European Corporate Governance Institute (ECGI)
ECGI Finance Working Paper No. 138

London Business School
Finance Working Paper Series Number – FIN 462

Returns to Shareholder Activism

Evidence from a Clinical Study of the Hermes U.K. Focus Fund

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We acknowledge financial support from the London Business School's Centre for Corporate Governance, the European Corporate Governance Training Network under European Commission contract number MRTN-CT-2004-504799 and from the ESRC under contract number R060230004.

We are grateful to Hermes for having made data on their U.K. Focus Fund available on an arm's length basis and to current and former Hermes staff for their patience and support: Steve Brown, Tim Bush, Peter Butler, Michelle Edkins, David Pitt-Watson, Fatima Shaikh, Mike Weston and in particular Leon Kamhi. We are grateful to the London Business School's Centre for Corporate Governance for providing access to Factiva, Datastream, the London Share Price Database, and the LBS annual reports collection. We are also grateful to Sarah Wilson and Tim Clarke at Manifest for data on shareholder proposals and to Bureau van Dijk Electronic Publishers for giving us access to their OSIRIS database. We would also like to thank the following for helpful comments: Lucian Bebchuk, Patrick Bolton, Brian Cheffins, Paul Coombes, Xavier Gabaix, Oliver Hart, Andrew Metrick, Randall Morck, Rafael Repullo, Jeremy Stein, Raman Uppal, Paolo Volpin, Michael Weisbach, Ivo Welch, Lucy White, an anonymous referee, and seminar participants at the NBER Corporate Governance Meetings, London Business School, Harvard Business School, INSEAD, IUI Stockholm, Norwegian School of Management, SIFR, SNS, Stockholm School of Economics, Tilburg University, University of Amsterdam, University of Rotterdam, The Berne University Conference on Family Business, and the Vanderbilt University Law and Business Conference on Investor Activism. Leonardo Cordeiro provided excellent research assistance.

Abstract

This article reports a unique analysis of private engagements by an activist fund. It is based on data made available to us by Hermes, the fund manager owned by the British Telecom Pension Scheme, on engagements with management in companies targeted by its U.K. Focus Fund (HUKFF). In contrast with most previous studies of activism, we report that the fund executes shareholder activism predominantly through private interventions that would be unobservable in studies purely relying on public information. The fund substantially outperforms benchmarks and we estimate that abnormal returns are largely associated with engagements rather than stock picking. We categorize the engagements and measure their impact on the returns of target companies and the fund. We find that Hermes frequently seeks and achieves significant changes in the company's strategy including refocusing on the core business and returning cash to shareholders, and changes in the executive management including the replacement of the CEO or chairman.

Keywords: Shareholder activism, institutional investors, real authority

JEL Classifications: G32

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Shareholder activism by institutional investors is controversial.[1] To some, activism holds the promise of resolving monitoring and incentive problems in widely-held companies, thereby improving corporate performance [Black (1992)]. To others, shareholder activists lack the skills and the experience to second guess the target firm's management [Lipton and Rosenblum (1991)], with fund managers replacing corporate managers in the pursuit of private benefits and their own agenda [Romano (1993)]. As a result, activism is often described as disruptive, opportunistic, misguided, and at best as ineffective. For example, Black (1998) declares, "A small number of American institutional investors, mostly public pension plans, spend a trivial amount of money on overt activism efforts. …. Institutions achieve the effects on firm performance that one might expect from this level of effort – namely, not much."

Current empirical evidence, summarized in surveys by Black (1998), Gillan and Starks (1998), and Karpoff (2001), finds that U.S. institutional investors on the whole engage in little activism and even when they do, there is little or no link between activism and performance. The much celebrated "CalPERS effect" associated with the fund's own activism program [Nesbitt (1994); Smith (1996); and Anson, White and Ho (2004)] is reported to be very small or non-existent [English, Smythe, and McNeil (2004)]. The same holds for activism by other public pension funds [Del Guercio and Hawkins (1999)], the Council of Institutional Investors [Opler and Sokobin (1995)] and the United Shareholders Association [Strickland, Wiles, and Zenner (1996)]. Karpoff (2001) concludes, "Most evidence indicates that shareholder activism [in the United States] can

[1] Shareholder activism refers to a range of actions taken by shareholders to influence corporate management and boards. Actions range from threatening the sale of shares ("exit"), letter writing, meetings with management and board, to asking questions at shareholder meetings and the use of corporate voting rights. Under a common definition, an activist shareholder is a shareholder "who tries to change the status quo through 'voice,' without a change in control of the firm," [Gillan and Starks (1998)].

prompt small changes in target firms' governance structures, but has negligible impact on share values and earnings."

These repeated failures to link activism to performance are often blamed on three elements: inadequate monitoring due to free riding, legal and institutional obstacles to activism, and incentive problems amongst institutional investors in the United States. With respect to the first, fund managers often hold relatively small stakes in listed companies, particularly in the case of diversified index funds. Pension fund trustees and fund managers will not spend sufficient resources on shareholder activism, because there is no market mechanism for internalizing the benefits of activism; the benefits accrue to all shareholders, also those who did not bear the cost of activism.

Secondly, the major U.S. institutional investors are said to face conflicts of interest [Black (1998); and Romano (2000)]. For example, the fund managers of mutual funds hold stakes in companies where they also have a pension fund mandate, which might be at risk if they were to engage. Also, company pension funds are not run independently of corporate management, while union pension funds are sometimes instruments of the struggle between organized labor and management. Public pension funds are under the influence of politicians, who are elected by constituencies whose interests are not identical to those of the pension fund beneficiaries.

Thirdly, the U.S. legal and regulatory system limits the anti-director rights of shareholders. Black (1990, P. 532531) notes that "[..] legal obstacles are especially great for shareholder efforts to nominate and elect directors, even for a minority of board seats." As a result, activism in the U.S. is often confined to public "naming and shaming" via focus lists and filing non-binding shareholder proposals in proxy statements. Highly regulated private intervention is mild and usually takes the form of letter writing [Carleton, Nelson, and Weisbach (1998)]. In contrast, Black and Coffee (1994) argue that the U.K. is an ideal institutional setting for shareholder activism, because it provides more legal tools than the U.S. to institutional investors [see also Bebchuk (2005)]. We describe the institutional differences between the U.K. and the U.S. with respect to shareholder activism in more detail in Section 1.1.

This paper studies an experiment initiated by the trustees of one U.K. pension fund, the Hermes U.K. Focus Fund (HUKFF), to overcome free riding problems in an institutional environment that is particularly friendly to activist shareholders. The investment correspondent of the *Financial Times* has characterized the HUKFF as a "mix of traditional investor, private equity firm and hedge fund," [Tucker (2005)].[2]

The HUKFF increases the stakes in companies that Hermes is already invested in through its index tracker fund; thereby the HUKFF partially internalizes the benefits of its activism. The paper studies targeted, high-intensity shareholder activism over the period 1998-2004 by the HUKFF, and takes advantage of unprecedented access to the entire records of the fund's activity from its inception. As a result, we were able to construct a private and comprehensive dataset of the fund's letters, memos, minutes, presentations, transcripts and recordings of telephone conversations, and client reports. To our knowledge, this is the first such database.[3] The HUKFF has been very successful

[2] The recent U.S. literature has stressed the difference between traditional shareholder activism and hedge fund activism. Kahan and Rock (2006) argue that hedge funds are very promising activists because they face fewer regulatory barriers, political constraints, and conflicts of interest than traditional investors. Partnoy and Thomas (2006) argue that hedge fund activists have more radical objectives than traditional activists (e.g., board changes and restructuring). The HUKFF has more in common with this "new" U.S. hedge fund activism than with traditional institutional investor activism.
[3] Carleton, Nelson, and Weisbach (1998) examine the correspondence between TIAA-CREF and their target firms to study the negotiation process in connection with the filing of proxy statements. In addition to the correspondence with target firms, our approach allows us to identify all the internal organization

in generating returns for its investors, measured by both annual raw returns net of fees of 8.2%, and abnormal returns net of fees of 4.9% a year against the FTSE All-Share Index over the period 1998-2004. We estimate that around 90% of such fund returns areis due to activist outcomes.

To estimate the contribution of activism to performance, we develop a novel methodology for understanding and documenting the characteristics of shareholder activism, link them to the target companies' performance, and ultimately to the fund's returns. We begin by reporting the stated objectives of Hermes interventions under the headings of board changes (both executive and non-executive directors), financial goals of selling unfocused businesses and unprofitable assets, restricting capital expenditure, increasing payouts, and changing capital structure. We then classify the interventions under the headings of engagement with management, engagement with other shareholders, public meetings, and other public interventions. We then address concerns about a potential selection bias in our sample, namely that Hermes invests in underperforming companies that intended to restructure even in the absence of shareholder engagement. Based upon target companies' responses to activism by Hermes, we classify these interventions as collaborative or confrontational or a mixture of the two. Restructuring might have occurred in collaborative engagements event absent Hermes engagements. In contrast, it is unlikely that management would have initiated restructuring it opposed in mixed and confrontational engagements. Using different categories of engagement objectives and the degree of hostility, we relate outcomes to measured abnormal returns to shareholders through an event study. Thus, we attribute an

processes of a shareholder activist fund, from initial research into potential targets to investment objectives and outcomes, allowing us to estimate precisely the connections between activist's actions and policies and stock returns.

outcome to Hermes' engagement if and only if two conditions are met. First the outcome must be listed as an objective prior to investing, and second, such an objective has to be specifically mentioned as such in private communications with the target management.

We record very different results from those previously reported. We find that shareholder activism is predominantly executed through private interventions as opposed to shareholder proposals at a company's annual meeting, or filings of proxy statements. HUKFF invested in 41 companies, and engaged with 30 of them. These engagements involved numerous meetings and telephone calls with chairmen, CEOs, and CFOs. In more than half of the cases, HUKFF also engaged with other executives, such as divisional managers, heads of investor relations, and with non-executive board members. HUKFF also privately contacted other institutional shareholders, with a view to communicating its engagement objectives and soliciting support for its activities. Strikingly, engagement rarely took a public form. From the cases we have seen, we believe that this in part reflects the potent threat of the Fund to requisition an extraordinary shareholders' meeting (EGM), alone or with others.[4]

What were the engagements objectives that gave rise to these events? We find that HUKFF's engagement objectives seek to bring about substantial changes in the governance structure of target companies. In 28 out of 30 engagement cases, HUKFF aims at a substantial restructuring of the operations of diversified firms in order to provide more focus (e.g., by selling non-core divisions and assets, and by limiting diversifying investments and acquisitions). In more than half of the cases, HUKFF

[4] From conversations with the fund's managing partners and our reading of letters and meeting notes, "soft" factors that are hard to measure might also play a role. These include a general desire of directors to "do the right thing for the company" or deadlocks (e.g., a CEO who needs to overcome opposition to a restructuring plan from the chairman, or vice-versa).

explicitly aims at replacing the CEO or the chairman, with a view to appointing new executives who are more willing to implement the required business restructuring of the target firm. Finally, in more than half of the cases, HUKFF seeks an increased cash payout to shareholders, which are often related to proposed divestment policies.

