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What If a Hedge Fund Invests in my Family Business?

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At many publicly traded firms, the presence of activist investors forces them to innovate. This didn't hold true at the family businesses we studied.

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Publicly traded family firms may attract all sorts of investors from outside the family. And like other publicly traded firms, they sometimes attract activist hedge funds, whose primary purpose often is to make money quickly by disrupting the established order of doing business.

Because they typically focus on preserving the business for the next generation and keeping a huge chunk of ownership for themselves and their successors, families often take a long-term view and are cautious about taking risks. What happens if an activist investor with an “opposite” profile enters the scene? Do you get the best or worst of both worlds, particularly in relation to innovation, which benefits from both a long-term mindset and a willingness to take risks?

We investigated this intriguing question by looking at publicly traded, family-controlled firms with activist hedge funds among their investors. Unlike the family stakeholders, these funds generally focus on the short term and are very comfortable with risk.

While other researchers have studied how individual ownership types (like families) impact firm-level innovation, we don’t fully understand how multiple ownership types - e.g., families and hedge funds - interact and jointly shape innovation outcomes. This is a crucial topic to explore as institutional investors dominate today's ownership landscape across all firm types.

Few researchers have looked at how this “heterogeneous” ownership impacts a business and shapes its strategy and approach to innovation. Having several influential owners introduces more intricate dynamics, potential synergies, and possible conflicts between the goals of the family and the other investors. This could be especially true when institutional investors with conflicting priorities get involved.

Our goal was to dive into this mostly uncharted territory and provide novel insights to guide policymakers, investors, and family business managers in their pursuit of innovation and sustainable long-term growth.

Innovation vs. Risk Aversion

We wanted to explain the impact of the ownership structure on the level of radical innovation that a company pursues and realizes. Radical innovations are truly novel innovations, not just incremental improvements. They can be risky, but in the long run they generally strengthen a firm’s financial position and boost long-term performance.

First, we suspected that firms heavily controlled by families would be hesitant to take risks, even if doing so would help them innovate and strengthen their long-term position. We thought this would be especially true at family firms listed on the stock exchange with its many external short-term pressures (e.g., financial analyst reports). So, while family owners are known to embrace a long-term strategy, we assumed that the inherent conservative risk-averse nature of family ownership would outweigh these advantages in relation to the pursuit of radical innovation among listed U.S. firms.

Second, although prior research shows that hedge funds, in general, have a positive effect on innovation outcomes (e.g., because they enhance innovation efficiency through various tactics like divesting underperforming business units and major workforce adjustments), we figured that this may not hold when they invest in family firms. Indeed, given the conflicting priorities of hedge funds (short-term and risk-seeking) and family owners (long-term and risk-avoiding), we hypothesized that a potential positive impact of hedge fund activism on innovation would not happen at family-owned firms. Instead, we proposed that the negative effect of family ownership may intensify when hedge funds are present in the firm's ownership structure, as these hedge funds push for short-term results and thereby further undermine the family's long-term orientation.

Our Study

We conducted an extensive analysis of publicly listed U.S. firms within the S&P 1500 index spanning the years 2002 to 2009. Our study focused on exploring the relationship between a firm's ownership structure (family ownership in combination with activist hedge funds) and its patented innovation outputs.

To gather the relevant data, we utilized data mining, automated algorithms, public databases, and additional data vendors. Next to non-family firms as a comparison group, we specifically targeted businesses where families held ownership stakes of at least 20% and were active participants in corporate matters. We obtained ownership data from publicly available records supplied by the Securities and Exchange Commission (SEC) and from the data vendor GMI Ratings.

We identified activist hedge funds by analyzing 13D filings retrieved from the SEC. This process was automated through a script designed for this purpose. To verify their activist nature, the identified funds were then cross-referenced with the SharkRepellent Database, an integral part of FactSet's comprehensive database focusing on corporate activism, takeover defense, and proxy-related matters.

To assess the firm's degree of radical innovation, we looked at citation-weighted patents, a metric derived from data obtained from the U.S. Patent and Trademark Office (USPTO). This patent data underwent meticulous compilation, and forward citations were matched using a sophisticated matching algorithm. Measuring citations helped us identify which patents were for truly radical innovations, with greater economic and technological significance.

