Hedge Fund Activism and ESG: Examining the Role of Activist Hedge Funds as Protagonists in Capital Markets

Karl Valentini (karlvale@wharton.upenn.edu)

Professor Sarah Light, Assistant Professor of Legal Studies & Business Ethics

(lightsa@wharton.upenn.edu)

Wharton School of the University of Pennsylvania

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Author Note

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All correspondence in relation to this article can be addressed to Karl Valentini.

Contact: karlvale@wharton.upenn.edu

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ABSTRACT

ESG investing is a recent trend that has been gaining major traction in the investment community. Within that community, activist hedge funds have been powerful agents in shaping the corporate landscape and in creating value at the companies they target. Research has been conducted on both hedge fund activism and ESG investing, but fails to examine the intersection between the two investment strategies. To fill that gap, this paper aims to examine whether the increased popularity of ESG investing is affecting how activist investors pursue value creation at the companies they target. The findings show that the most common ESG considerations in activist campaigns relate to "Governance". Further analysis of gender diversity as an ESG consideration suggests that activist hedge funds may be more likely to nominate female directors when target companies already have at least one female director. The paper ends with an analysis of why activist hedge funds are becoming more important for keeping companies accountable within the context of the rise of passive investing and how that can relate to more of a heightened focus on ESG considerations.

Keywords: Shareholder Activism, Hedge Fund, ESG, Sustainable Investing, UN Principles for Responsible Investing, Gender Diversity

INTRODUCTION

On July 4th, 2018, the tech giant Apple announced it would be introducing "wellness features" to curb its customers' excessive use of its devices, such as the iPhone and the iPad. Only a few months prior to the announcement, the activist hedge fund Jana Partners and the pension fund behemoth known as Calstrs (i.e. California Teachers' Retirement System) delivered a joint letter to Apple imploring them to explore software tools to control or limit people's use of their devices (Benoit, 2018). According to the two Apple shareholders, the changes would help address the major health issues related to device addiction, particularly among youth, and also allow Apple to build customer loyalty, avoid bad publicity and get in front of potential government regulations (Benoit, 2018). Apple listened to the concerns raised by the activist campaign, providing a compelling example of how activists are dealing with the growing trend towards sustainable investing.

In the past, activists campaigns have pushed Apple to return some of its huge cash pile to shareholders, but the most recent campaign was markedly different and could represent a new chapter in the activist's playbook: sustainable activist investing. For context, there are many different types of investors, but for this paper, the focus will be on two types: active and passive investors in public equities. Passive investors offer funds that buy securities tracking indexes or groups of securities, such as index funds or exchange-traded-funds, while active investors select which securities they believe will provide maximum returns ("Definition of passive management", 2018; "Definition of active management", 2018). Activist hedge funds, such as Jana Partners, are a subset of active investors who take large ownership stakes in public companies, often through equity and derivatives, and try to influence them ("Definition of activist investor", 2018). An activist can use a variety of tools to get its targeted company to follow its proposals, and in doing so, the activist's ultimate aim is to have the company's stock price increase and profit from its ownership stake (Bebchuck, 2015, p. 7). Often the proposals deal with governance issues, and at their best, activists can be powerful governance watchdogs.

Like any other campaign, Jana's Apple campaign utilized some of the activist's primary tools for affecting change, including disclosing a public letter and waging a public campaign. However, there are key differences. First, it was conducted with a large institutional and more passive investor – a pension fund. Second, the basis of the campaign was primarily a social issue that could drive potential business impacts, rather than a specific issue with Apple's business operations or finances. Third, the target company followed the activist's proposals to become more socially responsible. Historically, activists have been powerful agents of change at the companies they target, and Apple's reaction highlights the influence of activists. With the emergence of sustainable investing, investors are now becoming more conscious of sustainability issues at companies, which activists could begin to incorporate in their campaigns.

Given the rise in popularity of sustainable investing and the success of hedge fund activism, both strategies have been the subject of focused studies. Although much of the research on sustainable investing is recent, it is wide-ranging, looking at how to define it as well as how implementing its practices impacts firms, investors and capital markets (Esty & Cort, 2017; Eccles, Ioannou, & Serafeim, 2014). Similarly, the research on hedge fund activism is dedicated to studying the returns of activist investors; how they impact and behave in capital markets (i.e. objectives, choice of targets and tactics); how they are affected by public policies; how companies can deal with activists; and how they impact the companies they target (Brav, Jiang, & Kim, 2010; Sullivan & Cromwell LLP, 2016). Studies have looked at individual elements of sustainable investing and hedge fund activism. In fact, recently, researchers have found that women are underrepresented within the spheres of activist hedge fund managers and director nominees proposed by activists (Sutherland, 2018). Since gender diversity is an important consideration of sustainable investing, the research on gender diversity within the context of hedge fund activism represents an important intersection that should be further examined, but has not been a major subject of studies. Possible reasons for this are that sustainable investing is a relatively recent trend, activist investors are not traditionally associated with it, and there is a lack of clear and consistent data on sustainable investing (Esty & Cort, 2017, p. 8-10).

This paper will aim to contribute to the literature on sustainable investing and activist investing by analyzing activist investing through the lens of ESG. For the purpose of this paper, sustainable investing will be represented by ESG investing, which is using environmental, social and governance factors in an investment framework. While other studies have looked at activist campaign objectives, this study will add to them by looking at how activist objectives relate to ESG considerations. An additional analysis will be focused solely on the impacts of hedge fund activism on gender diversity in boardrooms since it is an ESG-related concern that has become a major focus for corporate governance and firm performance. The analysis will add to current research by breaking down the qualitative aspects of each activist intervention that is characterized by discussions on gender diversity or female directors. Few studies also incorporate data as recent as this study, which looks at the past three full years. This is important considering how recent sustainable investing has become popular and activists have waged "social responsible campaigns". Moreover, much of the research on activism relies on obtaining data from three sources: Activist Insight, SharkRepellent.net and public filings (Lazard's Shareholder Advisory Group, 2017). This paper uses data from SharkRepellent.net, but the main focus is on constructing a personalized database of activist campaigns from public filings.