One of the most important objectives of the paper is to determine if these engagement objectives are ultimately value increasing. We find that when the fund's engagement objectives are achieved, there are economically large and statistically significant positive abnormal returns around the announcement date of the change. When events with confounding information, such as earnings announcements or profit warnings are excluded, the mean abnormal returns are 5.30% in the seven-day event window around the announcement date (median 3.69%). Importantly, the largest returns stem from mixed and confrontational engagements as opposed to collaborative.

The largest mean excess return, 6.6%, is associated with restructuring activities, including sales of assets and divisions. Changes of CEOs and chairmen give rise to large and positive excess returns of 6.0%, often in connection with prospective restructurings.[5] Further analysis of the company's restructuring shows that the size of assets and the number of employees are substantially lower post-Hermes intervention, and the return on assets is higher two years after the exit of HUKFF. However, the latter results are only based on two-thirds of the sample because some interventions are so recent that insufficient time has elapsed for post-intervention performance to be observable.

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[5] For example, when Company AAA announced the appointment of a new chairman, the *Financial Times* wrote: "Mr X's appointment was welcomed in the City providing the first sharp upward movement in the group's shares in months. Yesterday AAA shares closed up almost 19 per cent at 57p. Current and former colleagues said he would not run away from making the difficult decisions required at AAA." (New Chief fuels recovery hopes, *Financial Times*, 2003). Note: Names omitted. This example illustrates that the market associates the change of the chairman with the prospect of significant restructuring activities, and that this translates into large and positive announcement returns.

The question arises whether the changes in the target companies would have occurred in the absence of shareholder activism by the HUKFF. Three recent U.K. papers provide a measure of excess returns from restructuring and from board turnover. Dedman and Lin (2002) study CEO departures over the period 1990 to 1995, Menon, Balachandran, Faff, and Love (2004) study voluntary sell-offs over the period 2000 to 2002, and Dimopoulos (2006) examines the excess returns around the announcement of board changes of underperforming companies, including CEO and chairman. The first two studies find zero or slightly negative announcement returns, while the third finds negative and significant returns, after adjusting for confounding events. Although these samples might not represent ideal control groups, they suggest that the returns to activism in our sample would not have accrued from a passive buy-and-hold investment strategy.

We therefore find very different results from previous studies in three respects: (1) there is a large amount of active engagement, especially in private; (2) these engagements have a substantial effect on corporate activities; and (3) the returns to activism are economically large and statistically significant. There are a number of important qualifications to our results. First, they are for one fund only, and we cannot generalize to other shareholder activist funds in the U.K. or in other countries.. Second, we provide evidence that the fund's trading activity gives rise to a risk profile that is significantly changing over time, both in the systematic and in the idiosyncratic component. This may raise the issue of appropriate benchmarks for calculating abnormal returns. Third, in our event study of outcomes, the abnormal returns might have been larger if the market had not anticipated the events prior to our window. These arguments imply that our methodology may actually *underestimate* the true impact of activism on stock returns. Finally, we are not in a position to compare the welfare costs of shareholder activism vis-à-vis other governance mechanisms. It could very well be the case that, for example, takeovers or electing large shareholder representatives to the board are less costly from the perspective of the various corporate constituencies. Equally, we do not provide evidence on the impact of shareholder activism on other corporate constituencies like creditors or employees.

In contemporaneous work, Brav, Jiang, Partnoy, and Thomas (2006), Klein and Zur (2006), and Boyson and Mooradian (2007) study U.S. hedge fund activism using publicly available information. They find large positive abnormal stock returns to target firms when hedge funds first disclose holdings larger than 5% in their 13D filings.[6] There are three main differences between these papers and the present article. First, unlike them we have full access to the private information on the fund's activism. Second, we have full information on stakes below the U.K. disclosure threshold of 3%. One striking implication of such differences is that reliance on public information alone in our sample would have excluded at least 12 out of 30 engagement cases.[7] Third, we have full access to the fund's trades and asset values, and as a result we can compute the fund's returns to activist outcomes, not simply the total fund return reported to the fund's investors.

In Section 1 we describe the data, in Section 2 the results, and Section 3 concludes.

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[6] We also study the stock market reaction to the first disclosure of Hermes' stakes, but we find small, negative, and insignificant abnormal returns. One likely explanation is that disclosure is often done by the BT pension fund for the total holdings of all its funds, so that it is not easy to figure out that the HUKFF has invested.

[7] There are only three block disclosures that were explicitly linked to HUKFF engagements in the press.

1. Description of the Legal Environment, the Fund, and the Dataset

1.1 The U.K. and U.S. legal environments for shareholder activism

Bebchuk (2005) compares the principal legal differences in four sets of shareholder rights: (1) rights relating to changes in basic governance arrangements; (2) director removal rights; (3) direct shareholder involvement in hostile bids; and (4) the speed of shareholder action.

A fundamental difference between the U.K. and U.S. law is the ability of U.K. shareholders to initiate a change in the basic contract by shareholder vote. Under U.K. company law, it is mandatory that shareholders can change the articles and memorandum. Under U.S. state law, it is mandatory that the shareholder cannot initiate a change to the company charter [Bebchuk (2005)]. As a consequence, it is not possible for U.S. shareholders to change the original charter without board approval; in the U.K., shareholders can always change the basic contract without the agreement of the board.

A second difference is the power of U.K. shareholders to remove directors, which is related to the way shareholder meetings are called and voting is conducted (Table 1). At annual general meetings, the statutory rule in the U.K. is cumulative majority voting, meaning that each and every director must receive a majority of the "yes" votes cast to be elected (excluding abstentions). A director coming up for [re]election might be removed from the board without an alternative director being proposed or appointed. In the U.S., where state law rather than federal law applies, the default rule in Delaware is plurality voting, meaning that in board elections the candidate receiving the highest number of votes wins. Thus a candidate does not need the majority of votes cast to be elected, as in the U.K., nor is it possible to cast votes against candidates; institutional investors can only register their disapproval by abstaining or voting for another candidate.[8] The U.S. legislation on voting is therefore more favorable to incumbent management [Bebchuk (2007)].

[Table 1 about here]

In addition in the U.K., shareholders can call extraordinary general meetings with 10% or more of the voting share capital, and put forward propositions to remove any and all directors at any time during their term. If more than 50% of the votes cast are in favor of such a resolution, then the director(s) is required to resign. Staggered boards do not constrain shareholders' ability to dismiss a director.[9] In Delaware, unless there are specific provisions in corporate charters, shareholders cannot call extraordinary meetings and therefore removing directors becomes much more difficult, particularly where there are staggered boards.[10]

These legal differences are also discussed by practitioners. For example, Bob Monks, the U.S. shareholder activist who was instrumental in setting up the HUKFF said,

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[8] In addition to plurality voting, the New York Stock Exchange listing rules contain a provision that results in shares held by brokers but no voting instructions being cast for the management on proposals classified as routine. There is evidence that these "broker votes" matter for voting outcomes and that management actively seeks to influence the classification [Bethel and Gillan (2002)]. The New York Stock Exchange has published a special report on broker votes [NYSE (2006)] but postponed a final decision to a later date [Global Proxy Watch (2006, Vol. X No 33)].

[9] The combination of U.K. company law with the City Takeover Code makes it much easier for activists to launch a hostile takeover bid than the combination of U.S. state law and federal securities regulation. Under the U.K. City Code, target boards may not initiate an action that might frustrate a bid and the whole purpose is to ensure the bid is put to a shareholder vote as quickly as possible. Under U.S. state law, an active board runs the takeover process, subject to judicial review. In the U.S., boards can adopt poison pills without shareholder approval; in the U.K. they cannot. In the U.S., the combination of poison pills with staggered boards is a powerful deterrent to unsolicited takeover bids [Bebchuk, Coates, and Subramanian (2002)]. As discussed earlier, staggering of terms in the U.K. would not constrain hostile takeovers.

[10] Kraakman et al. (2004, p. 37) conclude that in the U.K. unlike the U.S., company law "gives the shareholder majority a strong non-waivable right to remove directors without cause" mid-term between annual general meetings.

"I fully acknowledge that the U.S. is in a far worse state than the U.K. ... The U.K. market benefits [..] from a clause in the Companies Act, stating that 10 per cent of shareholders can requisition a meeting to dislodge any or all of the directors of a company at any time," [Monks (2005)]. Because of this, when in the U.K. activists write letters to the management of under-performing companies, the recipients are aware of the tools at the investors' disposal for changing management. Moreover, institutions are well organized in the U.K. and frequently act collectively through, for example, the Association of British Insurers (ABI) and the National Association of Pension Funds (NAPF).[11] The largest institutional investors also have specialized employees and/or departments who maintain a direct relationship ("core engagement") with the boards of the companies in their portfolios.[12]

1.2 The Hermes U.K. Focus Fund

We study the Hermes U.K. Focus Fund that is part of the Hermes Group, an investment management group owned by the British Telecommunication Staff Superannuation Scheme.[13] Hermes manages the assets of the BT Scheme and the Post Office Staff Superannuation Scheme, two of the largest four pension funds in the U.K. In addition,

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[11] The Institutional Shareholders' Committee, the association of the four U.K. institutional shareholder associations, has issued a statement of principle on institutional activism.

[12] The "core engagement" programs typically seek to ensure compliance with the U.K.'s Combined Code and the funds' own corporate governance and other principles (e.g., its executive remuneration policies). Core engagement also acts as an early warning system that can trigger higher intensity engagement, often in collaboration with other institutions. There is little available evidence on core engagement. Faccio and Lasfer (2002) examine occupational pension funds. They conclude that "the value added of these [pension] funds is negligible and their holdings do not lead companies to comply with the Code of Best Practice or outperform their industry counterparts. Overall, our results suggest that occupational pension funds are not effective monitors."

