

The 1st Annual American

Investment Seminar

The Fuqua School of Business, Duke University,
Raleigh-Durham, North Carolina

The 'Wall Street Walk' as a Form of Shareholder Activism

Paul Pfleiderer

Stanford University and Quantal International



Why this will be “Completely Different”

- Most risk modeling and alpha identification takes world as given.
- Corporate performance and equity returns are not assumed to be directly affected by investors.
 - Outcomes are determined by management decisions, the economy, the price of oil, etc.
 - Not by who holds the stock.
- If investors are active in monitoring and disciplining management, this is not true.

Outline*

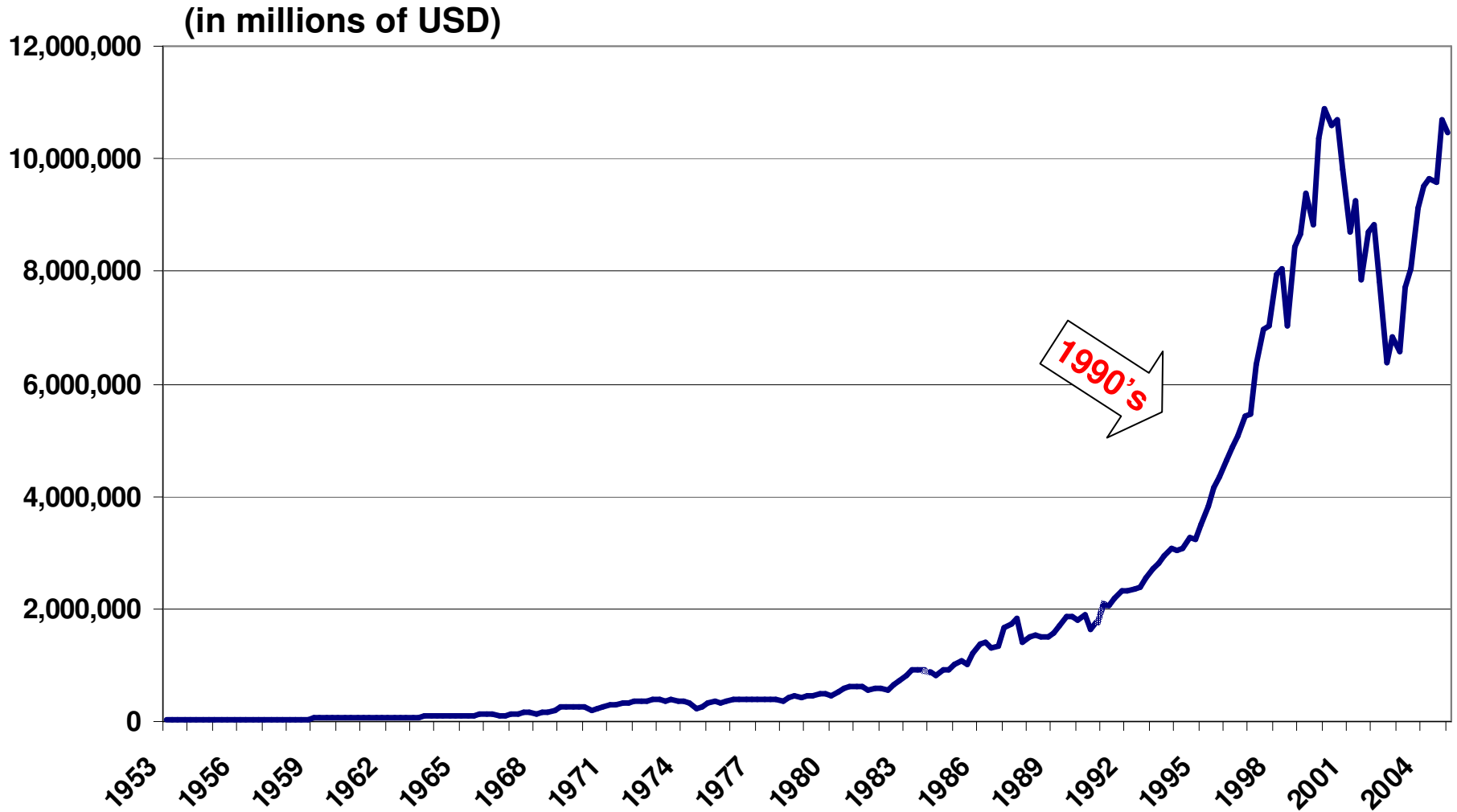
- Institutional Investors and Corporate Governance
- Shareholder Activism
 - Costs
 - Does it work? (Public versus Private)
- The ‘Wall Street Walk’ as a form of Activism
- Other forms of Activism
- Hedge Funds
- Empty voting

* Some of the background data and material used in this presentation was provided to me by Laura Starks (University of Texas at Austin)

Goals

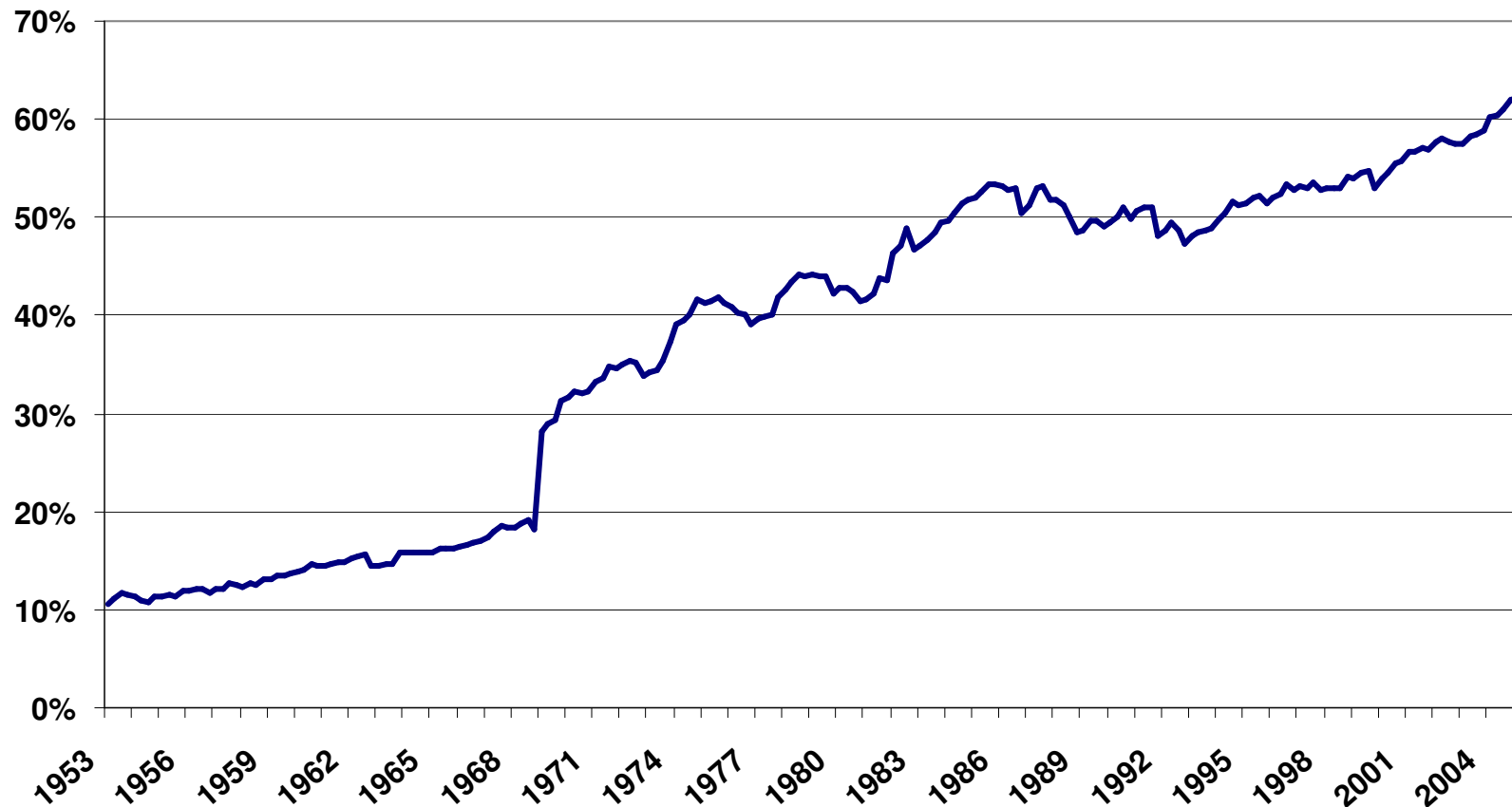
- Briefly tell you about game-theoretic research on the ‘Wall Street Walk’ (undertaken with my Stanford colleague Anat Admati).
- Look more generally at issues concerning institutional investors, shareholder activism, and corporate governance.
 - Raise more questions than answers provided.
 - Generate discussion (perhaps even controversy).
- An apology: a bit of this may be “U.S.-centric” in perspective. Nevertheless most issues I raise are global and the insights have potentially wide range of application.

