An Unintended Side-effect of Hedge Fund Activism? Human Capital Loss

When hedge fund activism triggers an exodus of key employees, everyone loses.

You can think of activist hedge funds as enforcers of economic efficiency. Alongside the rise of stakeholder capitalism, socially conscious activist investors have begun to push more sustainable business practices (see upstart Engine No. 1's recent **victory in a proxy fight** against Exxon). Over the last half-century, though, interventionist hedge funds have mostly rallied behind the flag of Milton Friedman, forcing changes geared towards boosting shareholder value.

Because activist hedge funds stick with an investment for only a few years at most, they are often suspected of thinking short-term. Yet their impact lingers long after they've moved on. Theoretically, targeted firms should end up leaner and meaner. The performance-enhancing effects of hedge fund activism should kick in strongly and last over time. However, **recent research** tells a more complex story.

In particular, unintended human capital loss pursuant to hedge fund activism may help explain why some firms targeted by activist hedge funds fare much better than others, according to my new paper in ***Strategic Management Journal*** (co-authored by my INSEAD colleague **Guoli Chen** and Wei Shi of University of Miami). As a rule, firms that were the object of hedge fund activism were far more likely to hemorrhage valued employees than their non-targeted peers – a difference directly linked to their financial performance in the following years.

When uncertainty reigns

We theorise that when talented and experienced employees learn that their firm has been targeted by an activist hedge fund, they feel anxious and uncertain. Are their jobs safe? If they manage to stay employed, will their job still be bearable if they have to dance to a hedge fund's tune? When humans feel threatened, it tends to trigger a "fight or flight" response. The power structure at most companies would prevent employees from mounting an effective counterattack. The second option – fleeing the firm and finding a job elsewhere – is much more attainable for the kinds of in-demand employees we're concerned with.

To test our hypothesis, we collected data from US public companies for the period 2004-2015. As we did not have access to information about voluntary employee departures at targeted firms, we used a proxy verified by past research: cancellation of employee stock options. This proxy also helps us to identify a firm's loss of key employees as opposed to its rank and file, since it is the most valuable employees of a firm that are typically rewarded with stock options.

Our analysis found that hedge-fund-targeted firms experienced a 24 percent increase in the cancellation of employee stock options compared to non-targeted firms. Moreover, the targeted firms that had the highest cancellation rates also received less of a performance boost from the shareholder-friendly changes introduced by the hedge fund. Human capital attrition, therefore, can weaken the impact of hedge fund activism on firm performance.

Ruling out alternative explanations

In verifying our results, we controlled for variables such as firm size, debt ratio, R&D activity and sales growth. Also, we looked at the potential role of layoffs, because we could not otherwise be certain that the stock option cancellations stemmed from voluntary departures as opposed to the usual deadwood-trimming that accompanies hedge fund activism. First, we excluded firms that implemented layoffs in one of our subsample analyses with no significant change to the results. Second, since the positive performance effect of hedge fund activism in targeted firms is weaker if those firms experienced a higher loss of employees, it is likely that the employees who left were not deadwood but valuable, productive contributors to the organisation.

Further, we undertook four separate analyses to rule out that layoffs are responsible for the effect we find. If layoffs were responsible, firms that were inefficiently run – i.e. that had lots of deadwood to chop away – should have lost more people, but the opposite was actually the case. Firms with higher operational efficiency experienced more employee exits.

We also found that hedge funds known to be confrontational, therefore more likely to militate for layoffs, were not associated with higher attrition compared to less confrontational hedge funds. But states with lax enforcement of non-competition agreements *were* associated with higher attrition – which suggests poaching of talent more than retrenchment.

Finally, the productivity of R&D employees in our sample of targeted firms – as measured by the annual number of patents filed – rose in their next job, suggesting that they left for greener pastures rather than being laid off.

Compromised activism

Overall, our paper shows that hedge fund activism can become compromised on its own terms if talented employees decide not to stick around. Most companies know that hedge fund activism may cost them in the long term, but our study can serve as yet another note of caution against becoming a target.

If a company does wind up in the crosshairs of a hedge fund, however, the performance implications may depend a great deal on the existing state of its employee relations. Preliminary results indicate that firms that treat employees well by offering retirement plans, profit-sharing programmes, a work environment tolerant of labour organisation, etc. are better able to retain key employees after an activist's attack. Of course, some caveats are in order. For instance, cushy perks and benefits for employees can be prohibitively expensive for some. Still, it's generally a good idea for firms to do what they can to ensure good employee relations, given the relevant financial trade-offs, whether or not activist hedge funds come calling.

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