0.10	[0.2]	0.73	[1.1]	-2.34	[-1.7]	-0.24	[-0.3]	-2.82	[-1.0]	-0.13	[-0.2]	2.67	[1.5]	-1.75	[-0.5]	-1.90	[-1.6]	1.77	[1.4]
-4	0.29	[0.7]	1.01	[1.5]	-2.17	[-1.6]	-0.42	[-0.5]	-2.08	[-0.7]	0.10	[0.1]	2.67	[1.5]	-2.71	[-0.7]	-0.94	[-0.5]	2.42	[1.7]
-3	0.44	[0.9]	1.24	[1.7]	-2.21	[-1.4]	-0.50	[-0.6]	-2.55	[-0.9]	-0.05	[-0.1]	3.27	[1.6]	-1.89	[-0.5]	-0.18	[-0.1]	3.05	[2.0]
-2	0.67	[1.4]	1.18	[1.6]	-1.68	[-1.1]	-0.10	[-0.1]	-2.43	[-0.8]	1.01	[1.1]	3.17	[1.4]	1.29	[0.3]	-0.78	[-0.4]	3.00	[2.0]
-1	1.27	[2.5]	1.40	[1.9]	-0.63	[-0.4]	0.98	[1.0]	-2.25	[-0.7]	2.09	[2.0]	3.16	[1.3]	5.87	[0.8]	-0.10	[-0.0]	3.24	[2.2]
Filing	2.41	[4.5]	2.28	[3.0]	-0.51	[-0.3]	1.48	[1.4]	-1.26	[-0.4]	5.21	[4.8]	4.54	[1.7]	8.37	[1.2]	1.40	[0.7]	3.98	[2.5]
+1	3.22	[6.1]	3.34	[4.6]	0.72	[0.4]	2.12	[2.1]	-1.49	[-0.4]	6.00	[5.4]	4.69	[1.8]	9.08	[1.4]	0.99	[0.5]	4.81	[2.9]
+2	3.39	[6.2]	3.44	[4.4]	1.49	[0.9]	2.35	[2.3]	-2.24	[-0.5]	6.60	[6.0]	4.98	[2.0]	6.53	[1.2]	1.42	[0.7]	4.91	[2.9]
+3	3.38	[5.9]	3.76	[4.6]	0.88	[0.5]	2.36	[2.3]	-3.48	[-0.7]	6.90	[5.9]	4.44	[1.8]	4.15	[0.7]	0.99	[0.6]	4.89	[2.8]
+4	3.50	[6.1]	3.98	[4.7]	1.00	[0.6]	2.31	[2.2]	-2.76	[-0.7]	7.05	[5.9]	5.02	[2.0]	3.80	[0.7]	1.08	[0.6]	4.85	[2.9]
+5	3.61	[6.2]	4.18	[5.0]	1.68	[1.0]	2.30	[2.1]	-2.32	[-0.5]	6.83	[5.7]	5.91	[2.4]	2.31	[0.4]	1.73	[0.8]	4.56	[2.8]

**Table 5. Monthly returns following activism.** Monthly abnormal returns are computed as follows. We first estimate factor loadings on HML, SMB and the market excess return using 100 days of returns prior to the first filing of the 13D. We form a matching portfolio as the factor loading weighted return on the HML, SMB and market portfolios. Abnormal returns are the difference between the monthly return and the return on the matching portfolio. Cumulative averages are shown for the full sample and for the various types of activism, classified at time of the 13D filing. Classifications are defined as follows: *Engage management*: The activist intends to discuss issues with management to increase shareholder value or makes a general statement that shares are “undervalued” without including any specific plans or proposals; *Capital structure*: The activist requests a recapitalization, stock or debt issuance, restructuring of debt, dividends or a stock repurchase. *Corporate Governance*: Activist seeks to declassify the board, remove a poison pill, elect activist-selected directors, fire a company officer or board member, or targets issues related to executive compensation, corporate fraud, or lack of transparency. *Business strategy*: The activist critiques excess diversification and the level of investment in some business lines or cites poor operating strategy at target. *Strategic Alternatives*: Activist requests that the target pursue various strategic alternatives for the firm, including a spinoff of an underperforming division. *Asset Sale*: The activist calls for the target to sell itself or certain assets in order to maximize shareholder value. *Block merger*: The activist tries to block a merger with another firm or seeks to increase the bid made for the target. *Financing/Bankruptcy*: The activist provides financing for the target during bankruptcy or financial distress. It may also include an offer to finance the target’s growth or acquisition strategies. *Proxy contest*: The activist files under Schedule 14A with the SEC, signaling an intention to solicit proxies from shareholders either to elect its own proposed director(s) or to adopt a shareholder proposal that the activist has submitted or plans on submitting. T-statistics are in brackets.