[13] Since the establishment of the HUKFF in 1998 as the first experiment of shareholder activism in the U.K., one of the authors tried to convince the Hermes' staff to grant us access to their internal records. When they finally did grant us such access in 2004, they were certainly aware of their fund's performance, but they had not devised, or even attempted, a methodology to link their fund's performance to shareholder activism—as opposed to other determinants, such as stock picking.

since 1997 Hermes has been offering management services to third party clients. As of 2005, Hermes has £61 billion under management.[14]

The Hermes asset split is heavily geared to equities, with 64% of total assets held in U.K. and other equities at the end of 2005. A large fraction of the U.K. equity is invested in index tracking funds, 28.5% of total assets versus 5.3% that were actively managed. It follows that the Hermes index fund alone represents approximately 1% of the total U.K. market capitalization.[15]

The HUKFF was created as a response to the problem of free-riding in institutional activism as perceived by the BT pension fund trustees. The trustees felt that the cost of higher-intensity activism could not be sufficiently internalized through core engagement, and it was therefore necessary to overweight the Fund's position in underperforming stocks that were to be engaged more intensively.[16]

The first HUKFF was established on September 30, 1998, as a joint venture with Lens Focus Management LLP (LENS) of the U.S.[17] In addition to the BT Pension Scheme and LENS, there are several other investors, including several U.K. local authority (public) pension funds, another company pension fund, a Canadian public pension fund, and a Japanese life insurance company.[18] The composition of the HUKFF's investor base improves its independence from the sponsoring company of its main

[14] http://www.hermes.co.uk/about/investment_style.htm consulted on March 14, 2006.
[15] According to the London Stock Exchange December Factsheet, the total market capitalisation was £1,781.4 on December 30, 2005.
[16] Statement of A. Ross-Goobey at a *Journal of Applied Corporate Finance* roundtable, LBS, February 9, 2006.
[17] The LENS fund was founded in 1991 by veteran shareholder activists Robert A.G. Monks and Nell Minow.
[18] In practice, the HUKFF today consists of three separate funds that have been set up as limited partnerships. For legal reasons, the maximum number of partners (investors) each fund could accommodate was 20. This legal requirement has recently changed. The partnerships are managed jointly and each partnership holds an equal amount of shares in each target company, so for practical purposes they act as and we refer to them as a single fund.

investor. In addition, there was a shareholder agreement between Hermes and LENS that ensured the independence of decision making relating to investments and engagements in the Fund vis-à-vis the Hermes Group management. The agreement included the appointment of directors independent from the Hermes Group and the executives of the HUKFF.[19]

The HUKFF gives high-power incentives to its managing directors and other fund staff. These funds are established as partnerships, where the senior managers are special partners in the fund, receiving a share in the total payout. They also have a shadow equity stake in the fund management company. In addition, managing directors and other key fund staff are on bonus schemes. Hence the remuneration of the fund staff is tied directly and substantially to the cumulative outperformance of the HUKFF. The incentive scheme could reward executives with seven-figure bonuses in years when performance is good.[20].

1.3 The HUKFF activism approach

The HUKFF applies a triple investment criterion, asking whether the company is under-performing, if the fund believes it can engage the company successfully, and whether the fund expects to obtain at least 20% more value over current share price. Only if the

[19] When LENS sold its 25% stake in the management company to the Hermes Group, the shareholder agreement was replaced by a Memorandum of Understanding between the board of the new Hermes Focus Asset Management Limited, the manager of the HUKFF, and the Hermes Group, designed to ensure the continued independent decision making of the fund. Bob Monks and the other independent directors continued to serve on the HUKFF board.

[20] "The complex pay packages comprised a relatively low base salary […], benefits, an annual bonus triggered by better performance, payments from a long-term incentive plan and a share of profits under a 'carried interest' plan," [Tucker (2005)].

answer is a triple “yes” does the fund invest with a view to bringing about governance changes.[21]

Once the fund is invested, it begins the engagement process by presenting the changes it seeks to the target management and/or board. Depending on the reaction of the target, three stylized engagement scenarios evolve. In the event the target reacts positively by accommodating the fund’s requests, the fund monitors the implementation of the changes, awaits the changes to be released to the market, so that the market re-evaluates the target’s shares and the fund can realize a gain and exit.[22] If the target reacts negatively, the engagement may become confrontational and a range of actions are taken to press changes on the company. We report the frequency and nature of these actions below. Finally, if the company adopts a neutral attitude, discussions continue and the nature of the engagement turns either positive or negative.

1.4 Data collection

The HUKFF provided full access to amounts invested, net-asset values and fees, and all internal and external documents including letters, memos, minutes, presentations, transcripts/recordings of telephone conversations, and client reports.[23] Fund staff coded additional information from agendas, personal notes, and memory. External data collected includes stock prices from Datastream and the London Stock Price Database

[21] Bethel and Gillan (2007) conduct a clinical study of the Relational Investor Fund, a fund that engages U.S. companies, and has a partnership agreement with the HUKFF, as well as a similar investment strategy. Dyck, Volchkova, and Zingales (2006) conduct a clinical study of the Hermitage Fund that engages Russian companies through the press and the pressure of public opinion.

[22] Note that the Hermes index tracker fund stays invested.

[23] Data access was provided on an arm’s length basis and subject to a confidentiality agreement. The agreement gave HUKFF the right to read and comment on drafts of this paper prior to publication and obliged the authors to give careful consideration to any comments received. If the fund had had “reservations about the style or content of the paper” we would have recorded the fact in the paper. No fees or expenses relating to this project were paid for by the Hermes Group or the HUKFF.

(LSPD), news flow from Factiva regarding all board changes, takeovers, divestitures, and payout policies at target firms.

The HUKFF has invested in a total of 41 companies between October 1, 1998 and December 31, 2004. The portfolio is dynamic. There are 4-8 new investments per year with a median duration of 517 trading days (Figure 1).

[Figure 1 about here]

We collect data on significant holdings for each of the 41 HUKFF investments. From (confidential) internal documents we know the date the fund first invested. This information is not observed by the market. From a Regulatory Information Service we obtain notifications of significant holdings after the date of first purchase.[24] Under U.K. listing rules, investors having a material interest in 3% or more in the shares of a listed company should disclose such an interest to the market.[25] In addition to immediate notification through a Regulatory Information Service,[26] the U.K. Listing Rules stipulate that companies must use these notifications to disclose the distribution of significant holdings in the annual report. We collect these data to analyze the distribution of blocks.

[24] We use the Hemscott Premium news database that collates information from all Regulatory News Services.

[25] Major holdings in a listed company incorporated in the United Kingdom must be notified under sections 198 to 208 of the Companies Act 1985. To be more precise, section 199 states a material interest in three percent or more of the nominal share value of any one class of shares that is acquired or ceased must be notified. It also states that a 10% or larger holding must be notified even when no material interest exists leading to notifications by large custodians, for example.

[26] The leading service is the Regulatory News Service of the London Stock Exchange (RNS).

In Table 2 we show statistics on the ownership stakes of the Hermes Group that includes the index trackers and the HUKFF. The mean stake is almost 4% (maximum of 13.5%) based on private information obtained from the Fund for all investments.[27]

[Table 2 about here]

Out of the 41 investments, 30 companies were actively engaged, 3 companies were invested in shortly before December 31, 2004, and engagement had therefore not yet started. The remaining 8 companies were sold relatively shortly after investment before the engagement had started, and after a sudden upward movement in stock prices prompted by exogenous events (e.g., unsolicited takeover bids).

Engagements can be further classified into collaborative, mixed, and confrontational. In collaborative engagements, the target agreed with the changes sought by the fund and implemented them in cooperation with Hermes. In confrontational engagements, there was disagreement about the Fund's objective from the outset and it was often necessary to remove the CEO and / or the chairman to implement the Fund's objectives. In the mixed engagements, the demands of the HUKFF were implemented reluctantly or grudgingly. In the Appendix, we illustrate the difference in attitudes with excerpts from letters, meeting memos, and press clippings.[28]

[27] In the U.K., under The Companies Act 1985 Section 199, investors must disclose stakes greater than 3% to the market. Not all investor stakes reached 3%.

[28] The attitude classification is subjective. We asked former and current fund staff to rank the attitude towards the Fund by the CEO and the chairman separately on a scale from 1 to 10, where one was fully collaborative and ten very confrontational. There was little disagreement about the classification of the most confrontational engagements. The distinction between collaborative and mixed is more subjective (see the Appendix).

As one would have expected, ownership by the Hermes Group varies with the engagement attitude and is at its highest at 6.9% on average in confrontational engagements compared with 3.2% in collaborative engagements (medians of 7.5% vs. 2.4%).

Panel B of Table 2 reports the various statistics on the largest outside stakes. The concentration of ownership is an important issue for Hermes and other activist funds since they must work with other large shareholders to bring pressure on the target management for change, if needed. The median size of the three largest outside shareholders with holdings of at least 3% is 19.7%, and Hermes is one of the three largest in 13 out of the 41 cases. The median size of the top 3 stakes is much larger in confrontational investments (27.3%) than in collaborative (12.6%) or in mixed engagements (16.8%). Similar results hold if one considers the sum of all stakes greater than 3%.

Panel C of Table 2 shows that the major U.K. institutional investors are frequent holders of outside stakes in Hermes' targets (e.g., the Legal and General Group has a stake greater than 3% in 15 out of 41 Hermes' targets). The Prudential holds a similar stake in 9 cases, and Barclays and Fidelity in 7 cases. These statistics on outside stakes show that it would be relatively easy to gather 10% of the votes to call an EGM in the face of a recalcitrant management.

Table 3 provides statistics on the duration of the investment and how it varies with the engagement attitude. Collaborative investments, where the changes are implemented in collaboration with the target management are shorter, a median of 469 trading days. Confrontational engagements take longer to resolve with a median duration of 1,284 trading days.

[Table 3 about here]

Table 4 reports performance prior to investments by the HUKFF. Panel A reports that the large majority of Hermes' targets were performing poorly, with more than 40% in the bottom quintile of performance in the six months prior to investment by Hermes. Panel B reports that Hermes' targets were underperforming the FTSE-All-Share Index by more than 2% in the year before the investment. These results differ from the recent U.S. hedge fund evidence, where Klein and Zur (2006) report that hedge fund targets outperformed market indices by more than 7% on average.

[Table 4 about here]

2. Results

In this section, we report three sets of results. First, we examine the types of engagement activities initiated by HUKFF and the extent to which they take a private or public form. Second, we report the fund's engagement objectives and evaluate the extent to which they are translated into outcomes. Third, using these outcomes we construct an event study to measure the effect of shareholder activism on stock prices.

2.1 Types and frequency of engagement activities

Table 5 reports the type of engagement activities entered into by HUKFF for the 30 companies in the portfolio in which they were engaged. Panel A examines contacts with management of target companies and shows that in all 30 cases HUKFF had numerous meetings with CEOs, chairmen, and CFOs. It also met with other executives including the head of investor relations, the senior independent director, and the chairman of the executive remuneration committee. HUKFF met target companies' executives repeatedly over the course of the engagements, on average 9.73 times (median 7) per company with a maximum of 48. In 60% of cases, HUKFF had contacts with non-executive directors, whether by letter, telephone or in person. In more than half of the cases, HUKFF also sent representatives to visit the headquarters and operations sites of target companies.

[Table 5 about here]

Panel B of Table 5 examines contacts with other shareholders and other parties and reports that in more than 80% of cases, HUKFF contacted other institutional shareholders so as to communicate its engagement objectives and to solicit support for its activities, although this resulted in joint actions in only three cases, a meeting or letter to the target board. HUKFF contacted company brokers in more than 70% of cases and head-hunters in 26.6% of cases with a view to helping target firms select suitable alternative candidates for senior executive positions. In no case did HUKFF contact banks or bondholders to solicit support for its activities.

Panel C of Table 5 examines HUKFF activities in connection with shareholder meetings. For annual general meetings, we found that in only one case did HUKFF pose a question or add an item to the agenda, and in only two cases did HUKFF solicit votes against the management. For extraordinary general meetings, shareholders had plans to requisition a meeting in three cases, but only one EGM was actually called: one EGM was planned by the HUKFF itself, one was planned by another shareholder, and one by the chairman of the target company. In at least one case, the plans had gone as far as preparing the necessary EGM papers.

Panel D of Table 5 examines U.S. and U.K.-style litigation and we observe only one U.S.-style class action. The action was neither initiated nor joined by the HUKFF.[29] Panel E examines higher intensity actions such as threats to block rights issues, press campaigns, and takeover attempts. HUKFF threatened twice to block a rights issue and was successful in both cases. Of the seven press campaigns that occurred in our sample, only two were initiated by HUKFF. Finally, none of the four observed takeover attempts were induced or facilitated by HUKFF.