Growth in Institutional Equity Investment in the United States, 1952-2005



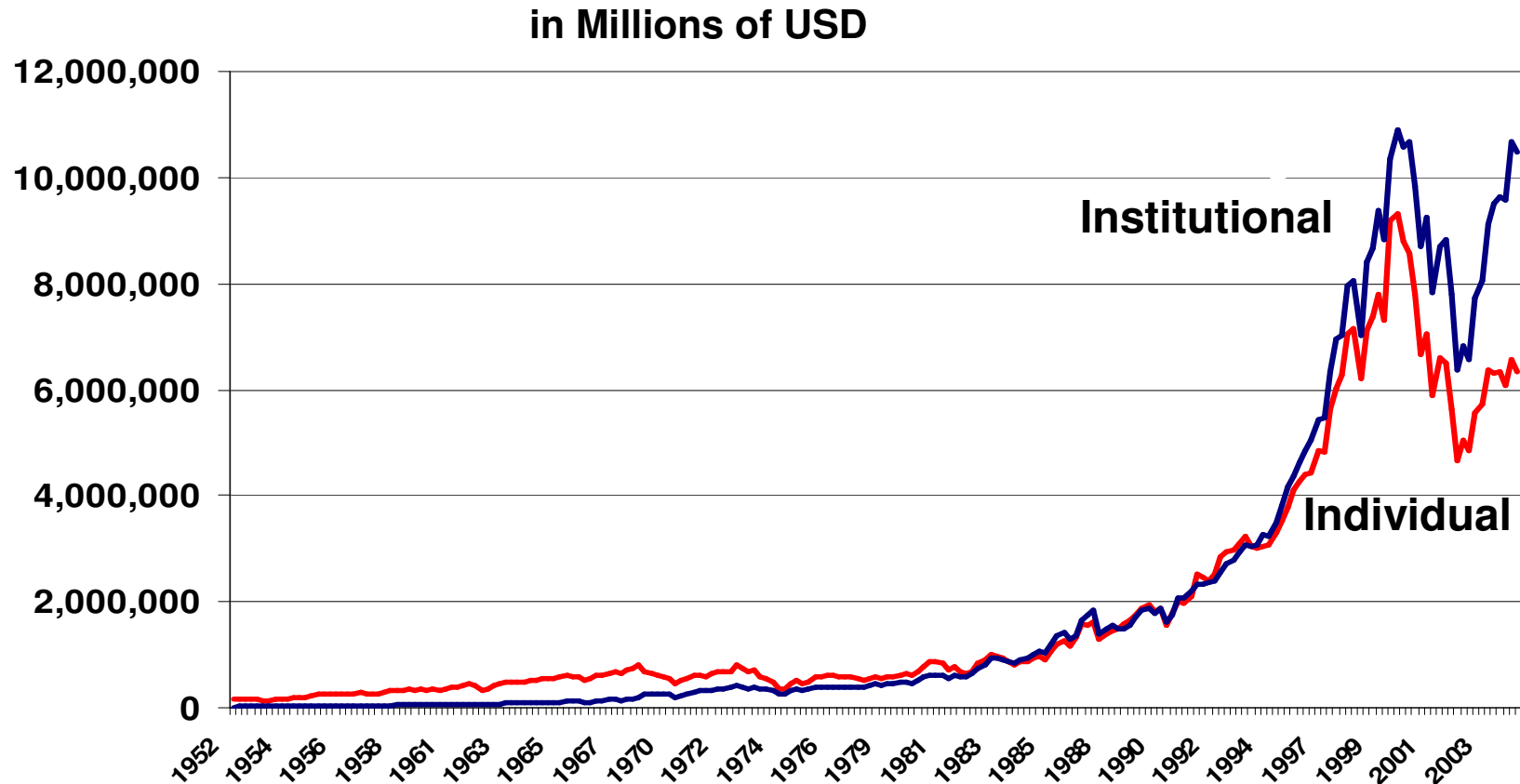
Source: Federal Reserve

Percentage of U.S. Corporate Equities owned by Institutional Investors, 1952-2005



