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WHEN SHAREHOLDER ACTIVISM GOES TOO FAR

BY JAMES SUROWIECKI

With the hedge-fund manager Bill Ackman having resigned from J. C. Penney's board of directors on Tuesday, we can now declare the end of his extraordinarily unsuccessful attempt to reinvent Penney. It was months in the making: Penney's board fired Ackman's handpicked C.E.O., the former Apple retail head Ron Johnson, back in April. But Ackman, who still owns more than seventeen per cent of the company, had stayed on the board after Johnson's departure, and still seemed to harbor hopes of remaking the company. The debacle at Penney (http://www.newyorker.com/online/blogs/newsdesk/2013/08/jc-penneys-martha-stewart-mistake.html) is now prompting people to look more skeptically at Ackman, who manages Pershing Square Capital, and that's fitting. But it should also make us skeptical, in general, of one of the more dubious trends in today's market: money managers who also fancy themselves corporate visionaries.

Shareholder activism on the part of hedge funds has, over the past decade, played an increasingly important, and high-profile, role in the market, with money managers like Ackman, Daniel Loeb, of Third Point, and Carl Icahn taking sizeable (though usually minority) stakes in undervalued or struggling companies and then agitating for change. That change-seeking has typically focussed on management—replacing C.E.O.s or board members—or on what's usually called "financial engineering": pushing companies to buy back shares, raise dividends, sell off underperforming divisions, and so on. And this approach seems to have been, on the whole, pretty successful: one comprehensive 2008 study of hundreds of activist campaigns between 2001 and 2006, for instance, found that companies targeted by activists didn't just see their stock prices outperform forecasts but also saw their profitability and operating performance improve.

What Ackman did at Penney, though, was much more dramatic than most activist efforts. Instead of simply focussing on financial engineering, he set out to remake the entire business, giving it a new strategic direction, revamping its stores, and changing its customer base. Ackman's vision for the company, as laid out in a presentation he gave at Ira Sohn's Value Investing conference in May, 2012, required what he termed "an extreme makeover." Some specifics of the turnaround effort may have been devised by Johnson once he took over as C.E.O., but the push for a wholesale transformation was Ackman's from the start. (That 2012 presentation was tellingly titled "Think Big.")

That turnaround effort was ill-conceived in myriad ways (which I wrote about in *The New Yorker* earlier this year (http://www.newyorker.com/talk/financial/2013/03/25/130325ta_talk_surowiecki)). But what was most ill-conceived about it was Ackman's fundamental premise—namely, that he knew what it took to run, let alone turn around, a major retailer. Ackman, after all, had no hands-on experience in retail management, and his two previous attempts at investing in and trying to change retailers (at Target and Borders) had both ended disastrously. Yet he still took it upon himself to save Penney. The surprising thing is not that he failed. It's that he was so sure he could succeed. The same can be said of Eddie Lampert, the fabled hedge-fund manager who bought Sears and Kmart and who, far from unlocking value at these companies, has instead run them into the ground. Lampert is now the C.E.O. of Sears Holdings (which owns both Sears and Kmart), and, as a recent *Bloomberg Businessweek* story detailed (http://www.businessweek.com/articles/2013-07-11/at-sears-eddie-lamperts-warring-divisions-model-adds-to-the-troubles), he's created a culture of "warring tribes," in which business units are forced to compete against one another for resources, often at the expense of the over-all brands. Plunging sales at Sears suggest that while Lampert may have interesting theories about management practices, he doesn't have much of a clue about how to get customers into stores. Ackman and Lampert's attempts to transform these venerable American retailers were farther-reaching than most shareholder activism. It's not a coincidence that they were also more catastrophic. It's natural that as shareholder activists have become more powerful, they've also become more ambitious in their plans—witness Loeb's recent attempt to get Sony to sell off its entire entertainment division. But those are ambitions that money managers would be smart to resist.

Critics often attack the small-bore management and financial changes that activists have typically pushed, saying that they encourage companies to focus too much on the short term. But the truth is that these changes often target real problems at corporations: owning lots of different businesses that have nothing to do with one another, empire-building by C.E.O.s, unnecessarily large cash hoards. More important, the solutions to these problems are often easy to identify and implement: focus on core competencies, tie C.E.O. pay to clear performance metrics, distribute money to shareholders. That makes it easy for money managers to recognize these problems and come up with sensible solutions for them, without having a deep understanding of a business.

The restructuring efforts that Ackman and Lampert have tried to pull off, by contrast, demand a kind of industry- or company-specific knowledge, and experience, that most money managers just don't have. That's why the 2008 study found that hedge funds tended to target "issues that are generalizable to all firms … rather than issues that are specific to one" company, and that this was sensible because many hedge funds "are not experts in the specific business of their target firms." There are, to be sure, a few hedge funds that seem able to effect meaningful improvements in the operations of the companies they target—the best known is Nelson Peltz's Trian Fund—but they're rare.

In most cases, money managers would do better by sticking to what they know best—finding undervalued companies—and to traditional forms of activism. Even Loeb's recent success at Yahoo, whose stock has risen sharply over the past year, had more to do with pursuing conventional activist strategies (bringing in a new C.E.O. and pushing for aggressive share buybacks) than with seeking a total revamp of Yahoo's business.

What Ackman's ill-fated experiment at Penney really demonstrates are the perils of overreaching. Ackman's record as an investor was (and in fact still is) solid. But that says nothing about his ability to help reinvent a company. And the fantasy that money managers can also be strategic visionaries profoundly undervalues the importance of experience and knowledge related to a particular business.

If hedge-fund managers are looking for a model, they might look to Warren Buffett, who runs Berkshire Hathaway by letting the C.E.O.s of the companies Berkshire owns focus on strategy and operations, while Buffett focusses on his true strength, allocating capital. As Harry Callahan says (http://www.youtube.com/watch?v=_VrFV5r8cs0) at the end of "Magnum Force," the 1973 Clint Eastwood cop movie, "A man's gotta know his limitations." Investors in Pershing Square Capital should hope that the Penney disaster has taught Bill Ackman his.

Photograph by Scott Eells/Bloomberg/Getty.

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