In summary, Table 5 shows that engagement by HUKFF tends to take a private rather than public form—a lot of letters, meetings, site visits, soliciting of support from other investors, and some press campaigns but few interventions at public meetings. In contrast with our findings, Brav, Jiang, Partnoy, and Thomas (2006) report that engagements by U.S. hedge funds take a much more public approach; in one-half of the cases they do not involve any private communication with the target management.[30]

[29] Actually, the HUKFF supported management, taking the view that the class action was not in the best interest of the HUKFF investment.

[30] Instead, U.S. hedge funds often seek board representation and even public confrontation, through shareholder proposals, proxy contests, lawsuits, and takeover attempts.

2.2 Engagement objectives and outcomes

Table 6 examines the objectives and outcomes of HUKFF's engagement policy. In a large majority of cases, HUKFF seeks to restructure the business, for example, selling non-core divisions by diversified firms is an objective sought in 28 cases, with an achieved outcome in 15.5 cases.[31] Selling non-core assets is an objective in 10 cases and is achieved in 6 of these. HUKFF also tries to stop diversifying acquisitions (10) and limit capital expenditures (7), and in more than 90% and 80% percent of the cases, respectively, target management agrees with the fund's demands. In 6 cases HUKFF seeks to reduce the discount on net asset values of investment trusts and property, and always achieves such a result.

[Table 6 about here]

HUKFF seeks also to bring about substantial board changes including replacing the CEO and the chairman, an objective sought in 14.5 and 18.5 cases,[32] respectively, and achieved in more than 80% and 75% of the cases, respectively. These figures for CEO and chairman turnover compare with those reported by Dimopoulos (2006), who finds that in a sample of poorly performing companies in the U.K., CEO turnover occurs in 11% of the cases, and chairman turnover occurs in 10% of the cases [see also Qiu (2005)]. This comparison suggests that the high level of top management turnover

[31] If the objective is mentioned in the Hermes investment committee report prior to investment, we code a dummy variable equal to 1 if the outcome is confirmed as fully achieved on FACTIVA, 0.5 when the outcome was partially achieved, and 0 otherwise.

[32] We add one-half when the objective is not board change *per se*, but it facilitates other objectives such as restructuring.

observed in our sample would not have occurred without activism by the HUKFF. In more than half of the cases, HUKFF also seeks to replace or add non-executive directors, and strengthen the "independent element" of the board, often in conjunction with other top executive appointments. Appointments of non-executives and independent directors were part of Hermes' objectives and are observed in more than 60% of the cases.

HUKFF also seeks to change financial policies such as promoting new equity issues by rights in two cases, and increasing cash payout to shareholders in 17 cases. We observe three rights issues, the third being unwelcome to HUKFF. By contrast, the objective of increasing cash payout is achieved in 11 cases, often combined with restructuring activities.

In addition to restructuring, changing boards, and financial policies, HUKFF's other objectives included the improvement of operational management and investor relations in 8 and 9 cases, respectively, and stopping unequal treatment of shareholders in 2 cases. Outcomes consistent with these objectives were observed in a majority of cases.

In sum, HUKFF seeks to restructure a large number of firms, focusing their activities, limiting acquisitions and capital expenditure, changing boards — CEOs, chairmen, non-executive and independent directors — and altering financial policy, in particular raising cash payouts.[33]

2.3 Returns to disclosure of activist stakes

We analyze the market reaction to disclosure to the RNS of stakes at least as large as 3% consistent with company law disclosure rules. In a review of the sample of engagements,

[33] Brav, Jiang, Partnoy, and Thomas (2006) report similar objectives sought by U.S. hedge funds with one exception, namely that unlike Hermes, U.S. hedge funds frequently seek the sale of the target company itself.

we found either that there was no notification (because the stake was below the 3% threshold), the disclosure was made by the BriTEL trustees for the Hermes Group without the HUKFF being mentioned specifically, or the notification made by the BriTEL trustees (or another HUKFF investor) revealed that the Fund had acquired an interest. We also examine cases where the press mentioned the Fund as a shareholder, which on occasion happened even before official notification to the RNS.

To be more precise, in the 30 engagements we identified from the fund's internal records, 13 were disclosed to the public on RNS and 15 were mentioned in the press, but only 6 were disclosed through both channels. In most cases a substantial period of time had elapsed before the disclosure of the acquisition by the fund, on average 503 days for the RNS and 435 days for the press, conditional on disclosure. When the information was disclosed through both channels, the press disclosure came on average 165 days after the RNS disclosure. Hence, in most cases the disclosure was routine and did not attract press interest.

This is confirmed by looking at the content of the press articles. Twelve of the 15 press disclosures were not "announcements," but retrospective pieces commenting on the outcomes of HUKFF engagements.[34] There was only one instance where a purchase crossed the 3% threshold immediately and was disclosed in the press the day after with the headline "Activist fund buys into Caledonia."[35]

[34] For example, on August 20, 2001 the *Financial News* published an article that contained the sentence "The Focus funds have been active in taking stakes in companies such as Tomkins and Trinity Mirror, where management changes have subsequently taken place," thereby revealing the name of two companies that were engaged. A rare headline announcement was "Pub group Greenalls next on Hermes investor 'hit list,'" (*The Observer*, January 31, 1999).

[35] *Financial Times*, July 26, 2001.

We find negative, but small and statistically insignificant market reactions to the first disclosure of stakes of the HUKFF, be it by the regulatory authority RNS or by the press (Table 7). For the sub-sample where there is first disclosure by the press, cumulative average abnormal returns (CAARs) are positive, although small and statistically insignificant. For the sub-sample of first disclosure by the RNS, CAARs are negative and in general statistically insignificant, except for the window [-5,+5] days where we find statistically significant and negative returns of -3.7%.[36] These findings compare with Brav, Jiang, Partnoy, and Thomas (2006), who report positive CAARs of between 5% and 7%, and with Klein and Zur (2006), who report CAARs of around 10% around the announcement of a 5% stake.

[Table 7 about here]

The most likely explanation of our findings is that it is very difficult for the market to determine whether the HUKFF holds shares in the target, because it is BriTel that discloses its holdings at the fund-family level. As a result, only in a handful of cases is it clear that the HUKFF is a separate shareholder, as distinct from other funds managed by the Hermes Group. In the rest of the cases, the media and the market are left to wonder whether that is the case.[37] This is corroborated by the absence of "headline news" that coincided with the disclosure of a block. In the one case where this did happen —

[36] The Fund's management suggests a momentum argument that they tended to buy when prices were falling.
[37] As an illustration, in one case the *Financial Times* referred to rumours that Hermes had bought stakes in eight companies. In reality, HUKFF was only a shareholder in four of those eight cases.

Caledonia — the [-2,+2] announcement abnormal return was 7.4%, in line with the hedge fund evidence from the U.S.

2.4 Event study on outcomes

To examine whether the HUKFF engagement program is value increasing, we examine whether the fund's engagement objectives give rise to abnormal stock returns. To measure this, we examine a sub-set of engagement objectives that by their nature lead to announcement events, such as restructuring, board changes, and increases in payout policy. Over the engagement period, we identify 98 such events, an average of slightly more than 3 events for each of the 30 engaged firms.[38] For each event, we construct an event window and measure the abnormal returns over the event window, after adjusting for the FTSE-All-Shares Index. The event window varies from 3 to 11 days around the announcement date of the engagement outcome. Table 8 reports the results of such an event study. Depending on the window, mean cumulative abnormal returns (CARs) range from 3% to 4% (medians from 1.9% to 3.4%) for the 3-day window [-1,+1] to the 11-day window [-5,+5]; all are statistically different from 0 using a variety of tests. Focusing on the 7-day window [-2,+2], we find a mean CAR of 3.9% (median 3).

[Table 8 about here]

[38] Regarding board changes, there are often two event dates for the same position, for example, when the previous CEO announces intention to step down, and subsequently when the board announces the name of the newly appointed CEO. The same is true for some restructuring events, when, for example, a company announces an equity spin-off, and when the subsequent IPO takes place. There are two carve-outs in our sample.

Frequently these events coincide with other announcements such as a profit warning or an earnings announcement. As a result, the announcement returns include both the effect of the engagement, as well as other changes to the performance of the company. When events with confounding information, such as earnings announcements or profit warnings are excluded, the mean abnormal returns increase and average 5.30% in the 7-day window [-3,+3] around the announcement date (median 3.69%). The largest excess returns, 6.6%, are associated with restructuring activities, including sales of assets and divisions. Changes of CEO and chairmen also give rise to large and positive excess returns of 6.0%. These are often accompanied by prospective restructurings. Cumulative abnormal returns for changes of non-executives directors are negative and insignificant.[39]

In sum, there are substantial share price reactions to engagement outcomes. There are particularly large gains associated with restructuring, and CEO and chairman turnover.

Table 9 partitions the share price reactions to engagement outcomes by engagement attitudes. Of the 98 engagement outcomes events, 96 occur in the 30 companies that are the targets of actual engagement by the HUKFF, and 66 events occur in the absence of confounding information (i.e., an average of 2.2 events per company). Focusing on the 7-day window [-3,+3] for events without confounding information, we find a mean CAR of 5.22% (median 3.5%). These figures may then be combined into an estimate of 11.5% "agency costs" for the HUKFF target companies (i.e., abnormal returns of 5.22% per event times an average of 2.2 events per company). Such estimated "agency costs" are largest in mixed engagements (12.7%, which is abnormal returns of

[39] In about a dozen cases, announcements of CEO or Chairman changes are associated with the appointment of non-executive directors (NED). These events are classified as CEO or Chairman, not as NED changes.

6.8% times 3.3 events per company), intermediate in collaborative engagements (11.5%, which is 4.04% times 2.9), and smallest in confrontational engagements (9.9%, which is 3.21% times 3.1).

[Table 9 about here]

2.5 Operating performance

In this sub-section, we provide a limited analysis of the operating performance of the target companies in the Hermes portfolio before and after Hermes engagement. If focus fund activism is successful, we would expect to observe poor pre-engagement operating performance and improved performance after a completed intervention. Table 10 reports operating performance pre- and post the HUKFF engagements and two measures of restructuring intensity. Given the limited sample size, none of the reported differences in operating performance are statistically significant, but the changes in the numbers are economically large.

[Table 10 about here]

Panel A of Table 10 reports that the median return on assets recovers substantially from the levels seen one year before and one year after the engagement; however, it is only slightly higher than two years before the engagement. The means follow a similar pattern. They decline from 8% two years prior to the engagement to 6.8% one year prior to the engagement and rise back to 8.3% two years after the completed engagements.

Panel B of Table 10 reports restructuring intensity. The value of total assets is similar in medians both one and two years after the completed engagements. The means show a significant decline in total assets. The decline in the number of employees is more pronounced, with the median number of employees being approximately 40% lower in the two years after completed engagements than in the two years leading up to the engagement. This finding is consistent with the Fund's main restructuring objective — more focus (see Table 6).