Qualitative research is conducted to create a description for each activist campaign that can be analyzed for specific ESG terms. Thus, the research methodology is distinctive since it combines qualitative and quantitative components, and utilizes an independently assembled sample

Ultimately, this paper focuses on finding how activist investors are incorporating ESG issues in their campaigns. It finds that the most common ESG-related concerns are issues related to “Governance”. Accordingly, the main objectives of the activist campaigns studied are similar to the main objectives highlighted in past studies on hedge fund activism. Although activists highlight fewer considerations related to the “E” and “S” dimensions, their emphasis on governance is significant because governance is the dimension perhaps most linked to a firm’s value and can serve as the basis for a company implementing other ESG-considerations that are value enhancing. Therein lies the essential part of any relationship between the rise in ESG and hedge fund activism: activism will and should promote ESG-issues as long as they are value enhancing. In terms of gender diversity, the results suggest that activist hedge funds may be more inclined to nominate a female director when there is already at least one female director on the board of the targeted company. Finally, by looking at existing data on the investment industry, this paper argues why activist hedge funds could become increasingly concerned with ESG factors, and offers recommendations for aligning hedge fund activism with ESG investing.

SECTION ONE: CONTEXT

What is sustainable investing?

At the beginning of the 21st century, the rise of cheap index funds tracking the market changed the investment landscape, and now sustainable investing promises to do the same. With its growing popularity, sustainable investing has brought a flurry of new investment frameworks and terms, including but not limited to: impact investing, socially-responsible investing, missionrelated investing, responsible investing, and environmental, social and governance investing (Caplan, Grisworld, & Jarvis, 2013). Of these frameworks, the most commonly referred to one is ESG, which encompasses environmental, social and governance issues (i.e. ESG) as core sub-categories (Esty & Cort, 2017, p. 17). A watershed moment for ESG investing came when the United Nations passed the Principles for Responsible Investment (PRI) in 2006 (Caplan, Grisworld, & Jarvis, 2013). The resolution called for six principles advocating for the use of ESG factors in investment decision making, ownership, disclosure and reporting. There exists no conclusive list of ESG issues, but there are some major examples. Typically, the environmental factors include measurable forms of climate change, greenhouse gas emissions, energy sources, protection of biodiversity, and waste or resource depletion. Social factors can cover gender diversity, human rights, consumer protection, working conditions, health and safety. Finally, governance concerns can relate to boardrooms (for example, their independence, bylaws and structure), corruption, tax planning, compensation, employee relations and disclosures (The Economist, 2017; Esty & Cort, 2017, p. 21).

Although still a recent initiative, the UNPRI has generated rapidly growing interest. As of April 2017, the total number of signatories to the UNPRI has reached 1,714 asset owners, investment managers and service providers who represent over $68 trillion of AUM, which is a little more than half of all institutional assets globally (“Principles for Responsible Investing”, 2017). Of these signatories, there are 346 asset owners with AUM worth of over $16 trillion. Likewise as of April 2018, there are $22.8 trillion worth of assets that are SRI compliant and $11 billion is invested in global ESG ETFs across over 120 funds (J.P. Morgan Markets, 2018). Today, BlackRock, Vanguard and Goldman Sachs, among many others, offer ESG integrated products. These numbers and examples highlight how sustainable investing is becoming a norm, rather than an outlier, in the investment industry. In fact, according to Axioma, more than 80 percent of S&P 500 companies now provide ESG disclosures (Thompson, 2018). More company disclosures and data can help improve metrics, scoring and analysis related to ESG investing.

Despite these developments, the investment community remains divided on some issues. Building on research by BNY Mellon, the researchers Esty and Cort (2017, p. 14-26) find that investors are uncertain of how to reconcile their interest in sustainable investing with their investment process and of possible trade-offs between sustainability and financial returns. To illustrate this, the researchers developed a spectrum denoting five categories of sustainability investor types. At the left end, driven exclusively by values, is the SRI investor who uses negative screening to avoid companies engaging in ethically dubious behavior, like tobacco or oil companies (The Economist, 2017; Esty & Cort, 2017, p. 25). Moving along the continuum, impact investors aim to create measurable social or environmental impacts while generating returns; risk-oriented mainstream investors avoid unsustainable companies to lessen financial risks; and mainstream investors try to allocate more money to sustainable companies and less to unsustainable ones. At complete right end, focused solely on maximizing financial returns, the green alpha investor actively chooses sustainability leaders to get market outperformance.

What is hedge fund activism?

When companies enter the public markets, they open themselves up to close examination and their boardrooms become accountable to public shareholders. These shareholders can be individuals, passive investors who own companies through the index funds or exchange-traded-funds they manage, or a variety of active investors. Of the different types of active investors, activist hedge funds have evolved from and refined the approach of corporate raiders from the

1980s to provide a counterbalance to bad managers and to act as watchdogs (The Economist, 2015).