	All events		Engage mgt		Cap. Struct.		Corp Gov		Strategy		Asset Sale		Block Merger		Fin/Bankruptcy		Alternatives		Proxy	
N	972		398		91		265		48		167		63		14		29		77	
	26.1%		23.7%		20.9%		15.7%		20.8%		35.7%		78.1%		26.7%		31.0%		18.2%	
Month:	CAR	[t]	CAR	[t]	CAR	[t]	CAR	[t]	CAR	[t]	CAR	[t]	CAR	[t]	CAR	[t]	CAR	[t]	CAR	[t]
-1	-0.59	[-1.2]	-0.90	[-1.2]	-1.03	[-0.7]	0.18	[0.2]	-3.07	[-1.3]	-1.23	[-1.2]	3.39	[1.6]	-9.34	[-1.6]	0.99	[0.5]	2.09	[1.3]
Filing	3.84	[5.3]	2.25	[2.0]	1.30	[0.6]	4.85	[3.4]	-2.67	[-0.8]	5.34	[3.6]	10.62	[4.0]	-9.38	[-1.2]	3.11	[0.9]	8.82	[3.7]
+1	4.20	[4.5]	2.26	[1.6]	-0.95	[-0.3]	5.75	[2.9]	-4.62	[-1.0]	7.63	[4.2]	11.02	[4.1]	-17.85	[-1.7]	0.11	[0.0]	10.74	[3.3]
+2	4.19	[3.9]	3.30	[2.1]	-1.82	[-0.5]	5.25	[2.4]	-5.44	[-0.9]	6.13	[2.8]	11.42	[4.2]	-21.13	[-1.6]	2.30	[0.5]	10.11	[2.5]
+3	4.35	[2.8]	3.59	[1.9]	-0.48	[-0.1]	4.04	[1.0]	-3.41	[-0.5]	5.36	[2.0]	13.49	[4.1]	1.38	[0.1]	2.24	[0.4]	10.80	[2.2]
+4	4.28	[2.5]	4.28	[2.0]	-2.04	[-0.4]	3.19	[0.7]	-4.44	[-0.7]	7.57	[2.5]	12.58	[3.9]	4.21	[0.2]	0.30	[0.0]	7.25	[1.3]
+5	3.99	[2.3]	3.84	[1.6]	-2.70	[-0.5]	3.40	[0.8]	-5.75	[-0.9]	5.71	[1.7]	13.76	[3.7]	3.09	[0.1]	-2.77	[-0.3]	6.22	[1.0]
+6	5.32	[3.0]	4.08	[1.6]	-0.62	[-0.1]	6.39	[1.6]	-0.46	[-0.1]	6.04	[1.6]	14.42	[4.0]	5.13	[0.3]	-1.44	[-0.2]	8.41	[1.2]
+7	5.59	[3.0]	3.90	[1.5]	-0.49	[-0.1]	7.54	[1.8]	3.53	[0.5]	7.61	[1.9]	15.18	[4.1]	7.23	[0.4]	-1.08	[-0.1]	6.91	[0.9]
+8	6.12	[3.3]	3.85	[1.5]	1.16	[0.2]	9.61	[2.3]	4.66	[0.7]	8.46	[2.1]	14.58	[3.7]	-0.18	[-0.0]	1.01	[0.1]	8.40	[1.1]
+9	5.79	[2.7]	4.36	[1.5]	1.47	[0.2]	7.50	[1.5]	3.29	[0.5]	7.47	[1.7]	15.17	[3.6]	-2.24	[-0.1]	0.41	[0.0]	9.57	[1.2]
+10	6.25	[2.8]	5.18	[1.7]	3.44	[0.5]	7.03	[1.2]	8.04	[1.2]	7.38	[1.6]	16.05	[3.7]	5.06	[0.3]	0.55	[0.0]	10.00	[1.2]
+11	6.64	[2.6]	5.94	[1.9]	3.66	[0.5]	6.56	[0.9]	6.25	[0.8]	8.26	[1.8]	15.78	[3.7]	5.23	[0.3]	0.19	[0.0]	10.37	[1.2]
+12	7.78	[2.9]	6.15	[1.9]	4.59	[0.6]	7.40	[1.0]	12.96	[1.5]	10.10	[2.2]	16.60	[3.7]	13.91	[0.5]	7.41	[0.5]	15.94	[1.7]
+18 months	10.26	[3.4]	5.90	[1.6]	7.24	[0.8]	13.75	[1.6]	12.56	[1.2]	11.04	[2.2]	21.02	[3.8]	16.52	[0.6]	8.11	[0.5]	14.93	[1.5]