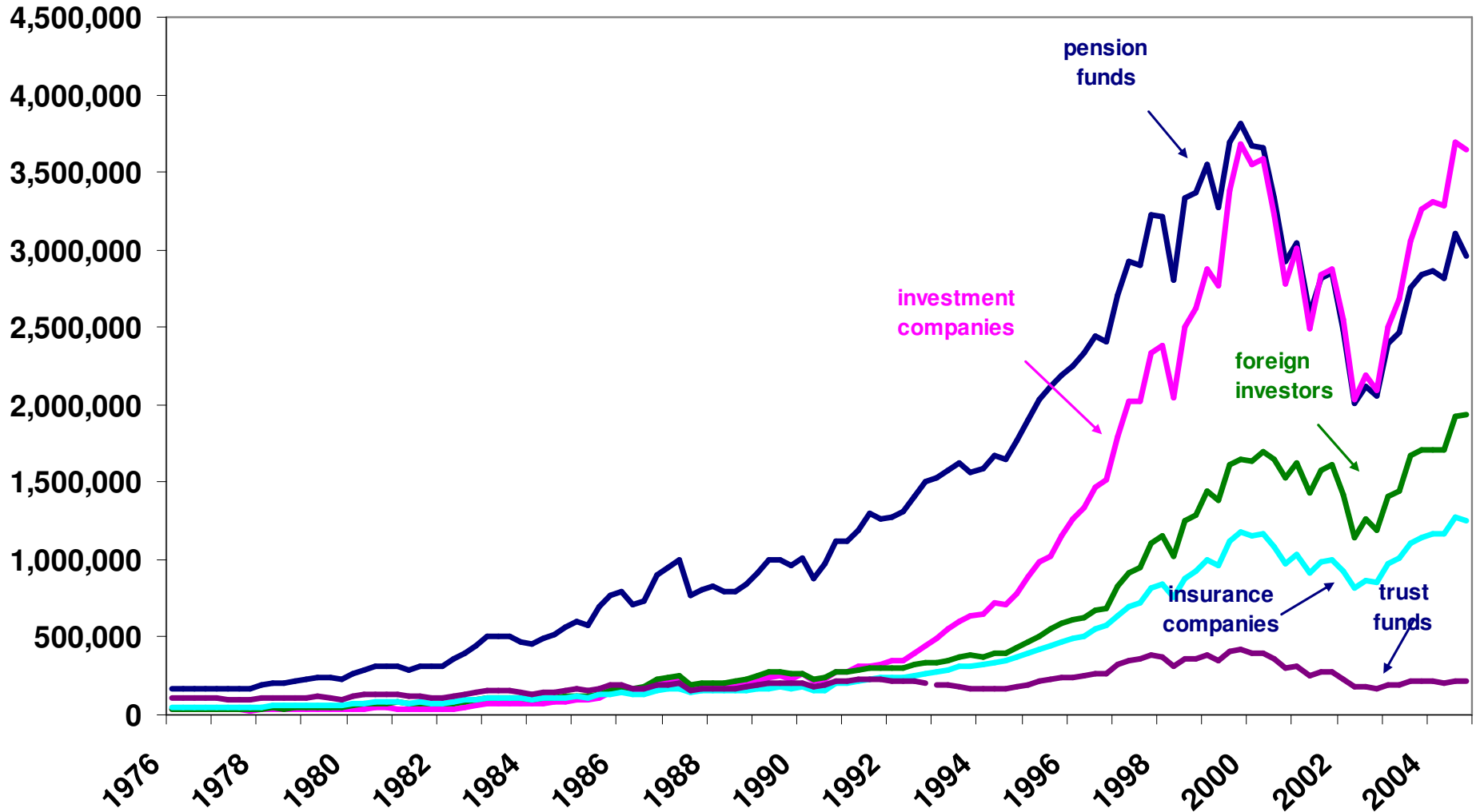
Source: Federal Reserve

Growth in Institutional and Individual Investor Equity Investment, 1952-2005



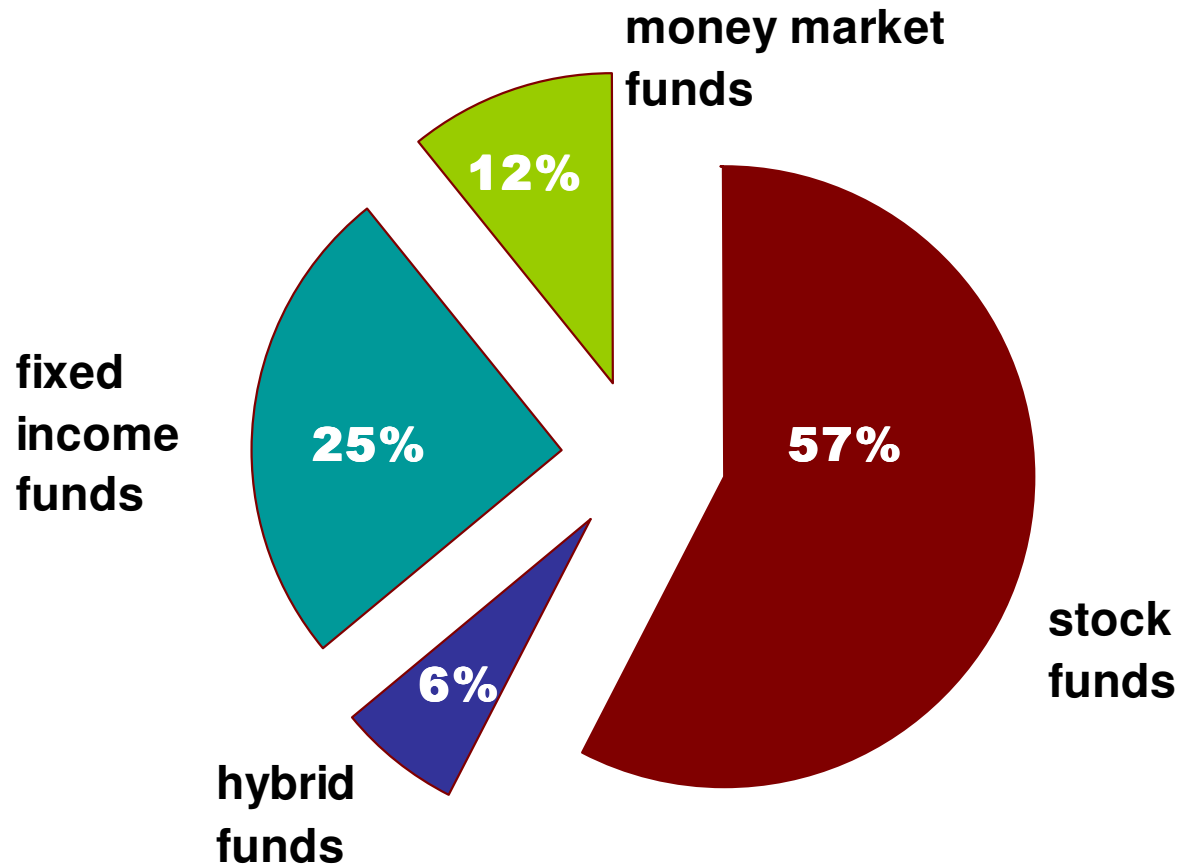
Source: Federal Reserve

Equity Assets of Different Types of Institutional Investors in the U.S., 1976-2005



Source: Federal Reserve (in millions of USD)

As of February 27, 2006, there were 7,989 Mutual Funds in the U.S. with \$9.2 Trillion in Assets Under Management.



Source: Investment Company Institute

Incentives to be Active can be Weak

- Monitoring and being active are costly
 - Classic collective action or free-rider problem
 - Perhaps this has become less of a problem over time as institutional ownership has increased, resulting in more concentrated ownership. However, agents in institutions may not have same incentives as the ultimate beneficial owners.
- Legal impediments and liability
 - Acquiring significant ownership stakes (e.g., 5% or 10%) leads to increased reporting requirements and potential “insider” status.
 - Concentrated ownership can violate fiduciary duty, change tax status, etc.

Incentives to be Active can be Weak

- Conflicts of interest
 - An institutional fund may do business with a firm and therefore may be reluctant to take aggressive stance with that firm's management.
- In many cases increased influence may come at the cost of reduced liquidity.
- Rewards for agents (institutional managers) may be low:
 - Extreme case: index funds
 - Yet some public pension fund managers seem to have incentives to pursue active strategies despite low pay for performance compensation components.
 - Rewards may also not be completely aligned with value maximization (unions, public pension fund managers).

Public Activism and Shareholder Proposals

- No significant price reaction to proxy proposals at the time of the mailing and no price reaction over a three year period. Also no significant improvements in long-term operating performance. (Diane Del Guercio and Jennifer Hawkins, “The Motivation and Impact of Pension Fund Activism,” *Journal of Financial Economics*, 1999)
- Generally no significant stock price reaction to proxy proposals offered by institutional investors. Significant negative reaction to proposals seeking to remove poison pills. (Stuart L. Gillan and Laura T. Starks, Corporate Governance Proposal and Shareholder Activism: The Role of Institutional Investors, *Journal of Financial Economics*, 2000)

Stock Market Reactions to Shareholder Proposals

(Gillan and Starks, “Corporate Governance Proposals and Shareholder Activism: The Role of Institutional Investors” 2000)

Proposals Sponsored by Institutions or Coordinated Groups

	Abnormal			
	Return	Z-stat	n	% positive
All Proposals	-0.4509	-1.3374	383	45.43
Board Issues	-0.5974	-0.8364	44	43.18
Confidential Voting	-0.0691	-0.0672	159	50.94
Repeal of Poison Pill	-1.0069	-2.1221	157	39.49
Other Issues	-0.3461	-0.4526	107	42.06

Proposals Sponsored by Individuals

	Abnormal			
	Return	Z-stat	n	% positive
All Proposals	0.2561	2.3140	946	50.74
Board Issues	0.1749	1.1236	432	49.31
Cumulative Voting	0.4458	1.8457	263	53.23
Confidential Voting	0.2724	0.2527	29	48.28
Repeal of Poison Pill	1.0360	1.4332	46	58.70
Other Issues	0.1417	1.7801	377	53.05

The Interesting Case of Poison Pills

- Argument 1: Poison Pills are Bad
 - They are put in place to protect management.
 - They lead to management entrenchment and weaken disciplinary action of the takeover market.
- Argument 2: Poison Pills can be Good
 - They allow the board to conduct an auction.
 - Benefits of an auction (through higher realized selling price) overcome possible reduction in the probability of a bid.
- One study found positive price effect when poison pills were adopted *if board consisted of a majority of outsiders.* (James Brickley, Jeffery Coles, and Rory Taylor, “Outside Directors and the Adoption of Poison Pills,” *Journal of Financial Economics*, 1994)

The Interesting Case of Poison Pills

- Institutional Investors are making mistakes.
 - Rescission of poison pills is value-reducing.
 - Active institutional investors do not appreciate the value of the poison pills, but the market does.
 - Individual investors appear not to make this kind of mistake.
 - All of this is highly implausible.
- More plausible explanation: market learns that management is uncooperative.
 - An active institutional investor first approaches management with proposal and negotiates.
 - A shareholder proposal by an institution indicates that negotiations were unsuccessful and management is “low quality.”