Like any other hedge fund, the overarching goal of an activist hedge fund is to generate outsized returns for its investors. Unlike traditional equity-oriented funds, however, activist funds use a variety of tools to proactively engage with companies that passive investors and most other active investors do not. In doing so, they seek to implement changes or influence decisions that, according to their analysis, will be better for the company and for maximizing shareholder value, thus boosting share prices. Activist proposals include changes to the management team, board members, governance structure, capital structure, capital allocation, operations and/or business strategy of a targeted company (Bebchuck, Brav, & Jian, 2015, p. 7; Brav, Jiang, Partnoy, & Thomas, 2008a, p. 47). In some recent intervenetions, activists have pushed for changes reflecting ESG considerations, which raises the possibility that activist hedge funds can become proponents of ESG investing while pursuing the maximization of shareholder value. Although activists may have a reputation of profiting from short-term price changes, in practice they take more of a medium- to long-term view on positions compared to other hedge funds, especially in large campaigns, and the average activist holding period is estimated to be longer than a year (The Economist, 2015; Boyson & Mooradian, 2011, p. 1; Brav, Jiang, Partnoy & Thomas, 2008b, p. 1731). The holding pattern suggests activists are often concerned with the long-term viability of a company, and again that ESG factors could become more and more important for them.

Depending on the activist's approach to engaging with companies, there are several paths to a successful campaign. In most cases, the activist will try to engage with its target and present proposals that its analysis suggests will boost shareholder value. Activists can and do target companies of any size – small, mid-sized and large cap companies – but they typically do not target operationally distressed ones (Sullivan & Cromwell LLP, 2016, p. 13; Boyson & Mooradian, 2011, p. 1). Instead, activists are likelier to target companies with strong operating cash flows, but with low valuations relative to their book value (Brav, Jiang, & Kim, 2010, p. 188; Brav, Jian, Partnoy, & Thomas, 2008b, p. 1730). Depending on how conversations with its target's management team go, the activist can then acquire a relatively substantial portion of its target, usually below 10 percent. One study puts the median ownership figures at seven percent across all campaigns and three percent in large-cap ones (Brav, Jiang, & Kim, 2010, p. 203; Boyson & Mooradian, 2007; Sullivan & Cromwell LLP, 2016).

During a campaign, an activist has several options for pressuring its target into making its desired changes. The most high profile strategy is to wage a proxy contest to replace a company's current board members and nominate its own slate of directors. Historically, activists have had a success rate of nominating on average around .50 board seats per campaign (Sullivan & Cromwell LLP, 2016, p. 12). The largest proxy fight waged by Nelson Peltz's Trian Partners against Procter & Gamble Co. costed nearly $60 million and gave Nelson Peltz a board seat (Benoit, 2017). Since proxy contests can be expensive, companies often reach settlement agreements with activists that include standstill provisions and support for an activist's involvement and board nominations. Data shows companies are now settling much quicker than before (Flaherty & Athavaley, 2015). Other common tactics include using public disclosures, such as sending public letters like Daniel Loeb from Third Point Management has been known to do, and in fewer instances, submitting shareholder proposals (Sullivan & Cromwell LLP, 2016, p. 16). Activists use these strategies to get greater control of a target company's board, which can then be used to more forcefully and effectively push for desired changes whether they are related to governance, capital allocation, operations or business strategy.

Although these tactics and strategies are effective, companies do often fight back and some corporate features make it easier to fend off activists. For example, when a company has staggered boards then only one-third of directors are subject to re-election in a given year, limiting the opportunities to replace board members and seek changes to governance (Bebchuck et al., 2015, p. 71). Other problematic features include plurality voting and poison pills (Sullivan & Cromwell LLP, 2016, p. 1). Yet, these corporate policies are becoming increasingly uncommon since activists can use them as platforms for campaigns against a company. Another area of concern for activists is “proxy access”, which is what gives shareholders the right to put their own board nominees on a corporate ballot without a proxy contest (Bebchuck et al., 2015, p. 72). Although proxy access has been supported by both ISS and Glass Lewis, the two main proxy advisory firms, it has not been widely adopted, and there remain restrictions that impede its practicality (Sullivan & Cromwell LLP, 2016, p. 29; Park, 2016). The higher volume and profile of activist interventions has led to more regulatory oversight and discussions, and so the evolution of the regulatory environment will be important for activists moving forward.

In the past decade, activist hedge funds have completed many successful campaigns and generated outsized returns, which has allowed them to attract large inflows – total activist funds under management are pegged at around $130 billion or $350 billion when counting active managers who can become activists (Foley, Inagaki, Massoudi, & Johnson, 2015). As fund commitments have increased so have the overall number of activist interventions per year and the amount of foreign interventions in Asian and European markets (Sullivan & Cromwell LLP, 2016; The Economist, 2017). However, the largest funds are responsible for a high proportion of campaigns – the largest funds are part of a list called the SharkWatch 50, which includes Icahn Associates, Elliott Management and Third Point Management (Sullivan & Cromwell LLP, 2016, p. 11; *SharkWatch 50*). Taken as a whole, the rise and professionalization of activists through hedge fund activism have changed the corporate landscape. The boardroom or CEO of any public company must be mindful of an activist hedge fund targeting them and campaigning for changes – in some cases, incumbents' board positions or jobs are at risk. The new question now becomes whether activists can affect the same level of change on the corporate landscape while also adopting ESG considerations in their investment framework.

SECTION TWO: RESEARCH OVERVIEW

Measuring the impacts of ESG

An increased interest in ESG factors has led to a growing body of research. According to Esty and Cort (2017, p. 18), two of the most important questions studied are whether implementing sustainability practices can improve business results and stock market returns, and whether it is possible to use metrics to determine which firms are truly sustainability leaders. Research has also been undertaken to better understand the data behind ESG scoring and metrics. Taken as a whole, the research on these various subject areas shows mixed results.

