The failures of the activist investor Bill Ackman have been on display in neon lights as the press chronicles the hedge fund manager’s bungled attempts to influence strategy at the struggling retailer JC Penney.

In a recent letter to investors, Mr Ackman, who lashed out at JC Penney’s management and board decisions, acknowledged that his investment in the store was a failure. Having endured hundreds of millions of dollars in losses, through his hedge fund Pershing Square Capital Management, Mr Ackman recently sold 39.1 million shares, which amounted to 18 per cent of JC Penney. His exit from the company sparked an immediate 2.9 per cent jump in the retailer’s shares to $13.74.

Mr Ackman’s trial by fire kicks off a debate about whether activist investors do more good than harm for share prices or vice versa when they fight for changes at public companies.

A new study led by a professor at Duke University’s Fuqua School of Business in Durham, North Carolina suggests the benefits of interventions by activist hedge funds are worth the downside risk. Defying the critics, Prof Alon Brav’s research suggests that the performance of listed companies improves on average when activists get involved as stakeholders. Prof Brav conducted the research with Lucian Bebchuk of Harvard Law School and Wei Jiang, a professor at Columbia Business School.

To arrive at their optimistic conclusion, the three academics examined about 2,000 interventions in the US by activist hedge funds that took place between 1994 and 2007. The team first identified the month of a particular intervention by an activist investor and tracked the operating performance and stock returns in the five years following that attempt to spark change. “We find that the operating performance improves following activist interventions and there is no evidence that the improved performance comes at the expense of performance later on,” says Prof Brav. He also notes that after activist interventions are reported publicly, the share prices in affected companies tend to jump by as much as 6 per cent.
Prof Brav adds: “This short-term market reaction to the entry of activists does not reflect an inefficient market reaction since we do not find any subsequent negative price drift in the ensuing few years post-activism.”

The trio of academics also shoot down the common complaint among industry watchers that activist hedge funds are looking to eke out short-term profits and do not care much about long-term gains.

The professors examined whether interventions constrained long-term investments by increasing companies’ leverage, ratcheting up payouts to shareholders or reducing investments.

They also looked at the sorts of interventions that involved hostile tactics in the boardroom. Their conclusion was that investors still won out in the long term. “In both cases, interventions are followed by improvements in operating performance during the five years following the intervention,” Prof Brav argues.

Other sorts of critical theories about activists were also debunked. One was that investors who engage with companies “pump and dump” or pour money into companies, but sell their stakes quickly, so they do not have to live with the long-term consequences of their actions. The trio analysed whether activists cashed out their stakes in target companies before negative returns arose. They did so by examining whether the companies affected saw negative returns after an activist publicly reported that its holdings dropped below the 5 per cent threshold that “subjects investors to significant disclosure requirements” in the US. “Again, we find no evidence of underperformance,” Prof Brav says.

Prof Brav and his colleagues, however, do argue that the profitability of activist investing is likely to fall if and when more hedge funds engage in activism and more capital flows into these funds.

The influence activist investors assert in public markets may diminish in coming years, but some industry watchers say they still provide an important check on the power of managers at listed companies, though Mr Ackman’s antics in public might suggest otherwise. “Activists play a key role in keeping management focused on the best interests of stock holders,” reports Donald Steinbrugge, managing partner with Agecroft Partners, a hedge fund consultancy.