Panel C of Table 10 reports statistics on the market-to-book ratio of Hermes' targets, both prior and subsequent to its engagements. The median market-to-book ratio shows a substantial rise on all previous years, consistent with the restoration of market valuations to the levels prior the decline in performance.

2.6 Case studies

Three case studies are described in this sub section. The first case illustrates how an EGM can bring about board changes, and why the threat of an EGM can give "real authority" [Aghion and Tirole (1997)] over the target board and management. We find that the threat of an EGM may be as effective as its actual execution, as a way of forcing management to accept the proposed change, very much in the same way as the threat of a cram down in Chapter 11 bankruptcies may force dissenting classes of creditors to vote for a proposed restructuring plan. The other two cases illustrate engagements by the HUKFF: the second case a collaborative one, and the third case a confrontational one.

Case 1: Brazilian Smaller Companies Investment Trust

The Brazilian Smaller Companies Investment Trust, better known as Brazit, was a closed-end fund managed by a subsidiary of Foreign and Colonial Management Limited. It had about $40 millions under management. Hermes started a campaign for change in late 1996, which came to a head in 1997. The HUKFF was not yet established and this activism campaign was initiated by the index tracker fund. The case is important because it showed to Hermes that the requisitioning of EGMs was a powerful threat when management refused to engage. It also established the authority of the individuals who made up the original HUKFF team in 1998.

Hermes had three objections to the way Brazit was managed. It had significantly underperformed the main relevant indexes, the board of the investment trust was dominated by members of the management company or individuals closely associated with it, and the service contract was unusually long at three years, although it was subsequently reduced to two.

Hermes and another large shareholder in Brazit engaged with the board of the management company to bring about change. When prolonged negotiations failed, the two shareholders requisitioned an EGM, with a proposal to dismiss the entire board of the target. Seventy percent of the shareholders voted and 97% of them voted to dismiss the board. The new board eventually agreed to liquidate the investment trust. The ramifications of this engagement were felt throughout the investment trust industry. The parent company with many other investment management companies changed their rules barring their employees serving on boards of investment trusts and allowed service contracts of only one year.

Case 2: Smith and Nephew

Smith and Nephew is an early collaborative engagement of the HUKFF. The Fund supported a new CEO's conglomerate transformation strategy while insisting on board transformation and cash-payouts.

In 1998, Smith and Nephew was a healthcare conglomerate with five divisions: wound management, casting, orthopaedic, endoscopy, and consumer products. The HUKFF invested in October 1998. Prior to making the investment, the Fund had identified a number of changes they felt could reduce the conglomerate discount.

In December 1998, the HUKFF met with the new CEO to discuss his strategic plans and vision for the road ahead. The Fund found that the restructuring plans of the new CEO and its own broadly coincided. However, the Fund still had concerns about the pending Chairman's succession and excess free-cash flow. These views were expressed in a letter to the CEO dated December 31, 1998.

The future course of the engagement followed the general line set out in this initial letter. In 1999, Smith and Nephew divested its bracing and support systems, as well as its cotton and wool business. In November, the chairman retired and was succeeded by an outsider. The 10-day abnormal returns around the announcement dates for these events are positive, but not very large; 4.7%, 1.1%, and 3.1%, respectively. At the beginning of 2000, the announcement of the Iruxol product from BASF resulted in a negative abnormal return of -13.8%. On June 29, the company announced the sale of the female hygiene and toiletries division to an MBO, the sale of Elastoplast to Beiersdorf, and plans to return £415m to shareholders. This announcement resulted in a 21% abnormal return over a -5 to +5 day window.

On July 4, 2000, the Fund wrote another letter to the CEO, congratulating him on completing the first the first stage of the transformation into a more focused company. In a final letter dated August 17, 2001, the HUKFF informed the CEO that it had divested from the company. The Fund also confirmed that Hermes would retain an overweight position in the stock in its mainstream portfolios. According to the HUKFF's own calculations, the internal rate of return of the Smith and Nephew investment (across all Hermes funds) was 46.77%, compared to an IRR of 2.99% had the same cash flows been invested in the FTSE-All-Share Index.

Case 3: Six Continents

In 2001, Six Continents PLC was a leisure conglomerate with assets in the hotel, brewing, and pubs business. Until June 2001, it was known under the name Bass PLC. The HUKFF first acquired a stake in the company in late 1999. This holding was never disclosed to RNS because it never crossed the 3% threshold, and was first mentioned in the press on August 20, 2001.[40]

The HUKFF invested because it was concerned about the lack of synergies between the conglomerate's divisions, its capital structure, and its acquisitions track record. In previous years, Six Continents has successfully acquired the Holiday Inn and Intercontinental Hotel chains but, in the view of the HUKFF, paid too much. These

[40] The press report in the *Financial News* is illustrative of the Hermes investment disclosure and engagement style: "[the companies] were not prepared to discuss Hermes' shareholdings. Hermes itself was also unwilling to comment on the extent of its involvement with the three FTSE 100 companies. The pension fund firm, […], prefers to keep its brand of what it calls "shareholder engagement" quiet," (Hermes sets its sights on UK's largest firms, *Financial News*, August 20, 2001). *Financial News* learned about the Hermes holding in Bass and two other companies from a well-known ownership database used by journalists and analysts.

factors combined had led to a significant underperformance of the FTSE-All-Shares Index in the year prior to investment by the HUKFF.

The Fund had four main engagement objectives for Six Continents: (1) simplify the conglomerate structure; (2) ask for cash to be paid out to shareholders through a share buyback program; (3) split the role of chairman and CEO; and (4) prevent further value-destroying acquisitions.

The role of chairman and CEO were split, although the press continued to assert that the chairman continued to dominate the company.

Six Continents divested its Bass brewing operations to Interbrew and 1,000 smaller managed and tenanted pubs to Nomura of Japan. This generated £1.5bn of cash holdings that at this point were not paid out to shareholders. Instead the company looked for further acquisition opportunities in the hotel sector.

In January 2002, the Fund wrote a strongly worded letter to the company. The letter was leaked and direct quotes started to appear in the press: "We are concerned that Six Continents may contemplate a significant acquisition that will be value-destroying... both Intercontinental and Holiday Inn have destroyed huge amounts of shareholder value... this must not be allowed to happen again," (*Daily Telegraph*, January 22, 2002). In the same letter, the fund demanded for £1bn of cash to be returned to shareholders.

On April 14, 2002, the press reported that Six Continents was preparing the requested £1bn share buyback. On October 1, 2002, further press reports announced the demerger of the hotels and the pubs division. On March 3, 2003, the entrepreneur Hugh Osmond launched a hostile bid.

2.7 Performance of HUKFF and the gains to activism

In this section, we examine the performance of the fund and the contribution of activism to its performance.

[Table 11 about here]

Table 11 reports statistics for the fund over the six years and three months, until December 2004. From Hermes' detailed records, we reconstruct the complete cash flows of the fund, including inflows, dividends, and outflows. We then use such cash flows, together with the fund's market valuations at the end of each month, to compute the fund's monthly time-weighted returns for an investor who held shares at the beginning of the month.[41] Raw returns, net of fees, average 8.2% per year, and 4.9% after adjustment for the FTSE-All-Share Index. These returns do not adjust for other factors such as size, book-to-market and momentum. Table 12 addresses this issue by reporting performance attribution regressions. The Fund's monthly alpha is positive in all four regressions, and is significant or marginally significant in three of them, including the CAPM, momentum, and the four-factor model. The fund's alpha is always economically large and is largest when controlling for momentum. The momentum factor is negative (and strongly significant in regression 3), indicating that the fund's performance is associated largely with reversal of the performance of previously underperforming companies.

[Table 12 about here]

[41] Results are similar using IRRs.

Table 12 still does not adjust for potential issues arising from the dynamic trading strategy used by the fund. The risk profile of the HUKFF portfolio changes over time. The portfolio's beta changes from less than 0.6 to 1.2. However, much of this variation occurred over the first year of the fund, when the fund was invested in only eight companies or less. For the remaining period the beta of the fund varies from slightly less than 1 to 1.2. The pattern of idiosyncratic risk is similar to that of systematic risk and ranges between 20% and 30%. The resulting monthly Sharpe Ratio of the fund is around 0.125, reflecting the risk of shareholder activism.[42]

Next, we link the event returns to the fund's overall performance, by defining and computing an Activism Contribution Ratio (ACR) as follows:

$$\text{ACR} = \frac{\sum_{i=1}^{N}\sum_{j=1}^{J}\left[\left(MV \text{ of block}\right)_{i,j,t-5} \times CAR_{j,[t-5,t+5]}\right]}{\text{Total Sterling Excess Return of Fund}}.$$

For each outcome j in the event study, we compute the sterling return of the fund for the event multiplying the market value of the block held at day -5 before the announcement by the CAR for the [-5,+5] window.[43] We then sum up these sterling returns across all the J outcomes and the N firms in the Hermes portfolio (a total 98 events) and compute them as a proportion of the total sterling excess return on the Fund between inception and December 31, 2004.[44] We find that 92% of the HUKFF's sterling

[42] We also check whether the Fund's performance may be attributed to a trading strategy exploiting patterns in the higher moments of the returns' distribution. To verify this possibility, we include additional factors that have been used in the hedge funds literature [e.g., Agarwal, Daniel, and Naik (2007)] to control for time-varying risk profile, including the volatility, kurtosis, and skewness factors. In unreported regressions available upon request, we find that the additional factors are not statistically significant, and the fund's alpha is only minimally affected.

[43] We can do this because the Fund gave us complete access to its portfolio holdings at any moment in time, so we exactly know how many shares were held over each event window.

[44] The Sterling excess return for the Fund as a whole is the sum of annual returns in excess of the market index that Hermes computes for remuneration purposes; the numbers are audited.

excess return is accounted for by the sterling excess returns from the event study. Splitting up the total Sterling return in the event study by engagement attitude, we find that 14.4% comes from engagements that we have previously described as collaborative, whereas 30.5% occurs in engagements that are described as confrontational. The largest contribution to the overall fund return comes from the mixed engagements, that contributed 55.1% of the Sterling return in the event outcomes. Thus, hostility is related to higher gains than collaboration, but the highest returns come from mixed engagements. This result compares to the gains to hostile versus friendly takeovers, measured by target bid premia, which are far larger in hostile transactions [Franks and Mayer (1996)]. It also stands in sharp contrast to the evidence on bidder returns in takeovers, with bidders earning very small or negative returns in friendly and hostile takeovers; the returns of the HUKFF from the engagement outcomes are positive throughout.

2.8 Returns to free-riding on the HUKFF

Table 13 attempts to determine if other investors could have earned the same return as Hermes by buying into the engaged companies at the time of the first public announcement of a block purchase by the Hermes Group. If shareholders had bought shares in target firms on the date of the public disclosure of the stake purchases of the HUKFF, they would have earned a 12.58% raw return per year if they had rebalanced in the same way as Hermes, or a 14.25% if they had not rebalanced but simply kept the shares until December 2004.[45] This compares with a raw-return on the Fund of 8.2% annually. The crude comparison suggests that public shareholders would have done better than Hermes by buying at the public announcements of the disclosed stakes.

[Table 13 about here]

[45] These portfolios are reported in Table 13 under the heading "Public Info Portfolio."