There are several viewpoints on how an emphasis on ESG factors can impact financial returns. Research from data providers suggests that ESG-focused portfolios tend to outperform (Mooney, 2017; Thompson, 2018). Several data providers find that their ESG-adjusted indexes outperform their benchmarks and the non-adjusted indexes by significant margins – the MSCI All-World index outperformed the non-adjusted index by an average of 39 basis points per year from 2012 to 2017. For fixed income, a team at JPMorgan compared ESG-adjusted emerging-market government debt indexes issued in U.S. dollars and in local-currency respectively as well as corporate debt indexes adjusted for ESG factors to the respective non-adjusted indexes, and found slight over-performance for those which were ESG-adjusted, except in the case of corporate debt – returns of 22.6% versus 23.9% when non-adjusted (Sindreu, 2018). While these studies offer guidance on ESG's possible impacts, they do not prove causation.

In terms of business performance, there is strong evidence that sustainability-focused firms can outperform their less sustainable peers (Eccles, Ioannou, & Serafeim, 2014). A pair of researchers find that for different industry sectors sustainable companies outperform their control group by achieving "*higher* mean sales growth, return on assets, profit before taxation and cash flow from operations" (Ameer & Othman, 2011, p. 69). For example, sustainable companies in the Industrials, Consumer Discretionary, Consumer Stables and Telecommunications spaces showed higher profit before taxation and cash flow from operations than peers in their respective control groups (Ameer & Othman, 2011, p. 69). Since performance varies across economic cycles, a study comparing the socially responsible FTSE4Good portfolio to the FTSE 350 portfolio found that the FTSE4Good portfolio had better performance and recovered in value more quickly following the 2008 financial crisis (Wu, Lodorfos, Dean, & Gioulmpaxiotis, 2015). The results suggest that socially responsible firms can be better equipped to deal with recessions or other economic crises. When incorporating the concept of materiality, three Harvard Business School researchers find that firms which excel in material sustainability topics outperform firms that perform poorly on those topics, and conversely, strong performance in immaterial sustainability topics provides no performance benefits (Khan, Serafeim, & Yoon, 2015, p. 3). An analysis of materiality-adjusted portfolios reveals similar results (Khan et al., 2015). The analysis is significant since it gives credence to the theory that investing based on ESG components material to a company could provide a framework for generating outperformance.

These findings are also supported by a meta-analysis conducted by two Oxford researchers and a director at Arabesque Asset Management. They find that 90 percent of studies show that sustainability leaders have a lower cost of capital; 88 percent show that these companies have better operational performance; and 80 percent of studies show that incorporating ESG or sustainability principles can boost stock price (Clark, Feiner, & Viehs, 2015, p. 9). Intuitively, the results make sense because sustainable practices often correspond to strong business practices too. Strong governance usually follows from having an effective management team, performance sensitive compensation policies and efficient capital allocation policies. Likewise, strong environmental and social practices can lead to more waste reduction, a more highly motivated workforce, greater efficiency and more innovation, which are all hallmarks of a good business. Implementing sound sustainable policies can also help with risk management, with avoiding fines or bad publicity, and with anticipating changes in the external environment. In terms of the "S" in ESG, there is strong evidence that a diverse workforce and boardroom can boost financial performance, corporate governance and facilitate innovation (Adams & Ferreira, 2009; Carter & Wagner, 2011; del Carmen Triana & Miller, 2009). Ultimately, there are certain sound business practices that also fall under the umbrella of ESG policies, which can make sustainability leaders out of strong businesses.

Within that context, however, there is also evidence that an ESG emphasis may not be best after all. Some studies find no evidence of a correlation between corporate responsibility and better performance (Esty & Cort, 2017, p. 19). An empirical study by Gerhard Halbritter and Gregor Dorfleitner (2015) used ESG data from several different providers to build ESG portfolios. Their findings indicate that companies with low ESG ratings perform just as well as those with high ratings, and that data parameters can have outsized influence on results. Other studies present potential pitfalls that come from implementing ESG investment considerations. The researchers Harrison Song and Marcin Kacperczyk (2009) show that "sin stocks" can have abnormal excess returns, which has been supported by other studies (The Economist, 2014; Eley, 2015). In fact, a study of 113 publicly-traded American software companies broke down companies' corporate social responsibility (i.e. CSR) practices into positive and negative ones, finding that associations to financial performance were dependent on a firm's competition actions to enhance its competitive position. Firms with high levels of competition action benefited from positive CSR, whereas when competition action was low firms benefited from negative CSR (Kim, Kim, & Qian, 2018, p. 1106-1110). The results suggest that investors can miss out on better performance when placing an emphasis on ESG factors, and that in some cases firms may be justified in curtailing ESG initiatives. A possible explanation for these results provided by Esty and Cort (2017, p. 19-20) is that bad actors can profit from regulatory shortcomings that do not punish negative externalities. With more stringent and relevant regulations, then perhaps ESG-focused firms could be rewarded compared to their counterparts.

The divergent views on the impacts of ESG activities on firms, markets and financial performance stem in large part from framing and data issues. First, companies that generate high incremental returns on capital are likely to have strong ESG practices because they are quality companies, which makes teasing out the causality of ESG practices difficult. For example, while ESG practices could boost performance, the inverse can be true when quality companies are capable of implementing ESG practices because they are already outperforming. Similarly, it can be difficult to separate sustainable companies from the nature of their business and industry. In fact, researchers have found it is difficult to distinguish an ESG-oriented process from a fundamental investing process (van Duuren, Platinga, & Scholtens, 2015).

