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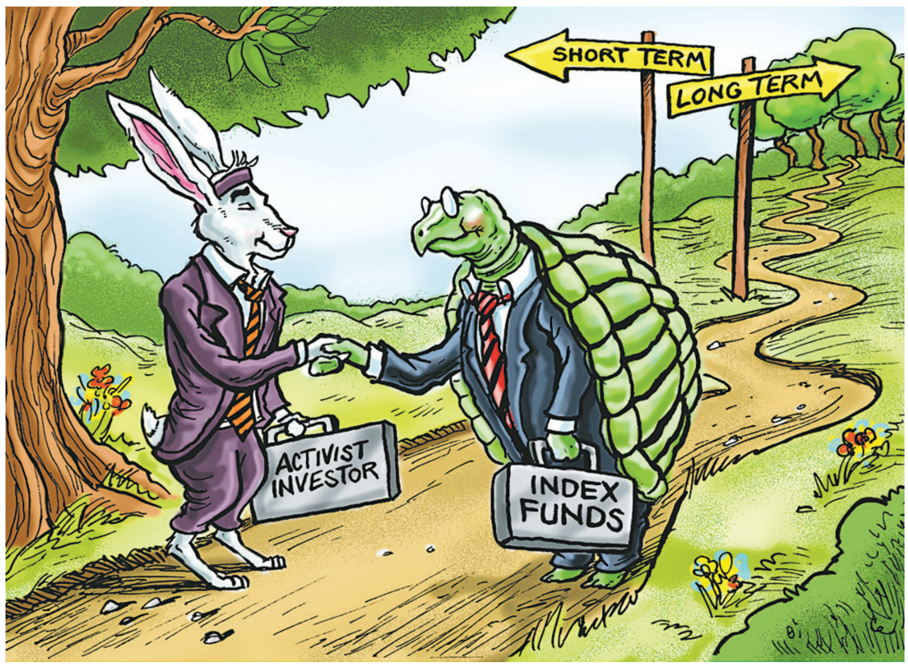
COMMENTARY

Efficient Markets Need Guys Like Me

Activists and index funds are natural allies. There's no conflict between short- and long-term value.

By Paul Singer



CHAD CROWE

The largest proxy battle in U.S. history ended last week in a near tie, leaving Procter & Gamble without the clear support of its shareholders and activist shareholder Nelson Peltz without a board seat.

P&G's three largest shareholders split their votes: Vanguard sided with P&G, while State Street and BlackRock voted almost all their shares for Mr. Peltz. The stakes held by these giant index funds were so large that had any of them voted differently it would have changed the outcome—either a clear victory for Mr. Peltz or a clear mandate for P&G management.

This power dynamic illustrates the enormous influence that the three largest index-fund firms (together with other passive institutional investors) have acquired over such contests—and helps explain an intensifying debate over where their allegiances should lie. On one side is a small class of legal, banking and public relations professionals who advise underperforming corporations. On the other are the activist investors who seek to hold those corporations accountable.

Rather than "short term vs. long term," how about "good ideas vs. bad ideas"?

There is a fair debate to be had about the appropriate balance of power between public corporations and their shareholders. But the debate has been badly skewed by a false narrative. "Anti-activist" advisers have attempted to drive a wedge between activist investors and index funds by suggesting that activists are interested only in short-term gains at the expense of long-term value. This divisive framing is objectively false and has done harm to the goal of generating sustainable returns for all investors.

For starters, all of a company's shareholders are more aligned with each other than they are, say, with a group paid to defend corporations from shareholder challenges. Index funds and activist investors share the goal of generating returns for their investors, even if they go about it in different ways.

The primary idea behind passive index-fund investing is the efficient-market hypothesis: Markets are said to be efficient because millions of informed investors continuously think about, research and analyze companies, markets and securities. Thus, all possible information and insight is said to be always contained in securities' prices at all times.

But passive investing is reducing the percentage of active managers to the point where they may actually become the minority in a few years. So who is going to do the work that theoretically creates efficient markets?

Activist investing provides one possible answer. Equity activism means using your voice and voting rights to improve companies in ways that maximize value for all shareholders. Seen in that light, index funds should consider activist investors to be natural allies.

Some index-fund firms have begun to focus on voting, governance and the potential benefits of activism. They've deployed teams of smart, honest professionals to promote best practices across their firms' entire holdings. Certain aspects of corporate governance as a whole have improved—in some cases meaningfully—thanks in part to these initiatives.

On a company-specific level, however, with thousands of companies to be evaluated, it is impossible for these teams to do the kind of comprehensive financial and operational analysis required to identify corporate situations in need of change.

Activist investors can play this critical role, so long as the governance teams at large passive investing firms are willing and able to evaluate activists' ideas on their merits. Unfortunately, as soon as an activist shows up at an underperforming company with an idea for creating value, the company's advisers frequently seek to make the debate about time horizons. Index-fund firms are encouraged to look with suspicion at any idea whose benefits would crystallize in the near term—regardless of whether the idea represents the best possible alternative for shareholders in the long run as well.

The canard that activist shareholders promote short-term gains at the expense of long-term value has been utterly demolished by academic research. Harvard's Lucian Bebchuk examined more than 2,000 activist events spanning 13 years and found that these interventions resulted in a 6% rise in stock prices on average and that targeted companies managed to hold on to these gains, above their benchmarks, over a five-year period.

Besides being contradicted by the facts, the short-termism accusation makes no logical sense. My firm has a 40-year track record. Our currency is our credibility. If our activism did not create long- and short-term value, we would have a hard time persuading management, boards and other shareholders even to listen to us, much less implement our ideas. Activists who push for solely "short-term" solutions are themselves going to be "short-term" players.

All shareholders would benefit from replacing this false distinction with a new framework for evaluating activist proposals. Rather than "short term vs. long term," how about "good ideas vs. bad ideas"?

Good ideas create better outcomes for shareholders. Far too often companies hide behind "long term" as a way to justify prolonged underperformance. There are good ideas that create sustained improvements and can be implemented quickly. Likewise, there are bad ideas that can take a long time to destroy value.

The benefits of fixing a broken strategy, getting rid of a bad acquisition, redeploying an underperforming asset, or replacing an ineffective management team or board may show up right away in a company's stock price, but that immediate result doesn't diminish the long-term benefits.

America has a lot riding on the success of its public companies, as do index-fund firms themselves. Important conversations about strategy, governance, capital allocation, corporate culture and leadership are being stifled by the divisive, distracting and intellectually dishonest framing of "short-term vs. long-term." Instead of debating time horizons, index-fund firms and activists should work together to promote the very best ideas for improving America's businesses.

Mr. Singer is founder and co-CEO of Elliott Management Corp.