HOW DOES HEDGE FUND ACTIVISM RESHAPE CORPORATE INNOVATION?

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“Institutional Investor Activism and Engagement”

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Determinants of innovation are important because innovations establish companies’ competitive advantages (Porter, 1992) and are important drivers of economic growth (Solow, 1957).

Main Challenge: “… in the presence of asset specificity, uncertainty, and opportunistic behavior - differences in internal organization may impact innovative behavior...” Wiliamson (1985)

Novel projects are especially characterized by significant informational asymmetries between researchers and outside evaluators.

Researchers may manipulate information.

This paper: How, rather than just the extent, hedge fund activism impacts corporate innovation.
Main Results

- Hedge fund activism events covering the period 1994-2007
- Data on patents quantity and quality

- **Result I**: Firms targeted by activists improve innovation efficiency
  - Tightening of R&D expenditure while increase in innovation output

- **Result II**: New evidence on mechanisms through which hedge fund activism reshapes target firms’ innovation
  - Improvement mostly driven by firms with diverse patent portfolio
  - Reallocation of innovative resources
  - Redeployment of human capital
  - Change to board-level expertise
Overview of Discussion

- Research motivation
- Main results

- **Comment I:** The paper’s (second) core results take the literature on innovation in a new direction: rather than (just) determinants of innovation, paper informs us about the mechanisms.

- **Comment II:** Role of hedge fund activists vis-à-vis other institutional investors: assortative matching?

- **Comment III:** How does the individual (activist) hedge fund acquires innovation-specific skills consistent with paper’s results?
Comment l: Paper’s Contribution

- Blooming literature shows relations between innovation, market and firm characteristics:
  - **Competition** (Aghion, Bloom, Blundell, Griffith, and Howitt, 2005)
  - **Bankruptcy laws** (Acharya and Subramanian, 2009)
  - **Labor laws** (Acharya, Baghai, and Subramanian, 2013, 2014)
  - **Corporate venture capital** (Chemmanur, Loutskina, and Tian, 2014)
  - **Investors’ attitudes toward failure** (Tian and Wang, 2014)
  - **Stock liquidity** (Fang, Tian, and Tice, 2014)
  - **Firm boundaries** (Seru, 2014)
  - **Analyst coverage** (He and Tian, 2013)
  - **Institutional ownership** (Aghion, Van Reenen, and Zingales, 2013)
  - **Dependence on external finance** (Hsu, Tian, and Xu, 2014)
  - Etc.
  - Etc.
Question: Is this paper about hedge fund activism and innovation in target firms?

The paper is much broader than this narrow focus.

It is less about “who” (or “what”) determines innovation and more about the mechanism (actions taken by target firm management, perhaps under pressure from hedge funds) to reshape the innovation process.

This “evidence from the ground” is a new direction, and a useful contribution, in this literature.
Comment II: Institutional Investors

**Question:** Are the results driven specifically by an activist hedge fund or, more broadly, an institutional investor (with ability to monitor management, address career concerns, size to match up threat, etc.)?

- This will inform us about the type of market-based governance needed to make firms more innovation-lean

- Aghion, Van Reenen, and Zingales (2013)

- Contrary to the view that institutional ownership induces a short-term focus in managers, their presence boosts innovation (even after accounting for an increase in R&D)

- Risk considerations at the managerial level play an important role in preventing innovation
Comment II: Institutional Investors

- Paper informs us about the change in the behavior of firms after the entry of an activist hedge fund rather than the level of innovation itself, but...

- ...the question remains about the underlying economics of an activist investor vs. other (generic) institutional investors

- Suggestion: Assortative matching based on the stage of the firm’s life cycle?

- Are non-hedge fund institutional investors more valuable when the firm is at a stage when it needs to grow (and diversify) its patent portfolio to a strategic point...

- ...while hedge funds more valuable when it needs to pass to commercialization? [Hence a more focused, “ruthless”, approach?]
Comment II: Hedge Fund Skills

- **Question 1**: Are the results due to hedge funds’ innovation-specific skills or general skills that make firms leaner and more focused?

- **Question 2**: How does the individual hedge fund learns innovation-specific skills to evaluate the portfolio of patents?

- Hedge fund “type”/culture/approach or “manager effects”?

- Answering these questions will provide important color to the nuanced evidence that the paper presents.
Conclusions

- Paper gives us a new dimension about how the innovation process can be reshaped following an outside intervention.

- Very well executed and convincing in establishing the core results.

- **Suggestions for future research:**
  - Role of hedge fund activists vis-à-vis other institutional investors: is there any assortative matching driven by the stage in which the firm finds itself?
  - How does the individual (activist) hedge fund acquires innovation-specific skills consistent with paper’s results?