In terms of specific issues with the existing data on ESG, Esty's and Cort's (2017, p. 27-29) highlight several. The data is not focused enough on operational performance; ESG-related metrics are largely backward-looking; metrics lack materiality to track the impacts that matter most; disclosure requirements for companies are unclear and too broad; and there are errors, gaps and inconsistencies in the existing data. As an illustration, according to an NYU study called "Putting the 'S' in ESG", there are more than 1,700 different factors that can be used to measure the social component of ESG (The Economist, 2017). Esty and Cort (2017, p. 24) also cite a study that finds a 14 percent and a 31 percent correlation between the Governance and Environment sustainability scores calculated by two of the major ESG data providers, MSCI and Sustainalytics. Due to such issues, it is difficult to determine which sustainable practices will promise higher returns, whether a company is an ESG leader and whether it is possible to compare companies along ESG criteria. As sustainable investing continues to gain in popularity, researchers, investors and policymakers should examine, refine and develop new ESG and sustainability frameworks.

Examining the role of hedge fund activism

Studies on activist hedge funds look at several dimensions with particular attention given to studying the performance of these hedge funds and their impacts on the companies they target. Both areas of research are important since they can establish whether the activist approach is a successful one and whether it enables hedge funds to actually bring changes to targeted companies. If the activist approach is shown to be successful in bringing changes, then the question becomes whether activists are willing to push for ESG changes at companies.

First, the literature on financial performance is mixed, but does show that hedge funds and shareholders can benefit from an activist approach to investing in companies. Many studies examining stock market returns show that positive abnormal returns, usually between 5-10%, surround the announcement of activism, and that in the long-run these financial returns persist (Brav, Jiang, & Kim, 2010, p. 189; Brav, Jiang, Partnoy, & Thomas, 2008b). These findings suggest that activists succeed in bringing shareholders higher returns and that investors reward activists by boosting stock prices ostensibly because they believe these hedge funds can unlock greater shareholder value. In terms of the returns actually earned by these hedge funds, a group of researchers found that a sample of self-reported activist hedge funds had higher average excess returns than the samples of all hedge funds, of all equity-oriented hedge funds and of a peer group matched by size and age (Brav, Jiang, Partnoy, & Thomas, 2008a, p. 55-56). Likewise, another study found that aggressive activists boast better performance and activists pushing for governance-related changes have higher risk-adjusted returns by around 10.8% compared to non-activist hedge funds (Boyson & Mooradian, 2011, p. 20). The findings show that activists are better served having focused campaigns, and also substantiate the idea that activist strategies can be successful, especially when bringing ESG-related changes.

Despite these findings, there is still evidence casting doubt on the strength of the activist strategy. In the same study highlighted above, Boyson and Mooradian are not able to conclude that activist hedge funds generally outperform their non-activist peers. Another study also suggests the high net returns reported by activists should be adjusted downwards to account for the high costs of launching activist campaigns (Boyson & Mooradian, 2011, p. 20; Gantchev, 2011). It is also important to consider that activist hedge fund managers could be more skilled than their non-activist counterparts, and their skill accounts for the higher returns of their activist funds rather than the activist strategy they employ. Another claim levied against activist hedge funds is that the outsized returns they generate represent a redistribution of value taken away from other stakeholders, such as creditors and management, but there is strong evidence that this is not the case (Brav, Jiang, Partnoy, & Thomas, 2008a, p. 1766-1770). Within the context of the academic debate on the financial performance of these hedge funds, they still continue to raise record amounts of outside capital.

To show that activists are not just stock-pickers benefiting from publicly pointing out undervalued companies, researchers have looked at whether activists can influence targets and bring positive changes. In some quarters, activist hedge funds get criticized for being short-term profit driven and thus pushing for quick changes, such as boosting leverage or reducing long-term investments to increase payouts at the expense of long-term value creation. However, the literature details how hedge fund activist interventions can enhance operating performance, corporate governance and capital structures.

In terms of operating performance, a group of researchers conducted an exhaustive study of 2,000 activist interventions between 1994 and 2007 to find no reduced long-term operational performance at targeted companies (Bebchuck, Brav, & Jiang, 2015, p. 4). In digging deeper, the researchers use Tobin's Q to show that there is stronger operational performance three or more years following an intervention. They also find no evidence that activist interventions in the years leading up to a financial crisis made targeted firms prone to worse operating performance or that firms subject to "investment-limiting interventions" suffer from worse performance in the long-run (Bebchuck et al., 2015, p. 55-60, p. 65-69). Likewise, studies show that targeted firms have higher ROA (measured by EBITDA/lagged assets) and operating profit margins than their peers two years following an intervention, and that activist hedge funds can bring more efficient capital allocation (Brav, Jiang, Partnoy, & Thomas, 2008a, p. 1770-1772). As activist concerns related to the capital structure, a study finds that activist targeted firms increase their total payout and book value leverage, which suggests activists impose greater managerial discipline and lessen the risk of agency problems related to free cash flow (Brav, Jiang, Partnoy, & Thomas, 2008b, p. 1731). Overall, the results seem to validate the approach of hedge fund activism by showing that there are improvements to be made at targeted companies and that activists can bring material operational changes, which in some cases benefit targeted companies.