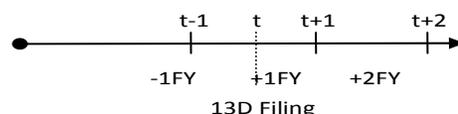
**Table 6. Outcomes of Activism.** Classifications are defined as follows: *No News*: no news of an outcome for the activist event; *Merger or Asset Sale Completed*: the target completed a merger or sale of either all or part of its assets; *Merger or Asset Sale Announced*: the target announced a merger or sale of either all or part of its assets (that either was later cancelled or is still pending); *Merger Called Off or Bid Increased*: a merger announced prior to the activist intervention involving the target was either called off or the bid price was increased; *Spinoff Completed or Announced*: the target announced a spinoff of one of its divisions that was either completed or is still pending; *Target Hires IB or Begins Auction*: the target hired an investment banking firm to explore strategic alternatives or began an auction process for either all or part of its assets without any further news of an announced or completed deal; *Shares Repurchased/Special Dividend*: the target announced an intention to repurchase its shares or pay a special dividend; *Greenmail*: the target bought back its shares from the activist; *Removal of Poison Pill*: removal, suspension, amendment or expiration of the target's poison pill; *Resignation of CEO/CFO/Chairman*: the announcement of resignations by the targets CEO and/or CFO and/or Chairman of the Board; *Board Seats Granted to Activist*: activist gains seats on the target's board of directors, either through a proxy contest or deal with the target; *Proxy Defeated*: the activist's proxy fight, either for directors or a shareholder proposal, was defeated at the target's shareholder meeting; *Activist Cuts Position Below 5%*: the activist reduce its stake in the target to below 5% of the shares outstanding thereby ending their 13D filing requirements; *Financing/Bankruptcy Agreement*: the target announces a financing deal, with either the activist and/or a third party as creditor. The financing agreement can pertain to cases where the target is about to enter, is in, or is about to exit bankruptcy. Outcomes apply to news announced no later than 18 months after the initial 13D activist filing. The 18-month abnormal return is the difference between 18-month return of the targets' and the return on the matching portfolio. Each event can have more than one classification; uniquely classified outcomes are in parenthesis. The sample is restricted to initial activist filings.