Institutional Investor A Believes Management of Company X is not Maximizing Shareholder Value

- **Alternative 1:** hold stock and do nothing.
- **Alternative 2:** hold stock and be “active.”
 - Pressure management privately.
 - Pressure management publicly.
- **Alternative 3:** vote with one’s feet, i.e., sell shares. This is the ‘Wall Street Walk.’

Is the ‘Wall Street Walk’ bad for Corporate Governance?

- An institutional holder who exits through the ‘Wall Street Walk’ escapes the “responsibility” of being active.
- If an institutional holder is “trapped” (holdings are illiquid and costs incurred in exiting are high), then that holder may be “forced” to produce some public goods through being active.
- An extreme proposal sometimes put forward: impose a transactions tax that would reduce viability of ‘Wall Street Walk’ and increase monitoring and activism.

Can Wall Street Walk be a Form of Shareholder Activism?

- Large shareholders may be able to affect managerial decisions through the “threat (actual or implied) of selling their holding and driving down the price of the targeted company.”

Alan R. Palmiter “Mutual Fund Voting of Portfolio Shares: Why Not Disclose?” *Cardozo Law Review*, 2002, pp. 1419-1491.

Can This Threat Work?????

- Do institutional holders have an effect on prices?
- Is the threat credible?
- If so, when does it work and how well does it work?
- Can the threat make things worse?

Do Institutions Move Prices?

(from Sias, Starks and Titman, “The Price Impact of Institutional Trading”, 2001)

**Average correlations
between quarterly changes in institutional ownership
and return over the prior, same, and following quarters**

Investor	Prior quarter	Same quarter	Following quarter
Average cross-sectional correlation			
All institutions	0.1302 (14.56)**	0.2678 (29.95)**	0.0216 (2.35)*
Bank trusts	0.0760 (9.16)**	0.1907 (20.54)**	0.0054 (0.66)
Insurance companies	0.0710 (11.71)**	0.1026 (16.92)**	0.0057 (1.19)
Mutual funds	0.0835 (15.93)**	0.1542 (21.34)**	0.0213 (3.34)**
Independent advisors	0.1110 (14.76)**	0.2413 (36.69)**	0.0229 (3.09)**
Others	0.0572 (8.97)**	0.0687 (11.54)**	0.0071 (1.28)

The Main Idea

- The manager cares about his firm's stock price (through stock based compensation).
- The large shareholder or institution has private information about the manager's actions and/or their consequences.
- Exit by the large shareholder or institution has a negative price impact (since the price reflects the possibility that exit may be based on negative private information).
- In attempting to prevent the large shareholder's exit, the manager might make decisions that are more consistent with shareholders' preferences.

The Conflict of Interest Between Management and Shareholders

- “Good” Action
 - If management takes the good action, the value of firm increases by δ .
 - Management, in taking the action, incurs private cost or loss of β .
- “Bad” Action
 - If management takes the bad action, the value of firm decreases by δ .
 - Management, in taking the action, receives private benefit of β .
- In either case the problem is more acute when β is large (relative to δ).

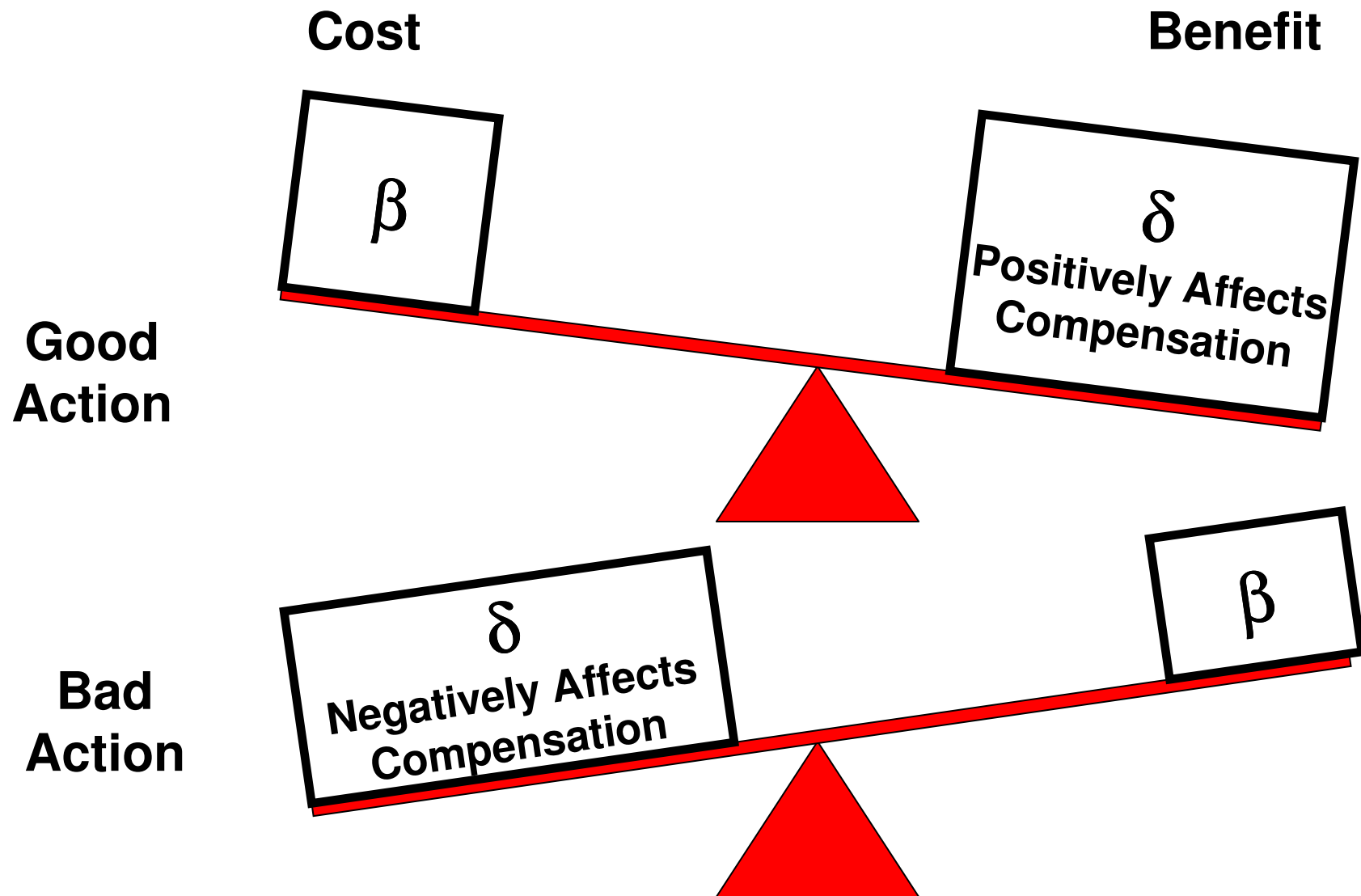
Management Incentives

- Compensation:

$$w_{\text{short run}} \times P_{\text{short run}} + w_{\text{long run}} \times P_{\text{long run}}$$

- Assume institution walks if management does the “wrong” thing.
- If bad action is taken:
 - Management loses $w_{\text{long run}} \times \delta$ for sure since action will reduce long run price.
 - Management loses $w_{\text{short run}} \times (\text{Decrease in short run price})$ if institution ‘walks’.
 - Management gains β .
- If good action is taken:
 - Management gains $w_{\text{long run}} \times \delta$ for sure since action will increase long run price.
 - Management does not lose $w_{\text{short run}} \times (\text{Decrease in short run price})$ since institution will not ‘walk’; institution walks when action is not taken.
 - Management loses β .