Likewise, from a governance perspective, studies show that activists can have measurable impacts on certain components of governance, which could again benefit targeted companies. In most campaigns, activists do not declare “changing the management team” as a defined objective to avoid starting a fight with their target. However, activists have a successful track record of replacing management teams as well as in making executive compensation more sensitive to performance and in reining in executive compensation overall (Brav, Jiang, & Kim, 2010, p. 234). During campaigns, activist will also target boardrooms, and one study looks at the impacts of activist-led proxy contests. It finds that within three years of a proxy contest, an activist can succeed in getting rid of more than 39% of incumbent board members, and that the ousted directors experience a decline in the number of other directorships they hold (Fos & Tsoutsoura, 2014, p. 318). These results are corroborated by a Harvard Business School study, which extends the analysis further by studying a universe of 1,490 activist interventions between 2004 and 2012. The study shows that higher director turnover is associated to hedge fund activism generally and that it can be just as high when hedge funds reach settlements as when they wage proxy contests (Gow et al., 2016, p. 3-4). It also finds that activist interventions lead director turnover to become more performance sensitive, which represents improved corporate governance (Gow et al., 2016, p. 21-22). These results do not necessarily prove that boards improve and governance can be difficult and subjective to evaluate. They do show, however, that when activist hedge funds push for governance changes they can achieve direct and observable impacts at targeted firms.

The impacts on corporate governance also touch on another related area of ongoing research on gender diversity in boardrooms. There are countless studies and reports that highlight the low proportion of female board members, and today, getting more women on boards has become a major priority in many countries (Noland, Moran, & Kotshar, 2016). The justifications for having gender diverse boards extend beyond basic principles of fairness. Studies show that having more female directors can improve performance, help companies become more responsive to the market, achieve better corporate governance and attract better talent (Adams & Ferreira, 2009, Carter & Wagner, 2011; Carmen Triana & Miller, 2009). As boardroom diversity pertains to activism, a major study of S&P 1,500 firms found that those targeted by activists reported a lower proportion of female board nominees than the proportion for the entire sample and that fewer of the targeted firms had at least one female director compared to before they were targeted (Staley, 2017). Since activist hedge funds nominate, push for and can often add their own directors, they can play a particularly important role within the context of debates on boardroom diversity, which itself is an important ESG consideration.

Ultimately, the body of literature largely supports the view that activist hedge funds can effectively influence and bring changes to companies, and in doing so, reward shareholders through greater stockholder returns and improvements to targeted companies. Although influence is difficult to measure, one study did find that activist hedge funds achieve complete or partial success with their objectives in around two-thirds of interventions studied (Brav et al., 2008b, p. 1744). Given the influence and success of these hedge funds, they can serve as powerful proponents of ESG initiatives at companies to further enhance shareholder value. As more studies examine the critical role of activists in shaping and challenging the status quo of the corporate landscape, it is important to be mindful of how to utilize their influence for society's benefit as well.

SECTION THREE: METHODOLOGY

The sample of activist interventions

The data on shareholder activism can come from several possible sources since there is no central database detailing every intervention undertaken by an activist hedge fund. An overview of the studies on shareholder activism reveals that many samples of activist interventions are based off of FactSet's SharkWatch database. Besides using FactSet, studies can use other data providers, like Activist Insight, hand collect their own samples from public filings or use a combination of these different sources. In this study, an independent sample is built off of the public Schedule 13D filings. Under section 13(d) of the 1934 Securities Exchange Act, when investor owns five percent of more of any of a public company's class of securities and wants to play an active role in the company's decision making, then they must file disclosures on the SEC's Schedule 13D (Brebchuck et al., 2015, p. 13). The information on Schedule 13D filings is obtained by using the SEC's "Full-Text Search" to get the full-text of EDGAR's Schedule 13D filings. There is a time-frame restriction to obtaining filings from the years 2015, 2016 and 2017: 2015 had 3,016 EDGAR filings, 2016 had 2,630 EDGAR filings and 2017 had 2,599 EDGAR filings.

Once all of the filings are downloaded, there are further steps taken to refine the dataset of Schedule 13D filings to only those representing activist interventions. Since the 13D forms include the name of the investor acquiring the stake and the company, Google is used to determine which investors represent activist hedge funds, and accordingly, which 13D filings correspond to activist interventions. In filtering through the different types of investors on the filings, the investors who represent individuals, mutual funds, banks, insurance companies, distressed securities hedge funds or fixed-income arbitrage hedge funds are not included, which follows the approach of past studies on activism. All of these steps yield a sample consisting of 99 interventions in 2015, 87 interventions in 2016 and 82 interventions in 2017, and this sample provides the basis for studying activism. In addition to the data from public filings, the information in the sample is complemented by data from FactSet in the form of available "Company Summary", "Corporate Activism", and "Campaign Profile" reports related to the specific activist interventions in the sample.

Procedure for data analysis

Once the universe of activist interventions is established, two layers of data analysis are conducted to tie together the study of activism with the study of ESG. For the activism portion, a qualitive analysis consists of searching for common activist intervention related terms on Google, such as “”activist campaign”, “board nominations”, “proxy”, “business strategies”, “balance sheet”, “M&A” and “governance”. The choice of terms is made based off of the key and most common objectives found in the literature review. From these searches, qualitative descriptions are created to detail the most relevant components of each activist intervention in the sample. The second layer related to ESG consists of constructing a list of ESG-related terms that can be used to analyse the ESG content of activist interventions. The list of terms is based off of an MSCI list of the most relevant ESG terms for each of the three sub-categories. It is important to note that the list of terms is not exhaustive and is not close to representing the entire universe of ESG-related terms, partly because there would be too many terms for the analysis and because there is no central database of ESG-related terms. For the environmental component, the terms were: carbon emissions, product carbon footprint, financial environmental impact, climate change vulnerability, water stress, biodiversity and land use, raw material sourcing, toxic emissions and waste, packaging material and waste, electronic waste, opportunities in clean tech, opportunities in green building, opportunities in renewable energy. For social the terms were: labor management, human capital development, health and safety, supply chain labour standards, product safety and quality, chemical safety, financial product safety, privacy and data security, responsible investment, health and demographic risk, controversial outsourcing and social opportunities. For governance the terms were: board diversity, executive pay, ownership and control, accounting, business ethics, anti-competitive practices, corruption and liability, tax transparency and financial system instability.