Next, we examine the returns that shareholders would have earned if they had invested on the *private* information of Hermes' first day (first week and first month, respectively) investments in target companies, and then failing to rebalance afterwards. That is, we assume that (minority) shareholders heard the "rumor" that Hermes had invested, but then did not have the subsequent information of Hermes' rebalancing activity. We find that such shareholders would have earned an annual return of about 10%, which is slightly better than the Fund's annual return of 8.2%. These results confirm that Hermes' returns are unlikely to be associated with trading on private information.[46]

Taken together, the findings confirm that when its stakes are disclosed, the HUKFF generates positive externalities. They also suggest that the Fund does not invest because it has insider information. It takes positions before starting the engagement process and — as shown in Table 7 — takes small losses when its initial stakes are disclosed. Ex post the fund more than recovers these initial losses from positive abnormal returns on publicly observable outcomes.

2.9 Comparison with U.S. hedge fund activism evidence

Two U.S. studies [Brav, Jiang, Partnoy, Thomas (2006), BJPT henceforth; and Klein and Zur (2006), KZ henceforth] analyze how stock prices react to the announcement that a hedge fund has acquired a significant holding of 5% or more in a listed target company (13D filing). They also investigate what kind of company is targeted, the stated objective of the engagement, and its outcome.

[46] The evidence is also consistent with the Fund management's view that it tends to build up its initial stake when the share price has negative momentum.

BJPT identify 110 activist hedge funds in 2004 and 2005 that disclose 374 block holdings in 339 targets. They find that these announcements generate positive shareholder returns for the target totaling 6% (median 4.8%) over a twenty-one day window straddling the announcement.

KZ examine similar filings between January 1, 2003 and December 31, 2005. They identify 102 different hedge funds that engage 155 target firms disclosing 194 block holdings. They find abnormal returns of 7.3% for a window beginning 30 days prior to the announcement and 5 days after the announcement.

Whereas BJPT are positive about the activities of hedge funds, KZ are more skeptical, observing that hedge funds target companies that outperformed the market prior to the engagement.[47] Moreover, accounting measures of performance decrease one year after the engagement. Both studies document significant levels of CEO/chairman removal following the block disclosure. They also find that hedge fund activists often seek and obtain board positions. KZ find the activists achieve their goals more often when they bring or threaten a proxy fight.

A related set of studies present evidence that hedge funds use stock lending to enhance their voting power over their ownership stake; they also engage in swap and other derivative transactions to alter the relationship between their economic interest and voting power in the target companies [Hu and Black (2006); and Christoffersen, Geczy, Musto, and Reed (2007)].

[47] KZ observed that hedge fund activists "appear to extract cash from the firm through increasing the debt capacity of the target firm and paying themselves higher dividends. The latter result, coupled with the positive stock price reaction surrounding the 13D filing date, suggests that stockholders perceive benefits to reducing agency costs associated with excess cash and short-term investments," [Klein and Zur (2006, p. 36].

3. Conclusions

In contrast to much of the previous literature, this paper has reported substantial effects and benefits associated with shareholder activism in the form of private engagements by an activist fund. This fund, HUKFF, intervenes in the face of poor corporate performance where it believes that there is a significant probability of intervention being successful and resulting in substantial share price gains. It engages in meetings with board members, often seeking the support of other institutional investors, sometimes mobilizing press campaigns but rarely relying on resolutions at shareholder meetings. It seeks corporate restructurings, changes to the boards of firms, and restrictions on corporate policies (e.g., takeovers and investments), sometimes requiring changes in financial policy, particularly dividend distributions. A high proportion of the interventions is successful and result in substantial shareholder gains, particularly in response to restructurings and board changes. These successful outcomes account for a large proportion of the significant out-performance of the fund relative to a variety of benchmarks over the sample period.

In sum, this study provides the first substantive evidence of gains to shareholder activism and suggests that well-focused engagements can result in substantial public returns to outside shareholders, as well as to those actually involved in the engagements.[48] This suggests an interesting line of research that the legal environment might have a significant impact on the activism by institutional shareholders.

[48] Additional suggestive evidence stems from the observation that after the results in the present article were presented, a number of U.K. institutional investors have started new activist funds.

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Table 1
Comparison of the U.S. and U.K. legal and institutional shareholder activism environment

Shareholder Powers	U.S.	U.K.
Ordinary General Meetings	- Under Delaware Corporate Law, Subchapter VII, (2) (b) annual meetings deal with the election of directors and are called as set out in the bylaws	- Ordinary General Meetings must be called each year for the election of directors (Section 366 (1) Companies Act 1985.
Extraordinary General Meetings	- Special Meetings can be called under Delaware Corporation Law, Subchapter VII, (2) (d), but shareholders cannot call these meetings, unless the certificate of incorporation or the bylaws state otherwise. Thus, company's bylaws can deprive the shareholder of the right to call special meetings.	- Under the Companies Act 1985, Section 368, a shareholder, or group of shareholders, commanding at least 10% of the company's paid up voting capital can requisition an Extraordinary General Meeting (EGM) ; the company's Articles cannot deprive the shareholders of this right.
Shareholder Proposals	- Shareholders can ask the company to add proposals to the company proxy under SEC Rule 14a-8, but this excludes all issues relating to elections; in general proposals receiving a majority of votes under this rule are not binding on the board; the cost is borne by the company - Shareholder proposals – also on board appointments - can be made under SEC Regulation 14A via a full proxy solicitation; the cost of the solicitation is borne by the shareholder	- At Ordinary Meetings, under the Company's Act 1985 Section 376 a shareholder, or group of shareholders, commanding 5% of the total voting rights of all members or 100 or more shareholders (each of whom have paid more than £100 of paid up capital) can compel the company to put a resolution to the Annual General Meeting and to circulate a statement of not more than 1000 words prior to the meeting. - At EGMs resolutions of shareholders requisitioning the meeting must be voted upon.
Appointment / Removal of Directors		
Through board election	- The voting rules set out in state law apply; in practice these are determined by the bylaws; under Delaware law by default plurality voting applies; this means that the votes in favour are counted for each candidate; the candidates who receive most votes (not necessarily a majority of the votes attending) win; in a hostile vote, if there are say six candidates for three board positions to be filled, the candidates with the three highest vote counts win	- Under the Companies Act 1985 election of directors must be by separate resolution for each director; (cumulative) majority voting applies. - A director can always be removed by ordinary resolution (see above) regardless of how he was appointed and irrespective of provisions in the articles (Section 303 Companies Act 1985).
by other means	- Under Delaware Corporation Law, Subchapter VII, (2) (b) shareholders can appoint directors (remove the board) by written consent, but this decision must be unanimous (a director holding one share could refuse to sign) and the bylaws can state otherwise	
Tenure	- Under Delaware Law it is possible to stagger the terms of directors, ensuring that only 1/3rd come up for election each year	- A director's term of office is usually determined by the articles, but shareholders can always move to remove a director (see above).
Restrictions on Voting Power Concentration	- Under Delaware Law it is possible to issue shareholder rights plans ("poison pills") that limit the ability of shareholders to concentrate voting power beyond certain thresholds, typically 10-15%; there is no mandatory bid requirement	- Poison pills are largely absent from the UK.; there is a mandatory bid requirement at 30%

Table 2
Ownership in Hermes' targets

Panel A: Ownership by Hermes Group

	Investments		Engaged by attitude		
	All	Engaged	Collaborative	Mixed	Confrontational
Mean	4.0%	4.8%	3.2%	3.9%	6.9%
Median	2.5%	3.9%	2.4%	3.3%	7.5%
Min	1.0%	1.0%	1.1%	1.0%	1.0%
Max	13.5%	13.5%	8.4%	9.4%	13.5%
No Companies	41	30	7	12	11

Panel B: Large stakes in Hermes' targets

		Investments		Engaged by attitude		
		All	Engaged	Collaborative	Mixed	Confrontational
Top 3 Stakes in Hermes' Targets (%)	Mean	19.9%	18.9%	13.3%	15.5%	25.6%
	Median	19.7%	19.6%	12.6%	16.8%	27.3%
	Min	3.1%	3.1%	3.1%	4.0%	3.1%
	Max	45.2%	45.2%	24.8%	23.1%	45.2%
	Hermes Top 3?	13	12	1	5	6
Sum of the Stakes>3% in Hermes' Targets (%)	Mean	26.1%	26.1%	18.3%	22.6%	34.3%
	Median	24.3%	22.6%	17.5%	16.9%	36.6%
	Min	3.1%	3.1%	3.1%	4.0%	3.1%
	Max	60.9%	60.9%	34.4%	60.9%	52.6%
Top Stake >3%?	Count	35	28	7	10	11
Hermes Stake > 3%?	Count	18	17	3	6	8
Number of Stakes>3% in Hermes' Targets	Mean	4.4	4.6	4.3	4.4	5.1
	Median	4.0	4.0	4.0	3.0	5.0
	Min	1.0	1.0	1.0	1.0	1.0
	Max	12.0	12.0	6.0	12.0	10.0
Companies	Count	41	30	7	12	11

Panel C: Most frequent holders of stakes greater than 3% in Hermes' targets

Investor	No Stakes > 3% in Hermes' Targets
Legal & General Group	15
Prudential	9
Barclays	7
Fidelity	7
AXA	6
Schroeder	6
Sanford C. Bernstein	5
Standard Life	5
M&G	4
Capital Group	3
Silchester	3
UBS	3
Franklin	2
Halifax	2
Phillips & Drew	2
Popeshead	2

Table 3
Duration of investments

	Investments		Engaged by attitude		
	All	Engaged	Collaborative	Mixed	Confrontational
Number of Days					
Mean	691.4	873.7	526.6	811.8	1162.1
Median	517	958	469	930	1284
Min	1	104	104	180	197
Max	1744	1744	1043	1433	1744
No Companies	41	30	7	12	11

The Table reports descriptive statistics of the duration of HUKFF investments for all 41 companies invested between October 1, 1998 and December 31, 2004, computed as the number of calendar days from date of first purchase to the earliest between date of last sale and December 31, 2004. Statistics are reported for all 30 engagements, and separately for different engagement attitudes. Engagement attitudes are based on the target companies' response and can be collaborative, mixed or confrontational.

Table 4
Performance prior to investment by HUKFF

Panel A: Relative performance prior to investment by HUKFF

Performance Deciles	6 Months Prior	1 Year Prior
1	1	0
2	0	0
3	1	1
4	1	3
5	6	5
6	6	6
7	4	8
8	4	5
9	10	7
10	6	4
No. Companies	39	39

Panel B: Excess returns (percentage) over FTSE-All-Share prior to investment by HUKFF

	Investments		Engaged by attitude		
	All	Engaged	Collaborative	Mixed	Confrontational
6 Months Prior	–2.54	–2.36	–0.94	–2.78	–2.55
12 Months Prior	–2.22	–2.02	–1.60	–1.92	–2.32
No. Companies	39	28	5	12	11

The Table reports performance prior to investment by HUKFF. Panel A reports the distribution of the target companies' relative performance to FTSE all shares index prior to investment by HUKFF. Columns 2 and 3 of Panel A report the number of target companies by performance decile based on a 6-months and 12-months period prior to investment by HUKFF. Performance decile 10 contains the companies in the lowest 10% performance interval. Panel B reports mean 6-months and 12-months excess returns prior to investment by HUKFF.