Outcome	Number (Uniquely Classified)
No News	379 (379)
News:	
Asset Sale Related:	
Merger or Asset Sale Completed	178 (178)
Merger or Asset Sale Announced	48 (25)
Merger Called Off or Bid Increased	12 (8)
Spinoff Completed or Announced	7 (2)
Activist Takes Over Target	7 (0)
Target Hires IB or Begins Auction	14 (5)
Capital Structure (non asset sale related):	
Shares repurchased/Special Div.	23 (9)
Greenmail	4 (3)
Corporate Governance:	
Removal of Poison Pill	15 (10)
Resignation of CEO/CFO/Chairman	25 (5)
Board Seats Granted to Activist	96 (69)
Proxy Defeated	14 (10)
Other:	
Activist Cuts Position Below 5%	35 (31)
Financing/Bankruptcy Agreement	17 (10)

**Table 7. Daily and monthly returns by outcome of activism.** Daily and monthly cumulative abnormal returns for activism targets, grouped according to the outcome. Abnormal returns are the difference between the daily or monthly return and the daily or monthly return on the matching portfolio. Outcomes are defined as follows: *Acquisition Announced/Completed* : the target completed or announced a merger or sale of either all or part of its assets; *No News*: indicates no news of an outcome; *Board or Resignations*: indicates the announcement of resignations by the targets CEO and/or CFO and/or Chairman of the Board and/or the announcement that the activist gains seats on the target’s board of directors, either through a proxy contest or a deal with the target; *“Reduces Stake to <5%”* indicates that the activist reduced its stake in the target to below 5% of the shares outstanding, thereby ending their 13D filing requirements. Outcomes apply to news announced no later than 18 months after the initial 13D activist filing. T-statistics are in brackets.