A second form of data analysis is conducted to focus on gender diversity within the context of activist interventions. As part of the qualitative analysis and description for each intervention, a list of activist director nominees and activist-supported elected directors is established for each relevant intervention when available. The interventions that include female board nominees or elected directors are then highlighted, and Corporate Affiliations from the LexisNexis Academic database is used to download the board history of targeted companies for the three years prior to the highlighted interventions. The data on board history is analyzed for a variety of possible trends, including those related board composition, nominating practices and director roles.

Possible limitations

The sample is built independently from publicly available filings, and so as a result, the frequency, types and identities of activist interventions may vary from those of other studies and from those found in the databases of major data providers, like FactSet and Activist Insight. For example, the sample contains fewer activist interventions in 2017 than the list of interventions compiled by Lazard in its 2017 annual report on shareholder activism (Lazard's Shareholder Advisory Group, 2018). The comparison suggests that the sample could be missing some interventions, which could affect the analysis and results. Since the sample is also restricted to 13D filings, the analysis is restricted to U.S. activist interventions, which means that possible ESG-focused activist interventions abroad are not considered. If activist interventions abroad have more of an ESG focus than American ones, then that limitation could prove more problematic. Another limitation common to nearly all shareholder activism studies is that the data does not capture the interventions when activists do not acquire ownership stakes of more than five percent and when activists instead choose to engage with targeted companies behind closed doors. In terms of the qualitative analysis, activist hedge funds may not publicly disclose all of their objectives or the information behind their interventions, and thus some information related to the interventions studied could not be obtained. It is thus possible that some interventions highlighted ESG-issues to companies that are not picked up on in this study. Likewise, the same applies to board nominees, especially as it relates to female nominees, since activists do not always publicly disclose the identity of all of their proposed nominees, which means there could be missing information in some of the interventions studied. Finally, given the nature of this study and how it is conducted, the classifications and descriptions of activist campaigns and how they relate to ESG issues are highly subjective, which means some elements could be unrepresented, under-represented or over-represented. These limitations could all impact the sample, the information in the sample and the analysis of its content.

SECTION FOUR: RESULTS

The "G" dimension is critical for activist hedge funds

This paper contributes to the literature by analyzing activist campaigns through the ESG-specific lens detailed in the methodology, looking across activist objectives for key ESG-related components. Looking at ESG components overall, the most common sub-category touched on by activist campaigns is "Governance" with 42 interventions highlighting ESG-related "Governance" issues. Among those issues, the most commonly cited ones deal with executive compensation, weak governance structures, poor ownership structure and business ethics. In regards to the "E" in ESG, one campaign makes reference to a shareholder proposal "with regards to food waste reporting to assess, reduce and optimally manage food waste", which relates to the ESG term of "waste" (FactSet Research Systems, 2018). Finally, for the social sub-category, no mentions of ESG-related terms are mentioned in the language of the activist interventions studied. These findings suggest that activist hedge funds still tend to campaign on primary business issues linked to value creation. They also reinforce the critical role activists play as governance watchdogs and the importance of governance issues for firm performance.

Meanwhile, an analysis of all of the activist interventions in the sample, with no ESG-filter, shows that the most common objectives and issues are the same as those cited in the literature review. For context, Lazard's Shareholder Advisory Group (2018) finds that, of the interventions they identified in 2017, around 32 percent of them dealt with demands for board changes, 37 percent for M&A/breakup, 11 percent for governance changes, 13 percent with capital allocation/return, 31% with business strategy, 19 percent with operations and 11 percent with management (Lazard 2018). Over the three year period, there is also no discernible linear trend, such as a progression of more ESG-related interventions over the three year period. In fact, although 2015 has the most activist interventions in the sample, there are more ESG-related interventions identified in 2016. As a result, there is not enough evidence to suggest that the rise in ESG's popularity has had a major influence on hedge fund activism or that its influence on activism has been growing over time.

The relationship between hedge fund activism and gender diversity

Given the links between ESG investing and the governance debate on boardroom gender diversity, this paper contributes to the literature by examining gender diversity within the context of hedge fund activism. Corroborating much of the literature, the results show that the majority of directors nominated are male. Likewise, the majority of elected directors – elected either through settlement, proxy or by the company following activist pressure – are male. Although several interventions are pushing for ESG-related issues within the "Governance" sub-category, none of the ones in the sample specify gender diversity, or lack thereof, as a governance issue.

However, the interventions leading to a female board nominee or elected director are analyzed more closely. The data shows an incremental increase in the number of female board nominees from 2015 to 2017, though the sample size is too small to draw conclusions. Another finding is that in every intervention, except for one, where a female director is nominated there is already at least one female director on the board of the targeted company. A possible conclusion to draw is that activists are more likely to nominate a female board member when there is already a female director on the board of a target company. The reasons for this could be varied. It is possible having a female board director creates a "snowball effect", signalling to others that the board may be more receptive to having women as directors. For activists, they could feel more comfortable and empowered nominating a women when they know boards are already receptive to having female board members. Again the sample of interventions with female board nominees is small, but it does suggest that given the right circumstances activists will propose female directors and get them into boardrooms. Similar to other ESG-related issues, the more gender diverse boards are shown to improve firm performance and increase value creation, then the more activists could view and push a lack of gender diversity as a governance issue, and thus get more women on boards.

