VIP Research Proposal - Predicting Targets of Activist Investing

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1. Introduction

Activist investing is the act of an institutional investor buying significant stock in a firm (often enough to require filing of a Chapter 13D) and attempting to influence management, through peaceful and/or aggressive means, to make changes to company structure in order to extract higher shareholder value. Brav, Jiang, Partnoy, and Thomas[1] state that activist investing has existed to some extent since the 1980s. Interestingly, hey note that it has been ineffective in generating returns for shareholders in most forms. However, they show that activist hedge fund investing is in fact successful in improving returns for shareholders.

2. Proposal

The paper notes that target firms for activist investing usually follow a few criteria. First, they usually have a low market cap relative to their assets. Secondly, they usually have high levels of institutional ownership. This author proposes that there are likely other signals of a firm that is a target for activist investing. Activist funds may already be aware of and actively monitoring these signals, or the signals may be unutilized and/or unintuitive. For instance, how the management sells or buys shares may give an indication of whether or not a firm is a target

The market usually reacts positively to activist investing, creating abnormal returns.[1] If a model could be constructed that predicts if a firm will be the target of an activist event in the next year, then the author hypothesizes that a trading strategy capitalizing on that could produce outsized returns. This model could also be used by prospective activist institutional investors to identify targets.

3. Models, Signals, Strategy, Etc

An incomplete list of possible signals includes: abnormally high management compensation, high management turnover, management trading large quantities of shares in the company, high employee turnover, low valuation relative to what is normal in the sector, etc. There are many possible signals that could indicate that a firm is a good target for activist investing.

The model would likely use some form of probit modelling, as the dependent variable is binary (firm will be a target or firm will not be a target). Thus, the model will use some form of regression. The exact specifications of such a model need further investigations as the requirements of the model become better understood.

The average position of a hedge fund in a target is approximately 20 months[1]. This suggests that it usually takes about 20 months for a fund to extract what it considers to be maximum value from its investment, which implies that any strategy will be a long term commitment. Ultimately, it is the author's belief that the model is a worthwhile pursuit that can provide benefits to academics, institutional, and retail investors alike.

References

[1] ALON BRAV, WEI JIANG, FRANK PARTNOY, and RANDALL THOMAS. Hedge fund activism, corporate governance, and firm performance. *The Journal of Finance*, 63(4):1729–1775, 2008.