What We Found

In line with our expectations, we found that the presence of a family blockholder in a publicly traded firm actually harms its level of patented innovation output. It thus seems that the conservative nature of family owners outweighs any possible benefit that their long-term mindset may bring in relation to radical innovation. This finding, however, may only hold among publicly traded firms (the only type of firm we sampled in this study), where the many short-term pressures of the stock market make it much more difficult for families to act in line with their inherent long-term outlook. Earlier research suggests that things might be different among privately held family firms, especially those with a solid financial position, in which the long-term orientation of family owners may prevail more strongly in relation to innovation. Nonetheless, our study revealed that the effect of family ownership on radical innovation appears to be negative at publicly traded U.S. firms.

When looking at the hedge funds, we find that – in general – they have a positive effect on a firm's patented innovation output. However, this didn't happen at the family-controlled listed firms that we studied. Hedge funds are often portrayed as an effective external governance mechanism to help boost firms' innovation. Yet, when the family is a big part of the firm's ownership structure, their opposing views and preferences seem to nullify any virtuous effect that hedge funds may have on innovation. Instead, hedge funds intensify the negative effect of family ownership by putting even further pressure on the family's long-term decision horizon.

Takeaways

Stakeholders of family firms who want to boost their innovation performance may find it interesting to learn

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that hedge fund activism is not effective in family firms. While in general hedge funds have a positive impact on innovation outcomes, our research shows that these benefits do not materialize among family-owned firms. Family owners may be surprised to learn that hedge funds can target even firms with strong family ownership positions and active family involvement. Here are some other things that family businesses and their stakeholders can learn from our research.

Have a strong board with outside members. Since the presence of hedge fund investors doesn't seem to affect their innovation, family firms that want to pursue higher levels of radical innovation should consider other strategies. Previous research has suggested that attracting influential external board members, especially those with positions at more innovative firms, is an effective way to encourage more radical innovation among family firms. Compared to hedge fund activism, change instilled by outside board members tends to be more consensus-driven rather than conflict-riven and thus more effective.

Manage your books and other shareholders. Family owners may not like being targeted by hedge funds due to their opposing views. While hedge funds are generally not harmful for innovation, their strong efficiency focus may undermine a family firm's culture. To minimize their chances of being targeted by activist hedge funds, these family owners can maintain strong firm performance and diligently manage their shareholders to establish resilient and trustworthy relationships. Activist hedge funds often need the support of other institutional investors to impose their strategic plans. Cultivating strong relationships with key shareholders to safeguard their support may discourage hedge funds from engaging in an intervention.

Talk to the activists. If a hedge fund targets a family business, the family owners should prepare to engage proactively in open dialogues with activists, aiming to establish common strategic objectives that align with both parties' interests. When conservative long-term minded owners meet bold short-term minded investors, there is in principle the potential of synergies – but realizing these will be difficult and requires constructive dialogue.

Encourage innovation. Despite their long-term orientation, family ownership on average seems to harm the innovation performance of publicly traded U.S. firms. This may undermine the long-term competitive position of these family firms and, in aggregate, slow economic progress at the societal level. It is therefore important that checks and balances are put in place to challenge the conservative innovation preferences of dominant family coalitions. For example, putting some limits on the use of dual class shares (in which family shares have more voting power than shares held by other investors) might help spur radical innovation by dampening the negative family effect, but the effectiveness of such measures remains to be tested in follow-up research.

Finally, a note to activist hedge funds. Think twice before investing in family businesses with the aim of exerting influence on their strategic decisions related to radical innovation. Our research shows that your efforts may fall flat.

Explore the Research

Ownership Heterogeneity and Corporate Innovation Output: A Study on Family Blockholders and Activist Hedge Funds (https://journals.sagepub.com/doi/pdf/10.1177/08944865231168918) **.** Matthias Leute, Yannick Bammens, Martin Carree, Jolien Huybrechts, *Family Business Review,* June 2023

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