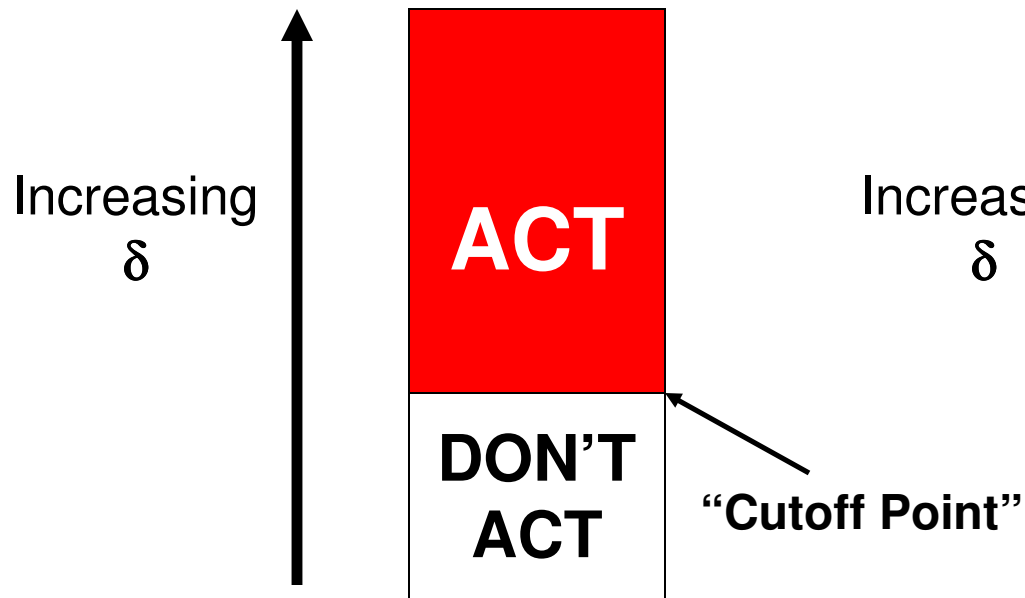
Manager Weighs Costs and Benefits



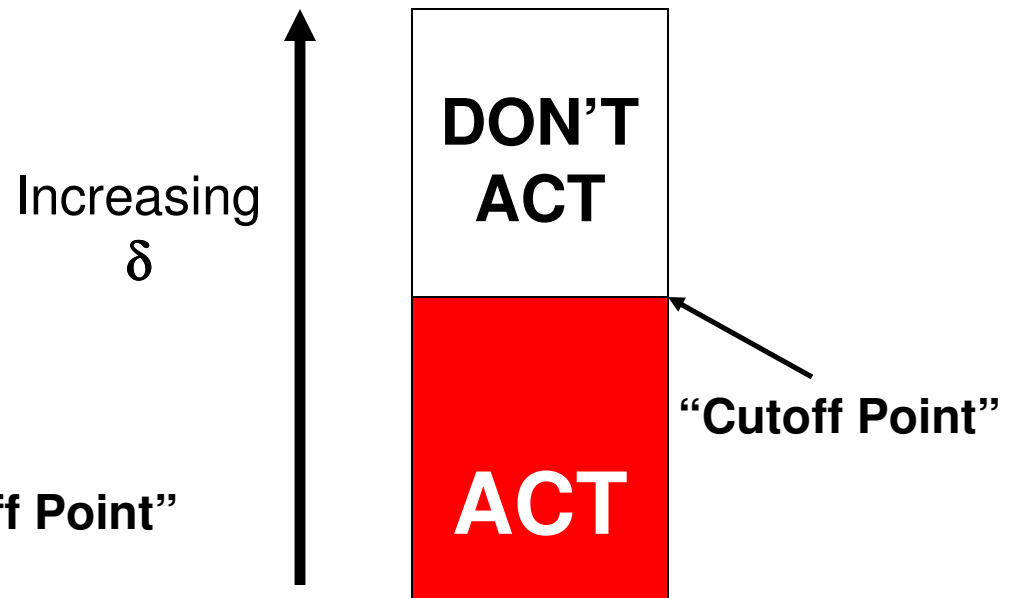
Management Incentives

- Whether management acts depends on size of δ .

If Action is “Good”



If Action is “Bad”



In both cases we want the cutoff point to be as low as possible.

Analysis

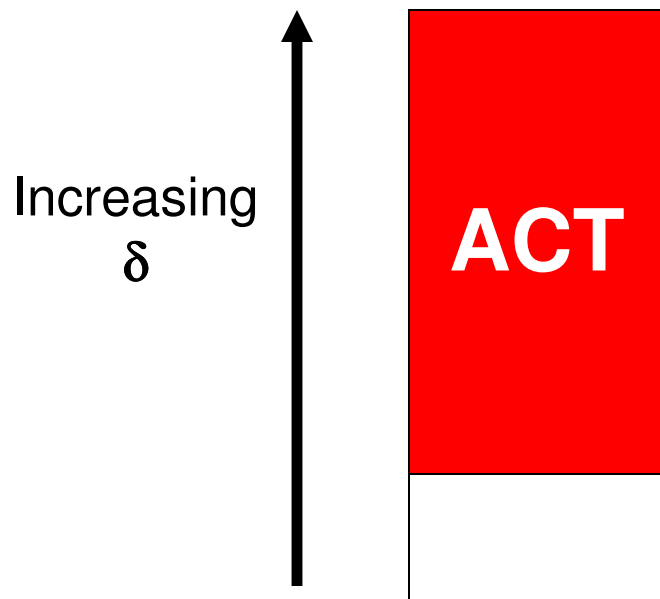
- We assume a “Bayesian Nash” equilibrium
 - All “players” (management, the institutional holder, and the market) make correct inferences about strategies and the statistical relation between actions and outcomes.
- We analyze model for
 - Various information structures (who knows what and when),
 - Various costs of trading,
 - Different assumptions about institutional holder’s other motives for trade,
 - Various dynamic issues when there is “repeated” play.
- For those interested, complete results and analysis are found in the paper.

Results

- Threat to sell can be credible: the institution has private information about the management's action and this gives trading profits.
- Everything else equal, threat is actually more valuable in motivating good actions than it is in dissuading management from taking bad actions.

Difference Between Good and Bad

- When Action is Good and cutoff is low, there is large difference between the consequences of doing the “right thing” (acting) and the wrong thing (not acting).