	Acquisition Announced/Completed (N=226)			Target is not acquired (N=585)										
	All		No News		Board/Resignations		Spinoff		Share Repurchase		Reduces Stake < 5%			
	CAR	[t]	CAR	[t]	CAR	[t]	CAR	[t]	CAR	[t]	CAR	[t]	CAR	[t]
Panel A: Daily Returns														
-10	1.29	[1.7]	-0.56	[-1.7]	-0.23	[-0.6]	-0.78	[-1.0]	0.36	[0.4]	-0.67	[-0.6]	-0.28	[-0.2]
-9	1.12	[1.4]	-0.69	[-1.7]	-0.38	[-0.8]	-1.02	[-1.2]	0.10	[0.1]	-0.15	[-0.1]	-0.36	[-0.2]
-8	1.00	[1.3]	-0.62	[-1.4]	-0.23	[-0.4]	-1.55	[-1.7]	0.56	[0.3]	-0.76	[-0.5]	0.07	[0.0]
-7	1.20	[1.5]	-0.68	[-1.4]	-0.40	[-0.7]	-0.68	[-0.7]	1.34	[0.6]	-2.12	[-1.1]	-0.73	[-0.3]
-6	1.12	[1.3]	-0.60	[-1.2]	-0.39	[-0.6]	-0.35	[-0.3]	2.10	[0.7]	-1.36	[-0.7]	-0.75	[-0.3]
-5	0.87	[1.0]	-0.37	[-0.7]	-0.01	[-0.0]	-0.83	[-0.8]	3.27	[1.0]	-1.54	[-0.7]	-0.55	[-0.2]
-4	1.23	[1.4]	-0.20	[-0.4]	0.10	[0.2]	-1.17	[-0.9]	2.96	[1.0]	-1.13	[-0.5]	1.50	[0.5]
-3	1.69	[1.7]	-0.19	[-0.3]	0.25	[0.4]	-1.48	[-1.1]	3.36	[1.1]	0.17	[0.1]	-0.13	[-0.0]
-2	2.00	[1.9]	-0.10	[-0.2]	0.13	[0.2]	-1.15	[-0.7]	3.73	[1.5]	-0.26	[-0.1]	1.97	[0.5]
-1	2.78	[2.5]	0.34	[0.5]	0.47	[0.6]	-0.32	[-0.2]	5.01	[4.0]	-0.36	[-0.1]	1.63	[0.4]
Filing	4.14	[3.6]	1.41	[2.1]	1.36	[1.8]	0.57	[0.3]	4.50	[2.4]	0.20	[0.1]	4.02	[1.1]
+1	4.75	[4.2]	2.12	[3.1]	2.02	[2.7]	1.24	[0.8]	5.56	[2.8]	0.08	[0.0]	5.56	[1.5]
+2	5.28	[4.7]	2.23	[3.1]	2.39	[3.0]	1.60	[1.0]	6.40	[4.6]	0.05	[0.0]	3.80	[1.0]
+3	5.19	[4.5]	2.23	[2.9]	2.34	[2.8]	1.63	[1.0]	6.07	[4.6]	0.81	[0.3]	4.31	[1.1]
+4	5.55	[4.7]	2.33	[3.1]	2.39	[2.8]	1.51	[0.9]	5.90	[4.3]	1.26	[0.5]	4.91	[1.2]
+5	5.72	[4.9]	2.36	[3.0]	2.51	[2.9]	1.34	[0.8]	6.40	[4.5]	1.36	[0.5]	4.75	[1.2]
Panel B: Monthly Returns														
-1	1.39	[1.3]	-1.69	[-2.9]	-2.25	[-3.4]	-0.67	[-0.6]	-6.52	[-1.1]	3.34	[0.9]	1.35	[0.5]
Filing	7.88	[5.7]	1.78	[1.8]	0.86	[0.8]	4.71	[2.2]	8.76	[2.6]	5.95	[1.0]	-1.32	[-0.4]
+1	8.85	[5.4]	1.81	[1.4]	0.45	[0.3]	5.46	[2.1]	8.29	[1.0]	8.01	[1.0]	-0.59	[-0.1]
+2	10.08	[5.2]	1.41	[1.0]	0.35	[0.2]	5.24	[1.9]	12.26	[1.4]	9.25	[0.9]	-7.69	[-1.1]
+3	13.39	[5.3]	0.25	[0.1]	-1.72	[-0.6]	3.75	[1.2]	12.19	[1.2]	11.32	[0.9]	-7.03	[-0.9]
+4	15.13	[5.8]	-0.44	[-0.2]	-2.32	[-0.7]	1.42	[0.4]	17.41	[2.0]	12.79	[0.9]	-7.36	[-0.8]
+5	15.79	[5.7]	-0.53	[-0.2]	-1.99	[-0.6]	1.07	[0.2]	8.64	[1.5]	19.07	[1.1]	-7.43	[-0.7]
+6	16.84	[6.1]	0.64	[0.3]	-1.15	[-0.4]	-0.57	[-0.1]	12.20	[1.7]	18.53	[1.0]	-3.41	[-0.3]
+7	18.25	[6.0]	0.71	[0.3]	-0.99	[-0.3]	-3.36	[-0.6]	10.11	[1.3]	21.86	[1.1]	-2.68	[-0.2]
+8	19.00	[6.4]	1.06	[0.4]	-1.03	[-0.4]	-2.27	[-0.4]	22.71	[1.5]	25.81	[1.1]	-2.54	[-0.2]
+9	19.13	[6.2]	0.63	[0.2]	-1.32	[-0.4]	-4.38	[-0.7]	21.24	[1.0]	27.18	[1.1]	-3.27	[-0.3]
+10	20.48	[6.7]	0.50	[0.1]	-2.09	[-0.5]	-2.98	[-0.4]	16.84	[0.7]	29.88	[1.1]	-8.50	[-0.6]
+11	21.31	[7.0]	0.78	[0.2]	-2.56	[-0.5]	-2.45	[-0.4]	12.25	[0.5]	30.70	[1.0]	-0.51	[-0.0]
+12	22.40	[6.8]	1.50	[0.4]	-2.63	[-0.5]	-0.93	[-0.1]	8.34	[0.4]	30.50	[0.9]	-1.64	[-0.1]
+18	25.85	[7.9]	2.85	[0.6]	0.00	[0.0]	-5.62	[-0.7]	-3.41	[-0.1]	29.97	[0.8]	-2.83	[-0.2]

**Table 8. Operating Performance Changes Following Activist Filings For Non-Acquired Targets.** This table reports descriptive statistics of changes in accounting measures, from Compustat, between the fiscal year prior to the initial filing of an activist Schedule 13D and the fiscal year following the initial filing.