Table 5
Activism tactics

Panel A: Contact with management

	Meetings	Letters	Total
CEO	30 [100.0%]	30 [100.0%]	
Chairman	30 [100.0%]	30 [100.0%]	
CFO	29 [100.0%]		
COO	8 [26.7%]		
Division Manager	17 [56.7%]		
Head of Strategy	11 [36.7%]		
SID	19 [63.3%]		
Head of IR	22 [73.3%]		
Chairman Executive Remuneration Committee	15 [50.0%]		
Non-Executive Directors			18 [60.0%]
Site Visits			19 [63.3%]

Panel B: Contact and cooperation with other shareholders and relevant parties

	Other Shareholders				Banks and Bondholders	Headhunters	Company Brokers
	Calls/Meetings	Solicit Support	Joint Letter	Joint Meetings	Solicit Support	Any Contact	Any Contact
No observed	26	25	2	3	0	8	22
[% of sample]	86.7%	83.3%	6.7%	10.0%	0.0%	26.7%	73.3%

Panel C: Shareholders general meetings

	Annual General Meeting			Extraordinary General Meeting				
	Pose Questions	Add Item	Solicit hostile votes	Planned	Requisi tioned	Planned by Hermes	Planned by other Shareholders	Planned by Company Chairman
No observed	1	1	2	3	0	1	1	1
[% of sample]	3.3%	3.3%	6.7%	16.7%	0.0%	3.3%	3.3%	3.3%

Panel D: Litigation

	U.K. Litigation		U.S. Class-Action			
	Observed	Hermes Induced	Observed	U.S. Lawyer Induced	Shareholder Induced	Hermes Induced
No observed	0	0	1	1	1	0
[% of sample]	0.0%	0.0%	3.3%	3.3%	3.3%	0.0%

Panel E: High-intensity actions

	Threaten Blockage Rights Issue	Hostile Takeover Attempt		Press Campaign		
		Observed	Hermes Induced	Observed	Shareholder Induced	Hermes Induced
No observed	2	4	0	7	4	2
[% of sample]	6.7%	13.3%	0.0%	23.3%	13.3%	6.7%

The Table reports various engagement actions by Hermes Focus Fund. Panel A reports the number [percent] of cases whereby Hermes had meetings with and wrote letters to various people within the organization. Panel B reports the number [percent] of cases of contact and cooperation with relevant third parties. Panel C reports the number [percent] of cases of intervention at shareholders general meetings. Panel D reports the number [percent] of cases of litigation in court. Panel E reports the number [percent] of cases of high-intensity actions such as threats to block rights issues, hostile takeover attempts and press campaigns.

Table 6
Governance objectives and outcomes

	Objective	Outcome	Outcome
Restructuring		(Conditional)	(% Conditional)
Restructure Diversified Firms to More Focus	28.0	15.5	55.36
Restructure Non-Diversified Firms through Asset Sales	10.0	6.0	60.00
Stop Acquisition	10.0	8.5	85.00
Discipline Capital Expenditures	7.0	6.0	85.71
Reduce Discount on NAV	6.0	6.0	100.00
Board Changes			
Change CEO	14.5	12.0	82.76
Change Chairman	18.5	14.0	75.68
Change Non-Executive Directors	17.0	10.0	58.82
Strengthen "Independent" Element on Board	15.0	7.0	46.67
Change Remuneration Policy	4.0	1.0	25.00
Financial Policies			
Rights Issue	2.0	2.0	100.00
Increase Cash Payout to Shareholders	17.0	11.5	0.64
Other Policies			
Improve Operational Management	8.0	4.0	50.00
Stop Unequal Treatment of Shareholder	2.0	1.5	75.00
Improve Investor Relations	9.0	4.0	44.44

The table reports the governance objectives and outcomes in firms in the Hermes portfolio. Column 1 lists the possible governance issues. Column 2 reports the cases in which Hermes set out the governance issue as an objective in their investment committee papers: It adds one for firms in which the objective was set as primary, one-half for firms in which the objective was set as not primary, and zero otherwise. Column 3 reports the number of cases in which the governance objective was achieved: It adds one for firms in which the governance issue was both set as an objective in the investment committee papers, and we could establish, based on a Factiva search, that the outcome was fully achieved, one-half for firms in which the outcome was partially achieved, and zero otherwise. Column 4 reports the percent conditional outcomes.

Table 7
Effect of disclosure of Hermes' stake on stock prices

Window	Mean (%)	t-stat	Median (%)	z-stat	% Positive	N
First Public Disclosure – either RNS or press						
[–1; +1]	–0.33	–0.65	–0.46	–1.37	33.33	21
[–2; +2]	–0.01	–0.02	–0.22	–0.16	42.86	21
[–3; +3]	–0.04	–0.04	0.39	0.02	52.38	21
[–5; +5]	–1.85	–1.51	–1.90	–1.51	33.33	21
First Disclosure by RNS						
[–1; +1]	–0.41	–0.62	–0.64	–1.40	25.00	16
[–2; +2]	–0.66	–0.76	–0.64	–0.88	43.75	16
[–3; +3]	–1.23	–1.24	–0.63	–1.03	43.75	16
[–5; +5]	–3.69	–3.68	–3.53	–2.74	18.75	16
First Disclosure by the press						
[–1; +1]	0.42	0.37	0.17	0.52	61.54	13
[–2; +2]	0.52	0.62	–0.40	0.25	38.46	13
[–3; +3]	1.23	1.04	–0.89	0.52	46.15	13
[–5; +5]	1.92	0.82	1.85	0.73	53.85	13

The Table reports mean and median cumulative abnormal returns (%) in various windows around the first disclosure dates of Hermes' ownership stakes.

Table 8
Effect of governance outcomes on stock prices, by type of outcome

Window	Mean (%)	t-stat	Median (%)	z-stat	% Positive	N
Panel A: All investments						
[–1; +1]	2.97	4.21	1.86	3.95	68.37	98
[–2; +2]	3.92	5.07	3.02	4.61	68.37	98
[–5; +5]	3.94	4.03	3.38	3.95	66.33	98
Panel B: All investments excluding events with confounding information						
[–1; +1]	3.72	4.49	2.15	4.38	74.63	67
[–2; +2]	4.60	4.96	3.20	4.42	68.66	67
[–5; +5]	5.74	4.67	4.17	4.41	71.64	67
Panel C: Restructuring						
[–1; +1]	3.57	3.13	2.27	2.90	68.89	45
[–2; +2]	5.22	4.41	4.79	3.75	71.11	45
[–5; +5]	4.97	3.05	3.32	3.00	68.89	45
Panel D: Restructuring excluding events with confounding information						
[–1; +1]	4.58	3.85	2.59	3.51	77.14	35
[–2; +2]	5.86	4.67	5.16	3.83	74.29	35
[–5; +5]	6.66	3.69	4.98	3.33	74.29	35
Panel E: CEO and chairman turnover						
[–1; +1]	2.83	2.12	1.16	1.88	67.86	28
[–2; +2]	4.00	2.44	3.46	2.64	71.43	28
[–5; +5]	3.95	2.07	3.57	2.16	71.43	28
Panel F: CEO and chairman turnover excluding events with confounding information						
[–1; +1]	3.71	2.13	1.65	2.27	73.68	19
[–2; +2]	5.21	2.69	3.85	2.78	73.68	19
[–5; +5]	5.92	2.37	3.61	2.50	78.95	19
Panel G: Payout						
[–1; +1]	3.30	2.24	3.18	2.22	81.25	16
[–2; +2]	2.97	2.62	3.08	2.17	75.00	16
[–5; +5]	2.81	1.64	2.77	1.40	62.50	16
Panel H: Non-executive directors’ turnover						
[–1; +1]	–0.23	–0.15	–0.23	–0.06	44.44	9
[–2; +2]	–1.09	–0.56	–3.01	–0.77	33.33	9
[–5; +5]	0.82	0.44	–0.02	0.53	44.44	9

Table 8
(Continued)

Window	Mean (%)	t-stat	Median (%)	z-stat	% Positive	N
Panel I: Chairman Turnover						
[–1; +1]	4.92	1.56	1.46	1.68	80.00	10
[–2; +2]	6.59	1.93	3.91	2.09	80.00	10
[–5; +5]	6.01	1.33	3.52	1.38	80.00	10
Panel J: CEO Turnover						
[–1; +1]	1.67	1.49	0.54	1.18	55.55	18
[–2; +2]	2.56	1.51	3.16	1.72	66.66	18
[–5; +5]	2.81	1.70	3.75	1.68	66.66	18
Panel K: CEO Turnover excluding events with confounding information						
[–1; +1]	2.37	1.88	1.65	1.42	55.55	9
[–2; +2]	3.68	2.23	3.85	1.96	66.66	9
[–5; +5]	5.82	2.92	6.61	2.07	77.77	9

The Table reports mean and median cumulative abnormal returns (%) in various windows around the announcement dates of various Hermes' engagement outcomes.

Table 9
Effect of governance outcomes on stock prices, by engagement attitude

Window	Mean (%)	t-stat	Median (%)	z-stat	% Positive	No Events	No Obs.
Panel A: All Engagements							
[–1; +1]	2.96	4.12	1.86	3.84	66.67	96	30
[–2; +2]	3.91	4.95	3.02	4.47	67.70	96	30
[–5; +5]	3.89	3.90	3.38	3.83	65.63	96	30
Panel B: All Engagements excluding events with confounding information							
[–1; +1]	3.68	4.38	2.12	4.27	72.73	66	30
[–2; +2]	4.58	4.86	3.11	4.31	68.18	66	30
[–5; +5]	5.65	4.53	3.89	4.32	71.21	66	30
Panel C: Collaborative							
[–1; +1]	3.26	2.08	1.98	1.83	65.00	20	7
[–2; +2]	4.11	2.95	4.31	2.54	70.00	20	7
[–5; +5]	1.92	1.19	3.12	1.60	70.00	20	7
Panel D: Collaborative excluding events with confounding information							
[–1; +1]	4.30	2.05	2.40	1.89	80.00	10	7
[–2; +2]	3.58	1.72	4.70	1.68	60.00	10	7
[–5; +5]	2.51	0.90	3.21	1.27	70.00	10	7
Panel E: Mixed							
[–1; +1]	2.45	2.37	1.68	2.28	65.00	40	12
[–2; +2]	3.82	3.05	2.41	2.78	67.50	40	12
[–5; +5]	4.79	2.92	3.39	2.68	65.00	40	12
Panel F: Mixed excluding events with confounding information							
[–1; +1]	3.68	3.12	2.21	3.33	73.33	30	12
[–2; +2]	5.37	3.83	3.60	3.50	76.67	30	12
[–5; +5]	7.23	3.87	5.19	3.67	76.67	30	12
Panel G: Confrontational							
[–1; +1]	2.76	2.30	1.84	2.18	67.65	34	11
[–2; +2]	3.10	2.36	2.79	2.18	64.71	34	11
[–5; +5]	3.30	1.92	3.50	1.99	61.76	34	11
Panel H: Confrontational excluding events with confounding information							
[–1; +1]	2.60	1.99	1.29	1.77	66.67	24	11
[–2; +2]	2.92	2.06	1.53	1.66	58.33	24	11
[–5; +5]	4.15	2.01	3.50	2.06	62.50	24	11

The Table reports mean and median cumulative abnormal returns (%) in various windows around the announcement dates of Hermes' engagement outcomes, partitioned by engagement attitude. Engagement attitude can be collaborative, mixed or confrontational.