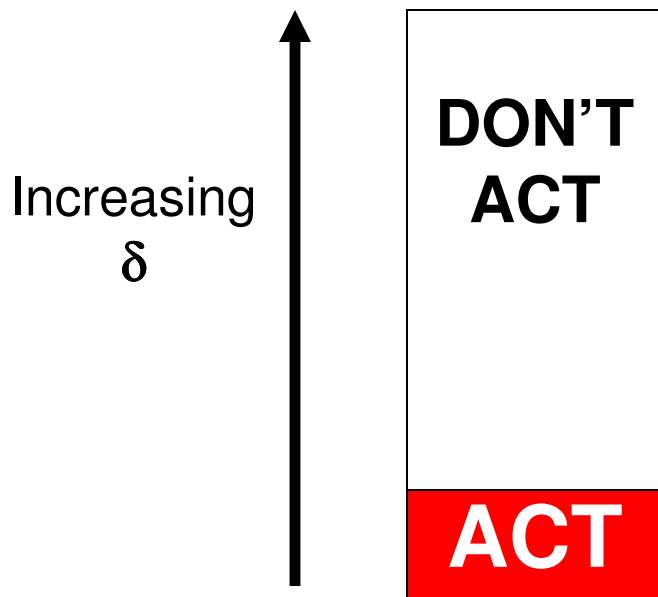


Value of doing the “right thing” is the gain measured by the expectation of δ falling above cutoff.

Value of doing the “wrong thing” is 0, since when no action is taken, no gain is achieved.

Difference Between Good and Bad

- When Action is Bad and cutoff is low, there is small difference between the consequences of doing the “right thing” (not acting) and the wrong thing (acting).



**Value of doing the “right thing”
is the value of not acting
and thereby
producing a loss of 0.**

**Value of doing the “wrong thing”
is value of acting and
producing a loss
measured by the expectation
of δ falling below cutoff.**

Some Other Results

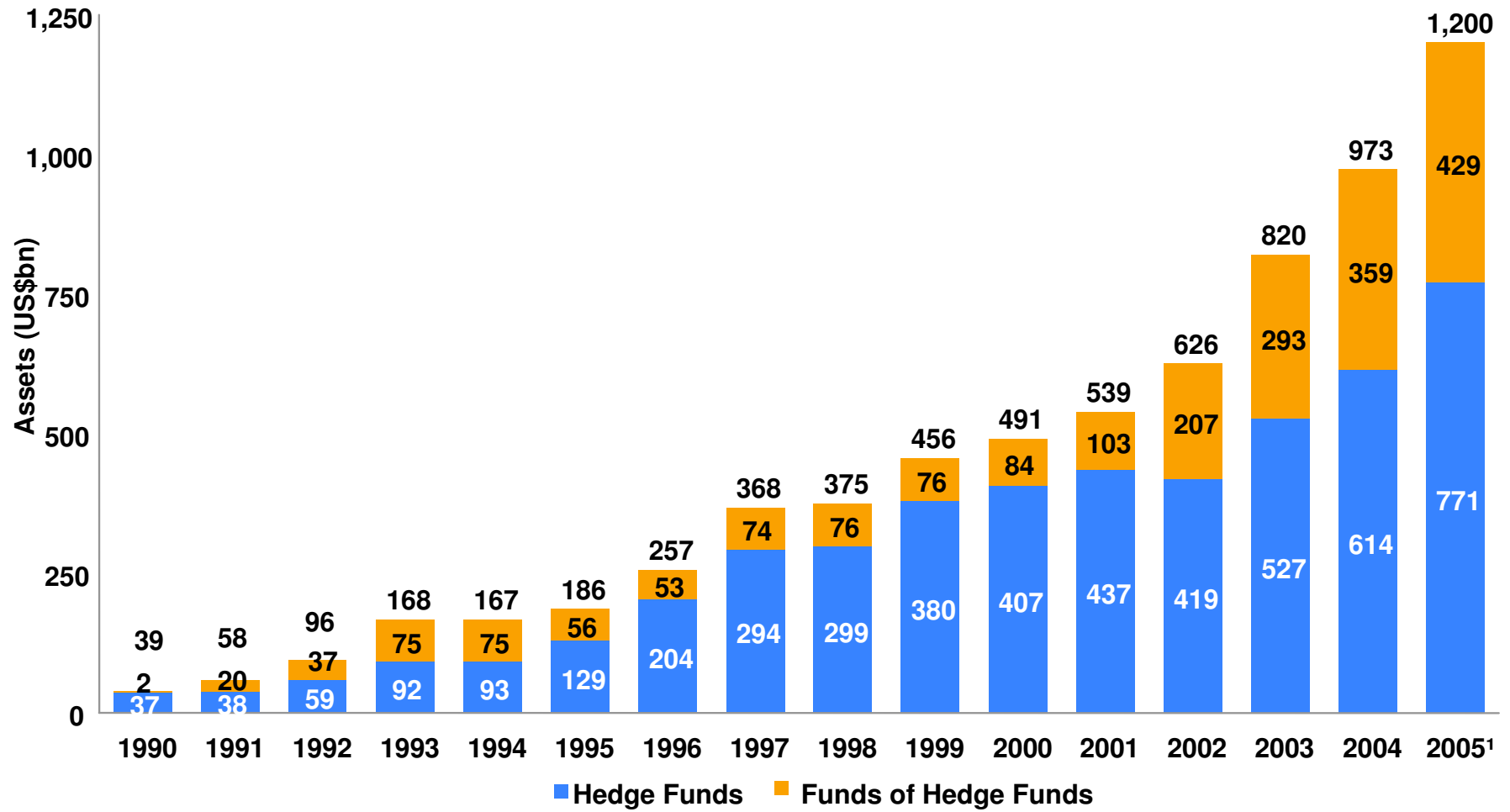
- Having more information does not necessarily make institutions more effective in making threat. In fact, in some cases more information can reduce institutional holder's effectiveness.
- Transactions costs and other costs of exit can actually make the institution more effective: the institution exits less often but with more effect.
- Threat may be carried out rarely, but can still be effective.

Example of “behind the scenes” activism: TIAA-CREF

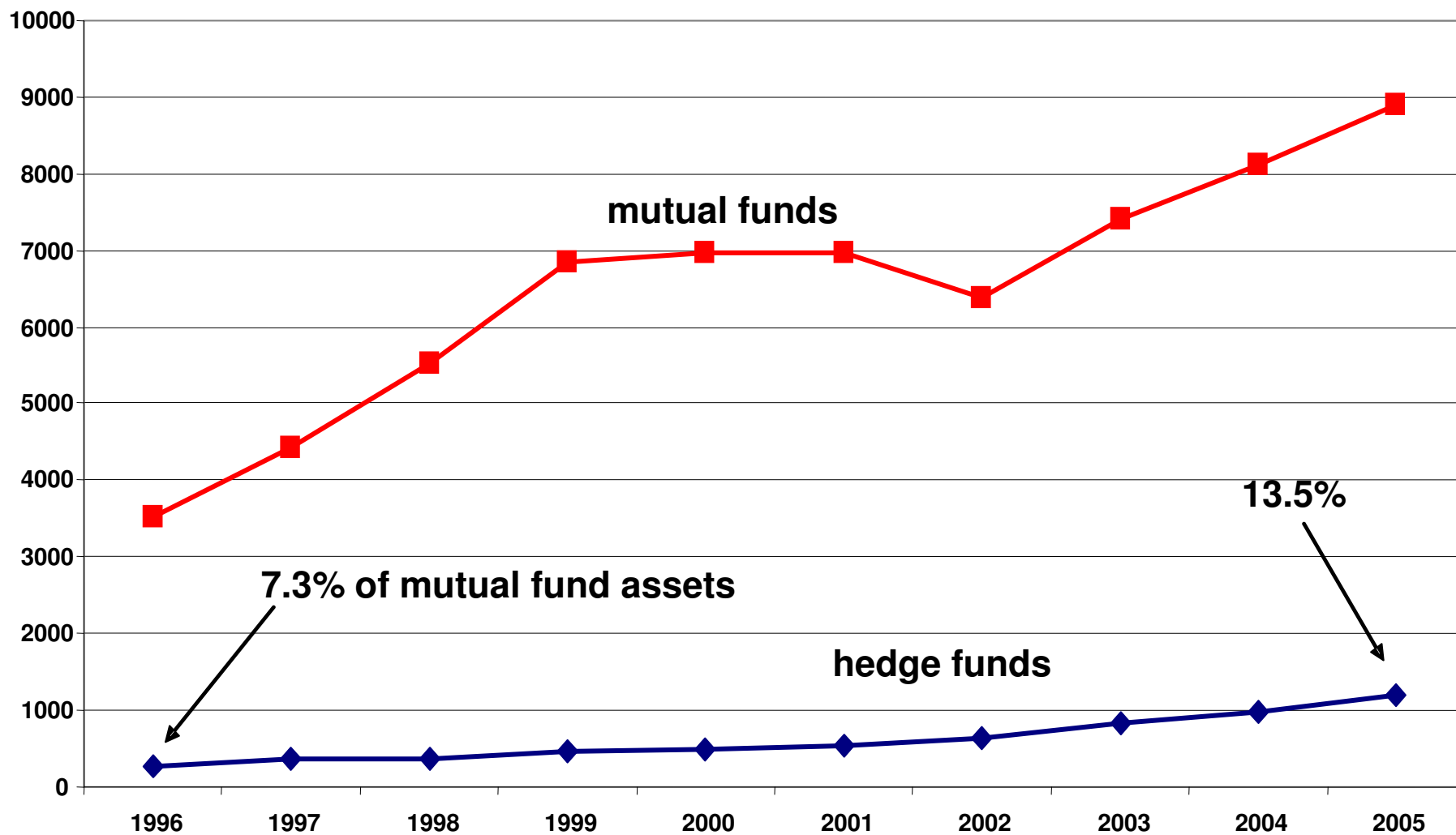
- Study by Carleton, Nelson and Weisbach, “The Influence of Institutions on Corporate Governance through Private Negotiations,” *Journal of Finance*, 1997
- Institutional investor reached agreement with targeted firm over 95% of the time.
- In at least 87% of these cases, the targeted firm took actions to comply with the agreement.
- Was there an implicit threat to exit?