The accounting variables are constructed as follows: *Capital Expenditures* is capital expenditures (item 128) over lagged net property, plant, and equipment (item 8); *Cash flow* is the sum of earnings before extraordinary items (item 18) and depreciation (item 14) divided by lagged net property, plant, and equipment (item 8); *Dividends/earnings* is the ratio of the sum of common dividends (item 21) and preferred dividends (item 19) over earnings before depreciation, interest, and tax (item 13); *Leverage* is long-term debt (item 9) plus current liabilities (item 34) divided by long-term debt plus current liabilities plus book value of common equity (item 60); *Operating return on assets* is the ratio of operating cash flow (item 308) over lagged total assets (item 6); *Return on assets* is the ratio of EBITDA (item 18) over lagged total assets (item 6); *Scaled Assets* is equal to the assets for a given year (item 6) over assets for the year prior to activism. Thus, scaled assets will equal 1.00 for the year prior to activism and changes in assets can be measured relative to this base; *Scaled Shares* is equal to the shares outstanding for a given year (from Thomson Financial) over shares outstanding for the year prior to activism. All accounting variables are winsorized at the 1% level to reduce the influence of outliers. T-statistics are in brackets.

	All Non-acquired targets		No News		Board/Resignations		Spinoff		Share Repurchase		Reduces Stake < 5%	
	$\Delta_{-1,t}$	[t]	$\Delta_{-1,t}$	[t]	$\Delta_{-1,t}$	[t]	$\Delta_{-1,t}$	[t]	$\Delta_{-1,t}$	[t]	$\Delta_{-1,t}$	[t]
Return on Assets	-0.001	[-0.15]	0.003	[0.25]	0.004	[0.25]	0.055	[1.34]	-0.049	[-0.99]	0.010	[0.43]
Operating ROA	0.010	[0.70]	0.018	[0.87]	-0.011	[-0.79]	-0.162	[-2.12]	0.028	[0.51]	0.031	[0.79]
Cash Flow	0.483	[1.65]	0.807	[1.85]	-0.092	[-0.56]	6.607	[1.42]	-0.274	[-1.27]	0.616	[0.79]
Leverage	0.408	[2.69]	0.350	[2.06]	0.352	[0.92]	-0.456	[-17.32]	0.486	[0.92]	-0.151	[-0.55]
Capital Expenditures	-0.144	[-4.11]	-0.148	[-3.22]	-0.134	[-2.78]	0.181	[1.89]	-0.216	[-2.32]	-0.118	[-1.12]
Dividends/Earnings	0.019	[1.31]	0.006	[0.45]	0.010	[0.21]	0.013	[0.67]	0.055	[1.91]	0.006	[0.44]
$\Delta A/A_{t-1}$	0.079	[0.59]	0.163	[0.81]	-0.053	[-0.92]	-0.055	[-0.14]	-0.025	[-0.26]	-0.043	[-0.54]
$\Delta S/S_{t-1}$	-0.203	[-1.06]	-0.021	[-1.54]	-0.027	[-0.68]	0.054	[1.82]	-0.035	[-0.65]	0.141	[1.61]

**Table 9. Operating performance and long-term performance for firms that are not subsequently acquired.** The accounting variables are constructed as follows: *Capital Expenditures* is capital expenditures (item 128) over lagged net property, plant, and equipment (item 8); *Cash flow* is the sum of earnings before extraordinary items (item 18) and depreciation (item 14) divided by lagged net property, plant, and equipment (item 8); *Dividends/earnings* is the ratio of the sum of common dividends (item 21) and preferred dividends (item 19) over earnings before depreciation, interest, and tax (item 13); *Leverage* is long-term debt (item 9) plus current liabilities (item 34) divided by long-term debt plus current liabilities plus book value of common equity (item 60); *Operating return on assets* is the ratio of operating cash flow (item 308) over lagged total assets (item 6); *Return on assets* is the ratio of EBITDA (item 18) over lagged total assets (item 6); *Scaled Assets* is equal to the assets for a given year (item 6) over assets for the year prior to activism. Thus, scaled assets will equal 1.00 for the year prior to activism and changes in assets can be measured relative to this base; *Scaled Shares* is equal to the shares outstanding for a given year (from Thomson Financial) over shares outstanding for the year prior to activism.