Reasons for the potential growth of ESG's influence on activism

Within the wider context of trends in the investment management industry, there are reasons to suggest activist hedge funds could integrate more ESG issues into their investment frameworks. A qualitative analysis of the current state of the activist hedge fund industry can offer some clues. Jana Partners is now starting a dedicated impact fund; Trian has a sub-heading on its website dedicated to its ESG focus and produces a factsheet on the ESG initiatives of its current portfolio companies; and Blue Harbour, often known as the "friendly activist", has its own ESG policy incorporating principles from the UNPRI and a dedicated ESG sub-heading on its website as well. These are just some of the most prominent examples, but there are likely other activist hedge funds showing more of an interest in ESG. These activists believe "that improvements in board diversity, employee retention, environmental policies, supply chain ethics and data security and privacy – all common ESG concerns – can drive earnings and limit the risks of costly litigation or run-ins with regulators" (Fortado, 2017).

Yet, without any insight into the actual thinking of these hedge fund managers, it is difficult to conclude too much from such a qualitative analysis. These statements and impact focused funds could be a means of raising money or appeasing institutional backers, rather than a reflection of activists being more willing to push forward ESG issues. If activists find that they can create greater value at companies by targeting certain material ESG-related issues, then the signals could be a sign of the latter.

From a quantitative perspective, there is also evidence suggesting activists will be incentivized to increase their focus on ESG factors. Aside from the activist and the target, there are two other major stakeholders in an activist campaign: the proxy advisors who counsel shareholders and the institutional investors holding large portions of a target's stock. Proxy advisors provide recommendations for how shareholders should vote on major company decisions, like the election of directors, and Institutional Shareholder Services (ISS), the largest firm controlling around 20 percent of votes, has recently release a scorecard based on ESG principles to evaluate corporate disclosures. ISS's greater emphasis on ESG issues is significant because the advisor has supported the activist in 45 percent of cases (Sawyer & Trevino, 2018). Thus, for activists to continue getting support from ISS and other proxy advisors, they could need to start putting more weight on ESG considerations.

Likewise, major institutional shareholders can also influence activist hedge funds. Just as retail ownership declined five percent between 2012 and 2016 to only 30 percent of public companies, the three largest index fund providers – BlackRock, Vanguard and State Street – now own around 18.5 percent of the S&P 500 (Sullivan & Cromwell LLP, 2016, p. 2; Lazard's Shareholder Advisory Group, 2018). Unlike retail owners, these institutions cannot divest from companies lacking ESG initiatives because most of their assets must be tied to the holdings of third-party indices. With that, the burden to shake up boardrooms falls on activists, but these activists still need the support of the institutional investors to lend credibility to their campaigns and to win their large voting blocks in proxy fights. In fact, research shows that the rise of passive ownership has had impacts on how activist hedge funds approach their campaigns. When passive owners own a large part of a target company, an activist is more likely to push for control or board representation, less likely to push for larger payouts and more likely to use hostile tactics (Gormley, 2016). An activist intervention is also more likely to be successful when a target has a large passive shareholder. In fact, BlackRock supported 39 percent of activist interventions in 2015, and supported dissident cards in one-third of Russell 300 fights in 2017 with Vanguard supporting 50 percent of them for the first half of the year ("The Activist Investing Annual Review 2018", 2018, p. 36; Boyd, 2017).

Similar to how activists need the support of proxy advisors, they also need the support of the largest shareholders of the companies they target, and recently, these passive investors have become more ESG focused. Both the CEOs of BlackRock and Vanguard have come out with public statements on their firms' commitment to sustainable investing principles. As the pressure on these major institutional investors to engage in sustainable investing continues to mount, the pressure could filter through to activist hedge funds. As a result, activist hedge funds could increasingly start to push ESG issues at the companies they target in order to ensure their campaigns are backed by the largest institutional shareholders.

Recommendations for aligning hedge fund activism with ESG's rise in popularity

The research on how to improve ESG data, investment frameworks, disclosures and ratings is all ongoing and promises to help refine those critical elements of ESG investing. Likewise, more research on the role activist hedge funds can play in promoting good behavior at companies is always beneficial. Increasingly, activist hedge funds themselves are documenting and demonstrating the positive impacts they are having on their portfolio companies. As activist hedge funds continue to witness the rise in ESG's popularity, there are a few policies that could help bring greater alignment between them and the ESG trend. First, the major third-party index providers, like MSCI, should develop a consistent framework for required ESG disclosures at companies, and then work with the largest passive managers to apply pressure on companies. Accordingly, passive investors should work with their index providers to develop mechanisms for divesting in problematic companies and companies who are not providing required ESG disclosures. All of this could serve to set the tone on how and to what degree ESG should be prioritized. Second, more specific to hedge fund activism, there should be a section on ESG disclosures on Schedule 13D forms. If investors have no ESG considerations they can leave the section blank, but at least the section would offer activist hedge funds an opportunity to express ESG considerations if they have any. This could anchor investor thinking towards looking for ESG issues that can have material impacts on value creation at companies and for how targeting these issues could help generate better investment returns.

FINAL REMARKS

The investment community is increasingly being shaped by the trend towards ESG investing. Within the investment community, activist investors place a strong focus on promoting and improving corporate governance. The more ESG-investing comes into focus and the more ESG-factors become tied to better financial performance, then the more likely activist investors could have further ESG considerations as key campaign objectives. As investors, activists have a strong track record of successfully bringing changes to companies and creating value for shareholders and their own investors. With ever larger amounts of money committed to passive managers, the burden increasingly falls on activist hedge funds to keep companies accountable, act as governance watchdogs and push for ESG-considerations that can drive value creation.

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