Hedge Funds

Hedge Fund Growth

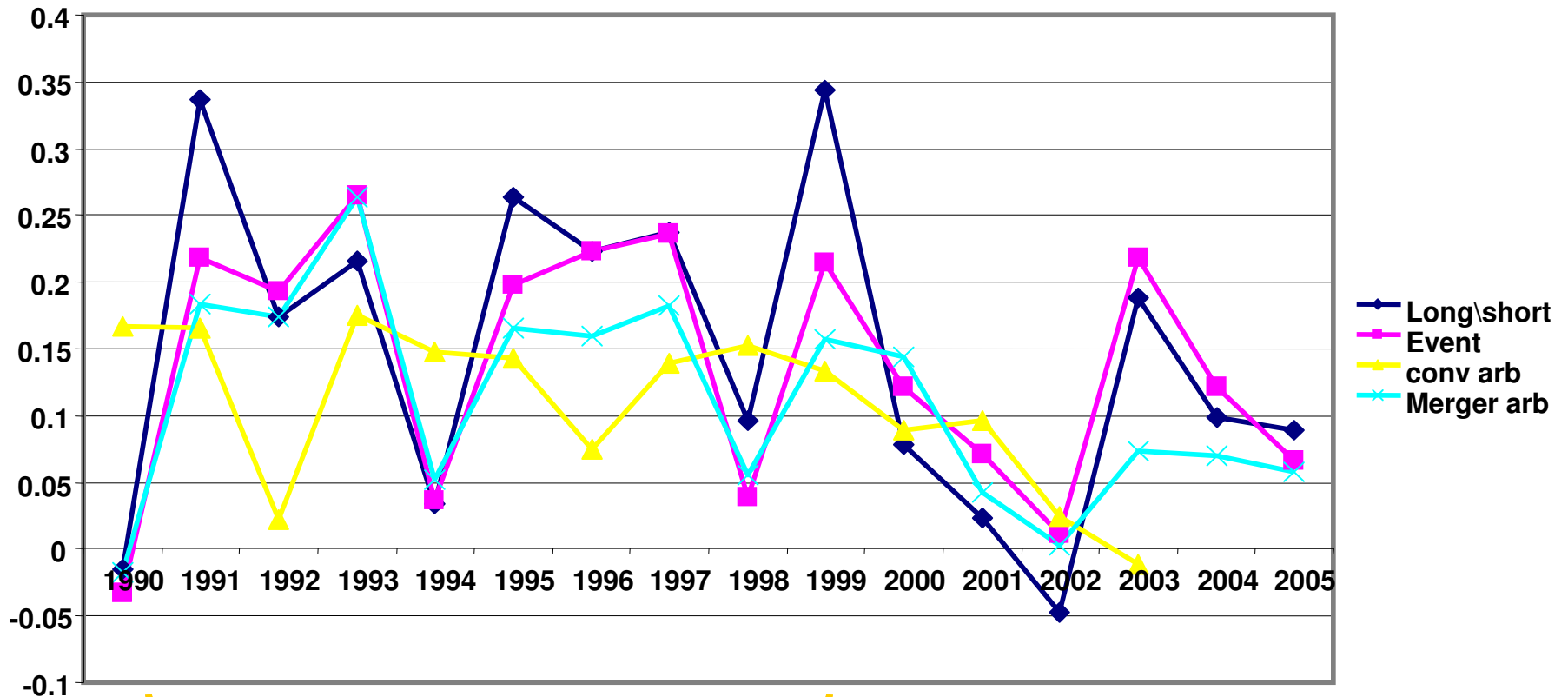


Mutual Fund and Hedge Fund Assets Under Management in millions of USD



Why have some hedge funds turned to activism?

Returns on hedge fund strategies



Avg returns: 1990-1999: 19%
Merger arb: 1990-1999: 14%

2000-2005: 9%
2000-2005: 5%

Example

- February 2005 - **Third Point, LLC** targeted **Star Gas Partners** after acquiring around 6% ownership.
- They publicly questioned the governance practices of the firm and the CEO's management:

“It is time for you to step down from your role as CEO and director so that you can do what you do best: retreat to your waterfront mansion in the Hamptons where you can play tennis and hobnob with your fellow socialites.”

