

Why is Hedge Fund Activist Pro-Cyclical?

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Abstract

Recent decades have seen the emergence of hedge funds as leading shareholder activists. It has been empirically documented that such funds are potentially able to add significant value via their activist positions. However, hedge fund activism is usually a fair-weather phenomenon: in economic downturns, activist hedge funds reduce their activist efforts and experience disproportionate outflows of investment funds. We provide a theoretical model for the pro-cyclicality of hedge fund activism. In our model, career-concerned hedge funds (who compete to retain rational investor flows) excessively leverage their target firms as part of an equilibrium strategy to signal their ability to investors. Such excessive leverage destroys incentives to monitor in downturns, thus generating pro-cyclicality. We delineate conditions to ensure that such excessive leverage is essential in equilibrium. Our model also provides a theoretical basis for interpreting the oft-repeated complaint of managers in firms targeted by activist hedge funds: That these funds take a short-term perspective and impose excessive leverage on their targets.