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Men like this are capitalism's unlikely heroes



* [THE ECONOMIST](http://www.businessinsider.com/author/the-economist)
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* FEB. 6, 2015, 5:57 PM

As inventions go, the public company is one of capitalism's greatest.

Initial public offerings promote innovation, by providing an exit route for entrepreneurs; being listed makes a firm open to scrutiny; and ordinary people have a chance to invest in capitalism's wealth-creating machines.

But the past 15 years have cast a shadow over the public company. There was not much sign of scrutiny or wealth creation in fiascos like Enron and Lehman Brothers. Governance has been weakened by the rise of passive index funds, which means that many firms' largest shareholders are software programs.

Institutional investors prefer to sell at the first sign of trouble rather than manage problems--so chief executives obsess about quarterly earnings and grab pay and power while they can. At the same time, tycoons in Silicon Valley have often turned outside investors into second-class citizens, by creating special voting rights for their own shares.

Private-equity barons say their model of concentrated ownership makes more sense. Some governments argue that companies need the steadying hand of the state. But there is a better way. Activist hedge funds take small stakes in firms and act like political campaigners, trying to win other shareholders' support for their demands: representation on companies' boards, cost-cutting, spin-offs and returning cash to shareholders. Mad, bad and dangerous to know, activists are often loathed by public-company bosses for their belligerence and opportunism. But the bosses are wrong. Activists are in fact the public company's unlikely saviours.

Hyenas laughing ...

Activists have been around since the 1980s, but the scale of their insurrection in America is unprecedented. Activists run funds with at least $100 billion of capital, and in 2014 attracted a fifth of all flows into hedge funds. Last year they launched 344 campaigns against public companies, large and small. In the past five years one company in two in the S&P 500 index of America's most valuable listed firms has had a big activist fund on its share register, and one in seven has been on the receiving end of an activist attack.

Americans encounter firms that activists have targeted when they brush their teeth (Procter & Gamble), answer their phone (Apple), log in to their computer (Microsoft, Yahoo and eBay), dine out (Burger King and PepsiCo) and watch television (Netflix). In December an activist fund called Trian broke new ground by winning a board seat at Bank of New York Mellon, custodian for many of the world's biggest banks.

A disgrace, say some; the cult of short-term shareholder value gone mad. Activists have a reputation for stripping cash and assets and loading firms with debt. Their rowdiness seems calculated to distract managers, good or bad. One prominent activist, Carl Icahn, likes to call chief executives "morons" and tease them on Twitter.

Another, Bill Ackman of Pershing Square, has compared Herbalife, a firm he says is a fraud, to the Nazis. When Dan Loeb went for Sotheby's, its then chairman branded him a "scumbag". Some have used dubious tactics, including building positions by stealth with derivatives.

So much money is flowing the activists' way that a few will no doubt go too far, harming a decently run firm or even breaking the law in the pursuit of an edge. Yet, despite their flaws and excesses, activists are a force for good.

... all the way to the bank

One reason is that plenty of companies suffer from rotten management. About a tenth of big American firms, and even more smaller ones, still employ tactics like "poison pills" and staggered boards that shelter incompetent managers.

Another is that today's activists belie the scavenging stereotype of the 1980s. They often seek to improve firms' boards rather than strip companies of assets. They work with other shareholders, frequently winning the support of big money-managers such as Capital Group and Fidelity.

They are raising longer-term capital and so stretching their investment horizons. ValueAct, based in San Francisco, locks in its investors for three to four years and has served on the boards of 37 firms, including Microsoft. Mr Ackman has raised a pile of "permanent capital". The Economist has analysed the 50 largest activist positions in America since 2009 (see pages 19-22). More often than not, profits, capital investment and R&D have risen.

Private-equity funds are another way of fixing misfiring firms. But activists have advantages over Wall Street's buy-out barbarians. Instead of loading up on debt to finance the takeover of entire firms, they get the work done with a stake of, typically, just 5% or so. That means activists are good value because they use less debt, pay no takeover premium and extract far lower absolute fees.

Most of all, activists fill a governance void that afflicts today's public companies. A rising chunk of the stockmarket sits in the hands of lazy investors. Index funds and exchange-traded funds mimic the market's movements, and typically take little interest in how firms are run; conventional mutual funds and pension funds that oversee diversified portfolios dislike becoming deeply involved in firms' management.

In the face of Wall Street's provocateurs, America's lazy money is waking up. Whether their ideas are barmy or brilliant, the activists make it harder for investors to stay on the sidelines. Mutual funds and pension funds are being forced to take a view, and hence become more active and forward-looking.

European and Asian shareholders say they do not need activists because they have more power than American investors over managers' pay and appointments. They typically dismiss Mr Icahn and his friends as an American solution to an American problem. And, for cultural reasons, the few European activists tend to be more diplomatic and consultative than their brash cousins.

Yet wherever there are stockmarkets you will find underperforming companies, clubbable bosses and lazy capital. The public company was never meant to be a bureaucracy run by distant managers accountable to funds run by computers. The activist revolt will help give it a new lease of life.

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