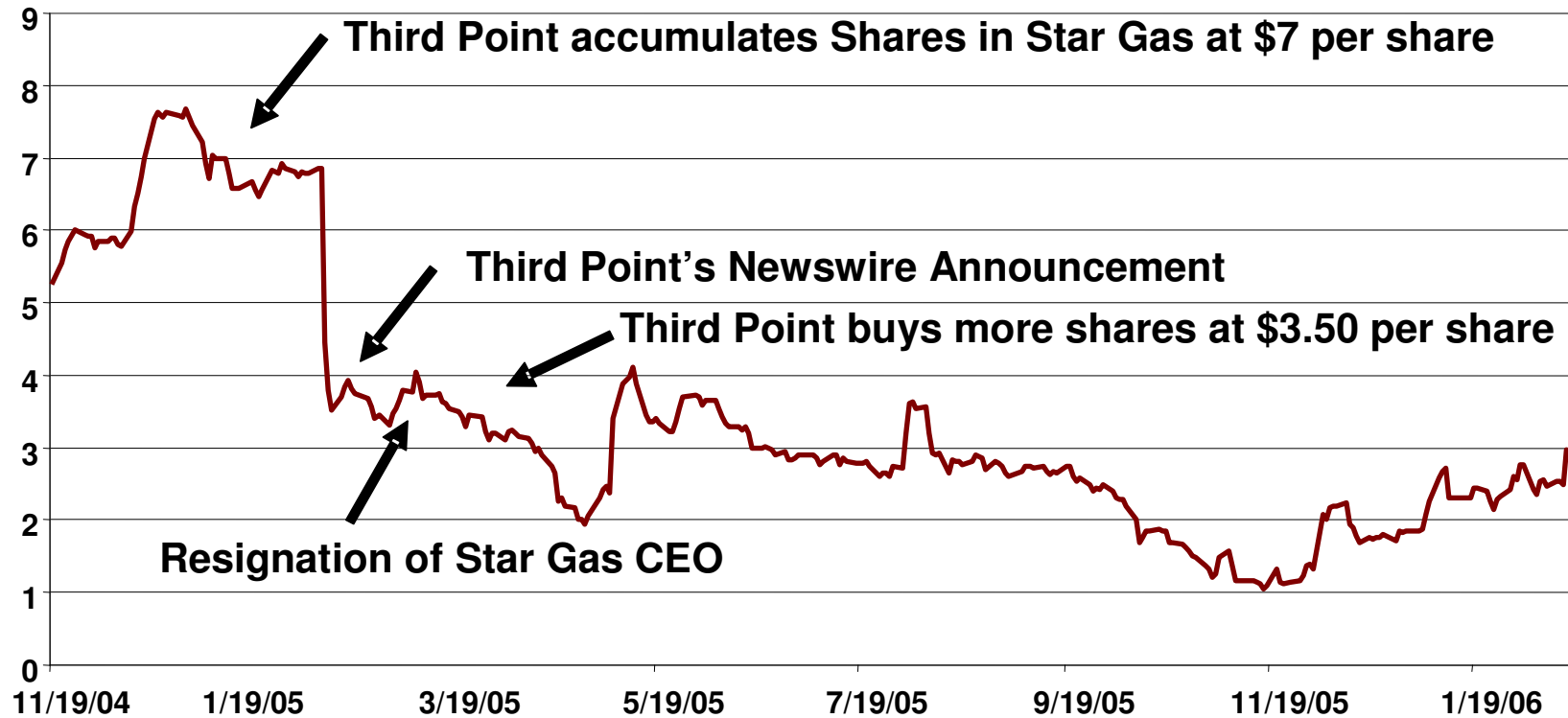
Example

- Third Point Capital to CEO of Star Gas Partners in 2005:

“How is it possible that you selected your elderly 78-year-old mom to serve on the Company’s Board of Directors and as a full-time employee providing employee and unitholder services? We further wonder under what theory of corporate governance does one’s mom sit on a Company board. Should you be found derelict in the performance of your executive duties, as we believe is the case, we do not believe your mom is the right person to fire you from your job.”
- March 2005 – CEO of Star Gas Partners resigned.

Was Third Point Successful?

Star Gas stock prices



Are Hedge Funds a Force for the “Good”

- High-powered incentives and leverage of hedge fund managers might enhance potential returns to activism.
- “Secrecy” of hedge funds might also enhance effectiveness, but in context of the discipline of the ‘Wall Street Walk,’ secrecy might reduce effectiveness. Highly visible exit would generally have a bigger effect on stock price.
- Are hedge fund activities always ones that serve to enhance shareholder value. Is there a need for regulation????

Epilogue: Empty Voting

- Presumption is that those who are active and influencing outcomes are acting to enhance shareholder value? Is this always true?
- It is now relatively easy to detach voting right from economic interest:
 - Costless collar
 - Equity swap
 - Record day capture
 - Etc.

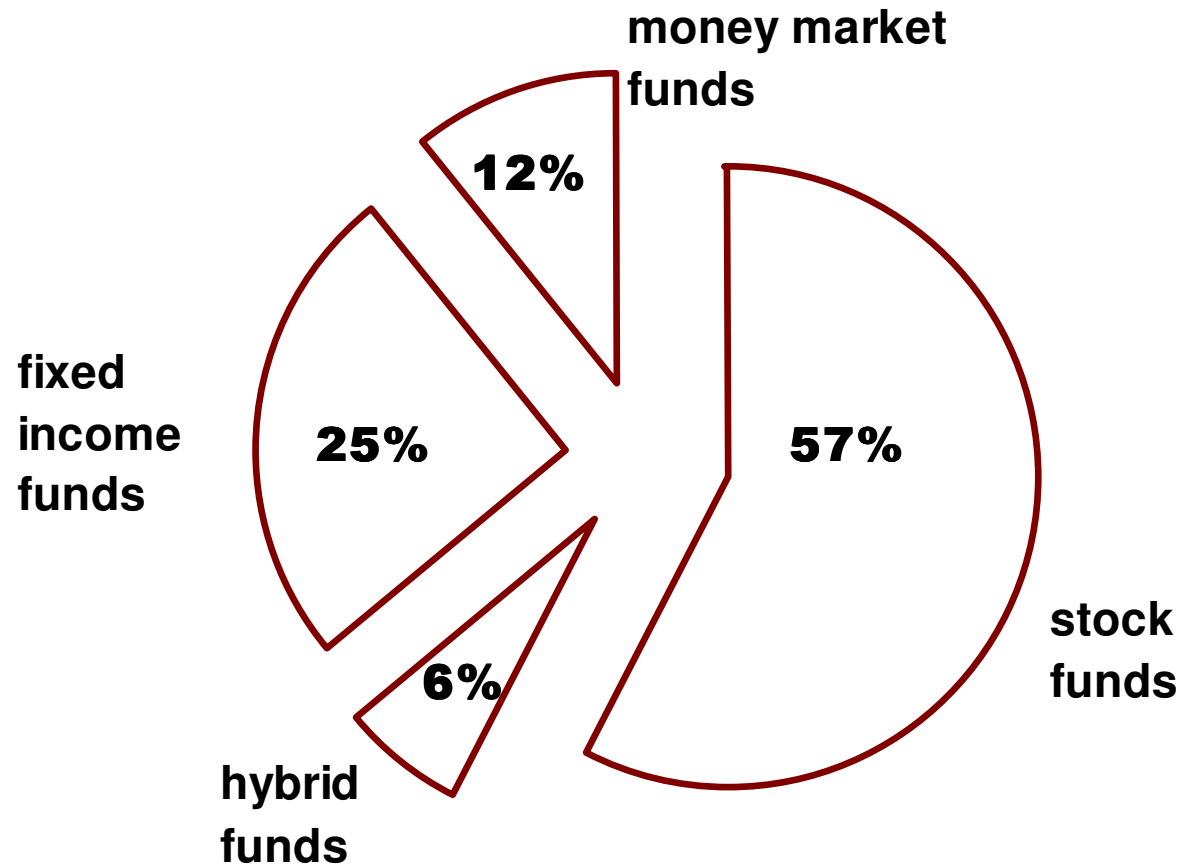
Example: Perry, King Pharmaceutical, and Mylan Laboratories

- Perry, a hedge fund, owned 7 million shares of King Pharmaceutical.
- Mylan Laboratories agreed in late 2004 to buy King Pharmaceutical at substantial premium.
 - Mylan shares dropped substantially in price upon announcement.
 - Mylan management still wanted to proceed.
- Perry
 - Bought 9.9% of Mylan, becoming Mylan's largest shareholder.
 - Fully hedged risk associated with share ownership.
 - Perry had 9.9% voting ownership but 0% economic ownership
 - Overall, Perry had negative interest in Mylan.

Example: Perry, King Pharmaceutical, and Mylan Laboratories

- Carl Ichan, a major Mylan stockholder, opposed Mylan acquisition of King.
- Ichan sued Perry.
- Eventually Mylan withdrew offer for King because of Accounting problems at King.
- This illustrates (in extreme form) that “shareholders” interests may not be aligned and raises the possibility that not all activity undertaken to influence outcomes enhances shareholder (and social) value.

As of February 27, 2006, there were 7,989 Mutual Funds in the U.S. with \$9.2 Trillion in Assets Under Management.



Source: Investment Company Institute