Table 10
Restructuring and operating performance

Panel A: Return on assets

		Pre-HUKFF Years		Post-HUKFF Years	
		Year –2	Year –1	Year +1	Year +2
Return on Assets (%)	(Mean)	10.17	7.07	5.02	10.72
	(Median)	8.01	6.84	4.52	8.31
No. Obs.		20	20	20	20

Panel B: Restructuring

		Pre-HUKFF Years		Post-HUKFF Years	
		Year –2	Year –1	Year +1	Year +2
Total Assets (£M)	(Mean)	5,388	5,735	3,463	3,725
	(Median)	1,439	1,589	1,495	1,570
No. Obs.		20	20	20	20
Employees	(Mean)	25,817	26,689	16,438	16,336
	(Median)	13,459	12,340	7,506	7,451
No. Obs.		19	19	19	19

Panel C: Market-to-book

		Pre-HUKFF Years		Post-HUKFF Years	
		Year –2	Year –1	Year +1	Year +2
Market-to-Book	(Mean)	3.02	0.37	2.63	2.75
	(Median)	2.08	1.60	1.64	2.52
No. Obs.		20	20	20	20

The Table reports measures of restructuring and operating performance of targets of HUKFF engagement for selected years pre- and post- engagement. Panel A reports mean and median return on assets and total assets, and Panel B reports number of employees and Panel C reports market-to-book ratios. The data was taken from DataStream.

Table 11
Performance Hermes UK Focus Fund, 10/1/1998 to 12/31/2004

Panel A: Raw returns and CAPM alpha over the sample period

	Hermes UK Focus Fund (Raw Returns)	FTSE All	Hermes UK Focus Fund (Excess Returns)
IRR monthly	0.660	0.270	0.390
IRR annual	8.209	3.285	4.925
Total Return	63.741	22.385	41.356

Panel B: Fee structure of Hermes UK Focus Fund

Year	Management Fees	Performance Fees
1998	100.0%	0.0%
1999	100.0%	0.0%
2000	100.0%	0.0%
2001	25.6%	74.4%
2002	31.0%	69.0%
2003	100.0%	0.0%
2004	45.6%	54.4%
Average	71.7%	28.2%

The Table reports performance of the Hermes Focus Fund asset management. Panel A reports the fund's buy-and-hold return, net of management and performance fees. Panel B reports the fund's fee structure.

Table 12
Performance attribution regressions

	CAPM (1)	FF (2)	Mom (3)	FF + Mom (4)
α	0.77	0.41	1.42	0.86
	(.10)	(.31)	(.02)	(.10)
RMRF	1.16	1.13	1.04	1.10
	(.00)	(.00)	(.00)	(.00)
SMB		0.39		0.41
		(.00)		(.00)
HML		0.34		0.34
		(.00)		(.00)
Momentum			–0.34	–0.13
			(.02)	(.29)
No observations	75	75	57	57

The dependent variable is the monthly time weighted rate of return net of both management and performance fees of the Focus Fund Hermes portfolio in excess of the risk-free rate, as proxied by the U.K. Gilts rate. Factor regressions of value-weighted monthly returns are then estimated and the results reported below. The table reports the raw monthly return, the intercept α and the coefficients (factor loadings) on the explanatory variables RMRF, SMB, HML and Momentum. These variables are the returns to zero-investment portfolios designed to capture market, size, book-to-market and momentum effects, respectively. RMRF, SMB and HML are computed by Alan Gregory for the U.K. using the methodology of Fama and French (1993) and Carhart (1997); Momentum is computed by Chui, Titman and Wei (2005) for the U.K. using the methodology of Jegadeesh and Titman (1993, 2001). The sample period is from October 1998 to December 2004 (75 monthly observations) for the dependent variable. P-values are reported in parenthesis.

Table 13
Returns to various replicating portfolios

Replicating Portfolio	Rebalancing?	Annual Raw Return
Hermes' Net of Fees	Yes	8.21%
Hermes' Gross of Fees	Yes	10.07%
Private Info (1st day)	No	9.65%
Private Info (1st week)	No	10.65%
Private Info (1st month)	No	10.17%
Public Info	Yes	12.58%
Public Info	No	14.25%

The Table reports annual raw returns to trading strategies designed to replicate Hermes' trading strategy, based on private or public information, with or without rebalancing. Returns to Hermes' actual portfolio, net and gross of fees, are reported as a benchmark.

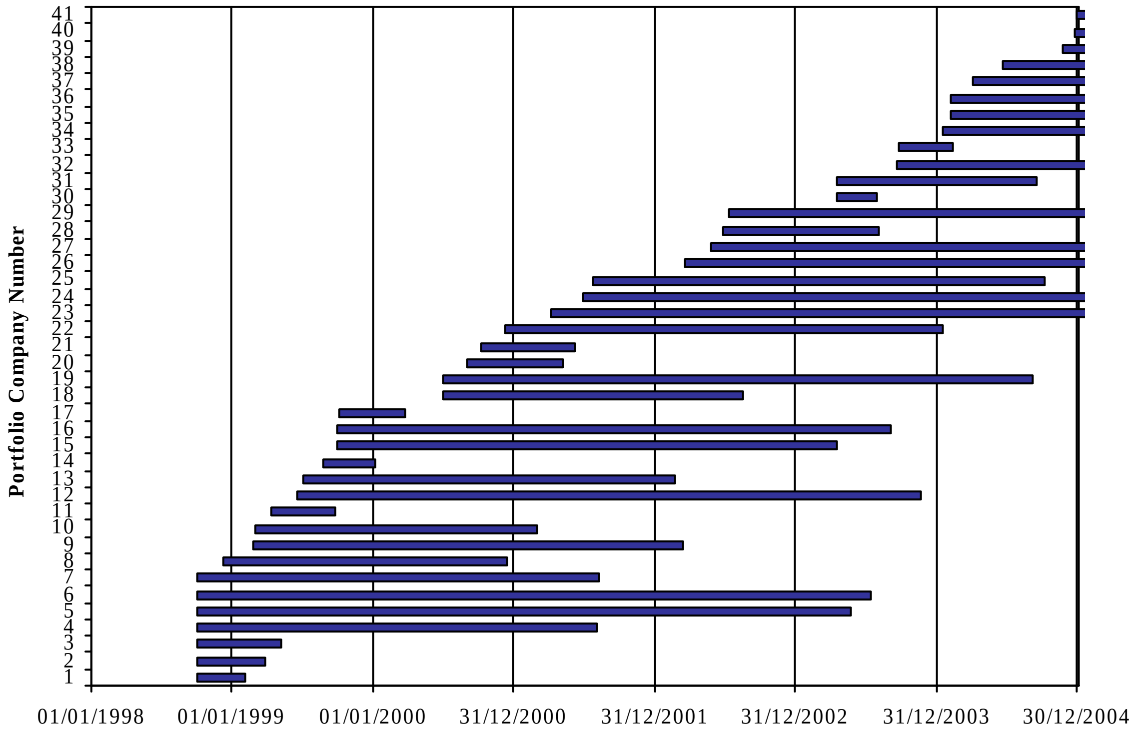

Figure 1
The Figure reports the timing and the duration of the 41 HUKFF portfolio investments that were made between the inception of the fund and 31 December 2004.

Appendix: Classification of engagement attitude

The attitude of engagements was classified into confrontational, mixed and collaborative. The classification is based on the subjective judgment of current and former fund staff and was corroborated by the authors using letters, memos of meetings and telephone conversations and press reports.

For each of the 30 companies that were engaged, we asked the staff to classify the attitude towards the fund at the beginning of the engagement, recording the attitude separately for the Chairman and the CEO (when the roles were split). The attitude was ranked using a score from 1 to 10, ranging from totally collaborative (1) to very confrontational (10). A score of 1 was never assigned, but a score of 2 was in several cases. A score of 10 was only assigned once.

Confrontational

Engagements were classified as confrontational when the target CEO initially rejected the proposals for change that were put to the company by the Focus Fund and this attitude did not change, or did not change voluntarily, throughout the engagement period. Engagements where the fund sought to replace the CEO and/or the Chairman against their own will were also classified as confrontational. The confrontational attitude finds clear expression in the exchange of letters between the Focus Fund and the company and, often more clearly, in meeting notes. The following examples provide illustrations of confrontational cases. Two were ‘very confrontational’ and were publicly hostile.

Case 1: The Focus Fund tried (and failed) to oust the Chairman of the target company A and replace him with an independent outside chairman. The Chairman and the target company resisted these changes. Press reports described the engagement as a "battle" or "storm", another wrote "Company A launched a blistering attack on two of its largest institutional investors yesterday, who had proposed the [company] be broken up in a radical restructuring".

Case 2: The Focus Fund and other institutions worked with a blockholder to oust family members, who were considered to be responsible for the underperformance of the target company. One newspaper observed: "the battle for control of company B, [....], is now pitting some of the City's richest and most prominent names against each other and threatening to spill some very blue blood on the carpet."

The following are less obvious examples of confrontational cases:

Case 3: A letter from the Fund to a non-executive director of a target company: "The purpose of this letter is to formally express our dissatisfaction with the performance of Company A PLC and advise that the current board can no longer rely on Hermes support as a representative of shareholders. Hermes believes that non-executive directors must be held accountable for long term destruction of shareholder value. We therefore support significant and early changes to the executive and non-executive components of the board and wish to see the process of restructuring completed before the end of the year."

Case 4: A letter to the Executive Chairman of the board of a company where the Fund sought a change in CEO: "To recap, it seems sensible to leave any major strategic moves until the new CEO is appointed and to allow him, or her, to own the way forward. As you said, it is many years since there was any new thinking in the business. Having said that I think it is fair to say that I suspect shareholders will need a lot of convincing that only the operations need to change, not the shape of the business."

Mixed

In the mixed engagements the demands of the Focus Fund were implemented reluctantly or grudgingly.

The following is a typical example of a mixed attitude engagement:

Case 5: Passage taken from the last paragraph of a letter written to the Finance Director: “Thank you once again for a fascinating day. We were very impressed by XX, and by the progress and effort which has characterized the last few years. However, as this letter has outlined, there are some areas where we have concerns, and these may be reflected amongst investors generally.”

The mixed category is less extreme and therefore more subjective than either confrontational or collaborative.

Collaborative

In the vast majority of the collaborative engagements there is no doubt about the attitude of the engagement.

A letter from the Focus Fund sent to the group CEO of a collaborative engagement towards the end of the engagement: "I remember when we first met, you talked about your early days at Company XY, when the future of British industry looked bleak and you were negotiating your way around daft restrictive practices. I'm sure that if you had told people then, that you would end up creating a British based [...] company, employing over 30,000 people, which was a global leader in its field, they would never have believed it. It is a fantastic achievement."

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