Operating measure:	Low		High		$\Delta$	
	Mean(X)	R	Mean(X)	R	R (High – Low)	[t]
Return on Assets	-0.091	0.028	0.080	0.165	0.137	[1.22]
Operating ROA	-0.096	0.114	0.122	0.074	-0.041	[-0.35]
Cash Flow	-0.974	-0.017	1.797	0.223	0.241	[2.06]
Leverage	-0.668	0.144	1.474	0.050	-0.094	[-0.75]
Capital Expenditures	-0.402	0.098	0.105	0.121	0.023	[0.19]
Dividends/Earnings	-0.115	0.188	0.204	-0.181	-0.369	[-1.61]
$\Delta A/A_{t-1}$	-0.344	0.045	0.479	0.135	0.090	[0.84]
$\Delta S/S_{t-1}$	-0.400	-0.015	0.098	0.188	0.203	[3.03]

**Table 10. Event Chronologies for targets that were subsequently acquired.** We focus on the subset of events in which a merger or takeover was consummated in the 18-months following the initial activism filing. Each event is summarized in four parts (1) the initial steps taken by the activist and potential acquirer, (2) methods used to force a takeover, (3) intermediate results, and (4) the conclusion. In category (4), the percentages sum to 100 percent, as all events must be assigned to a unique subcategory. In categories (1), (2) and (3), firms may be assigned to one or more (or none) of the subcategories.

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	<b>All targets that are subsequently acquired</b>
<b>Initial Steps:</b>	
Activist bid puts target in play	6.9%
Activist makes bid after target already in play	4.6%
Third party bid made after activist involved	42.8%
Third party bid made before activist intervention	58.4%
<b>Methods:</b>	
Board seats	8.1%
Lawsuit	5.2%
Amend takeover agreement/ Get higher offer	20.8%
<b>Intermediate Results:</b>	
Activist increases bid on target	4.6%
Third party increases target bid	18.5%
<b>Outcome:</b>	
Activist buys target	4.6%
Third party buys target	80.9%
Fourth party buys target	14.5%

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**Table 11. Delisting Outcomes for Targets and Other Companies.** The table presents statistics on the delisting of the target companies for all activist filings made between 1994 and 2006, hedge fund activist filings only, other companies in an industry-size and prior return matched sample, targets of non-activist 13D filings excluding those that delisted within two months of the filing, and the universe of all small CRSP stocks. Delisting information is from CRSP. Delisting data for “All Small Stocks” is based on an event date of December 31, 2004 for firms in the CRSP NYSE third size decile or less.

Panel A: Within one-year of initial filing					
	All Activist Events	Hedge Fund Activist Events	Industry-size-Return matched sample	Non-activist 13D filings	All Small Stocks
Still in Sample on CRSP	77.4%	77.1%	89.4%	84.6%	92.6%
Delisted	22.6%	22.8%	10.6%	15.4%	7.4%
<i>Acquired</i>	18.1%	18.6%	7.2%	12.6%	4.7%
<i>Other</i>	4.4%	4.3%	3.5%	2.8%	2.6%
Panel B: Within 18-months of initial filing					
	All Activist Events	Hedge Fund Activist Events	Industry-size-Return matched sample	Non-activist 13D filings	All Small Stocks
Still in Sample on CRSP	72.5%	72.6%	85.7%	80.4%	89.2%
Delisted	27.5%	27.4%	14.3%	19.6%	10.8%
<i>Acquired</i>	21.9%	21.9%	9.1%	16.1%	7.2%
<i>Other</i>	5.5%	5.5%	5.2%	3.4%	3.6%