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Corporate governance the focus for a new type of activist investor

Traditional activists were essentially value investors, but that profile might be changing

Carl Icahn has long championed the interests of shareholders. Yet even many who had watched him for years were surprised by the vehemence of his Wall Street Journal Op-ed after withdrawing from the shareholder vote on Dell's leveraged buyout. "Is it fair that CEOs make 700 times what the average worker makes, even if the chief executive is doing a terrible job and thousands of workers are laid off?" Icahn asked. "Why do CEOs get awarded huge bonuses by friendly boards when the share prices are down by double digits and then get their options reset to lower levels as an 'incentive'?"

Icahn undoubtedly struck a chord. The phrase 'divine right of boards' was on quite a few people's lips after that editorial, and nearly a hundred thousand people took Icahn up on his offer to share his musings on shareholder rights with them via Twitter. On October 24, Icahn launched a new website, The Shareholder's Square Table, hosting articles about the evils of poison pills and golden parachutes.

Whatever your opinion of Icahn, today's activists are clearly not the corporate raiders of 1980's legend. For a start, they tend to leave companies in good shape, even after exiting their investments. Moreover, some, although not all activists, now see corporate governance as a key part of their investment process.

For a start, more institutional shareholders and pension funds like Change to Win Investment Trust, CalPERS, CALSTRS and in the UK, M&G Investments are turning to activism. These investors often target companies with pre-planned campaigns or objectives. Change to Win targets companies with poor Say on Pay results, for instance, while CalSTRS successfully prevailed on 77 companies to adopt majority voting rules during its busy 2013 proxy season.

The more traditional activist, who is essentially a value investor and is therefore more likely to focus on share buybacks or arbitrage, has a lot to learn from these reformist funds. Indeed, Relational Investors LLC and CalSTRS recently put their heads together and came up with a full plan for Timken Corp, which involved the company spinning off its steel business. In a public letter, the two noted that the “family-dominated board chooses to perpetuate a business structure that apparently only serves their interests.”

Ask an activist of this second type what he thinks of corporate governance, and you tend to find him reflective. Engaged Capital’s Glenn Welling says that every one of his investments begins with a deep look at the company’s corporate governance profile. This includes how individual directors performed in re-election votes and how the company as a whole performed in ‘Say on Pay’ votes – the non-binding shareholder referenda on executive remuneration. If even half the activists who set about removing directors and gaining board representation have a corporate governance angle to their campaigns, the correlation between poor governance standards and activism may indeed be significant. Activist Insight research suggests around 40% of activist objectives involve board personnel changes.

Governance for Owners CEO Stephen Cohen says that bad corporate governance can often be the root of bad capital allocation policies, but that best practice doesn’t always lead to boards making good decisions. That requires frank discussions. Describing his thorough investment and research process, Cohen says “All kinds of things can add value. Sometimes, creating new incentives by changing remuneration can change the dynamic. Removing a poison pill can focus the mind wonderfully.”

However, there is a paradox in that issues such as poison pills, remuneration and classified boards appear neither to take up a great deal of activists’ time, nor be part of a fixed formula. For instance, Jason Ader, Co-CEO of the new activist fund, Owl Spring Asset Management, says that he approaches the issue of whether to separate Chairman and CEO roles on a case by case basis.

Nonetheless, just because corporate governance is understood in many different ways, activists should not necessarily be written off. More time needs to be spent understanding how they operate and explaining that modus operandi. A greater focus on shareholder best practice would further rehabilitate activists and give them a means of gaining influence with company secretaries and proxy advisors. More importantly, it could add value without hostile proxy fights. Activist Insight data shows that when activists lobby for the removal of plurality voting or poison pills, the results are impressive, with average annualized returns of 81 and 62% respectively over the last few years. As activism becomes more widespread, we may not get closer to the definition of perfect governance, but there will certainly be a healthier debate.

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Activist Insight was founded in 2012 by Nick Arnott and Kerry Pogue. The company provides the most comprehensive global information source on activist investment. This includes live alerts on activist investments, over 200 detailed activist manager profiles, over 2,000 relevant company profiles, unique stats on activist campaigns and proxy battles, and much more. A free monthly newsletter subscription is available on request.

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