Behind the Scenes: The Corporate Governance Preferences of Institutional Investors

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Motivation

Shareholder Activism

- An increasing phenomena
  - “Shareholder activism is gaining in popularity around the world.” (Economist (2014))
- But often private engagement
  - “Most activism now takes place privately.” (Economist (2013))
- Or private “threat of exit”
- Much theoretical and empirical research is based on assumptions or indirect evidence about these private engagements

Direct Evidence on Shareholder Activism

- Most direct evidence on shareholder activism by institutional investors from two sources:
  - <u>Analysis of hedge fund activism</u>
    - Brav, Jiang, Partnoy, and Thomas (2008), Klein and Zur (2009), Becht, Franks, Grant, and Wagner (2014), Clifford (2008)
  - <u>Case study analysis</u>
    - TIAA-CREF (Carleton, Nelson and Weisbach (1998))
    - Hermes UK Focus Fund (Becht, Franks, Mayer, and Rossi (2009))
    - Another UK fund (Dimson, Karakas, and Li (2013))
    - CalPERS (Smith (1996))

Our Goal

- Elicit institutional investors' governance-related preferences and actions
- Central focus of survey
  - How do institutional investors choose between exit and voice?
    - What determines the intensity of voice?
    - Are exit and voice complements or substitutes?
  - Do institutional investors think the threat of exit is effective (and why)?
  - How do they consider an increasingly controversial aspect of shareholder activism – proxy advisors?

Survey

- Methods of delivery
  - 3 conferences
    - ICGN event in New York
    - ICGN dinner in Rotterdam
    - Istanbul pensions conference
  - Email
- 143 responses (response rate of 4.3%)
  - Without mass email, response rate was considerably higher
- Respondent group probably biased towards more activist investors
  - But preferences of these investors particularly important

Demographics of Respondents

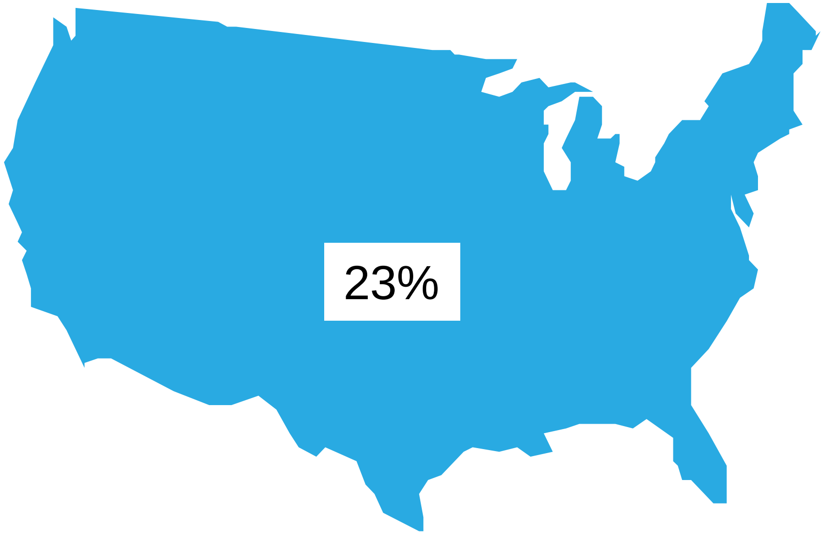
Institutional Investor Types	
Asset Manager	48%
Mutual Fund	21%
Pension Fund	12%
Insurance Company	5%
Hedge Fund	4%
Other	9%
Position of Respondent	
Corporate Governance or Proxy Voting Specialist	27%
Portfolio Manager	27%
Chief Investment Manager	18%
Board Member	15%
Other	8%
Analyst	4%

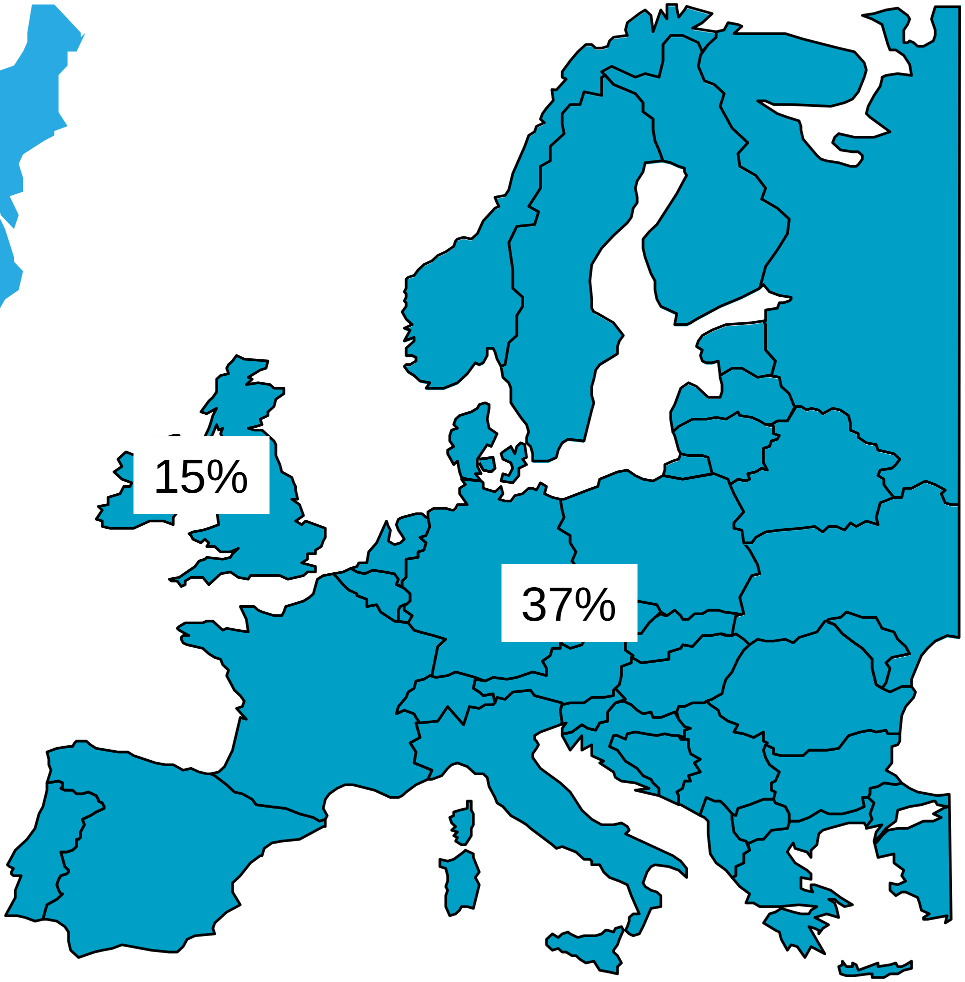
Demographics of Respondents

Assets under Management	
More than $100bn	34%
Between $1bn and $100bn	32%
Between $100m and $1bn	25%
Less than $100m	8%

We have 33 with more than $100bn in AUM.
(Only 128 in the world.)

Locations of Respondents





Rest of the World
25%

Investment Characteristics

Investor Horizon	
Short (less than 6 months)	0%
Medium (6 months to 2 years)	30%
Long (more than 2 years)	70%
Investment Structure	
Active Investments	89%
Stock Liquidity	
Not at all important	2%
Somewhat unimportant	4%
Neither important nor unimportant	4%
Somewhat important	53%
Very important	37%

Shareholder Engagement Channels

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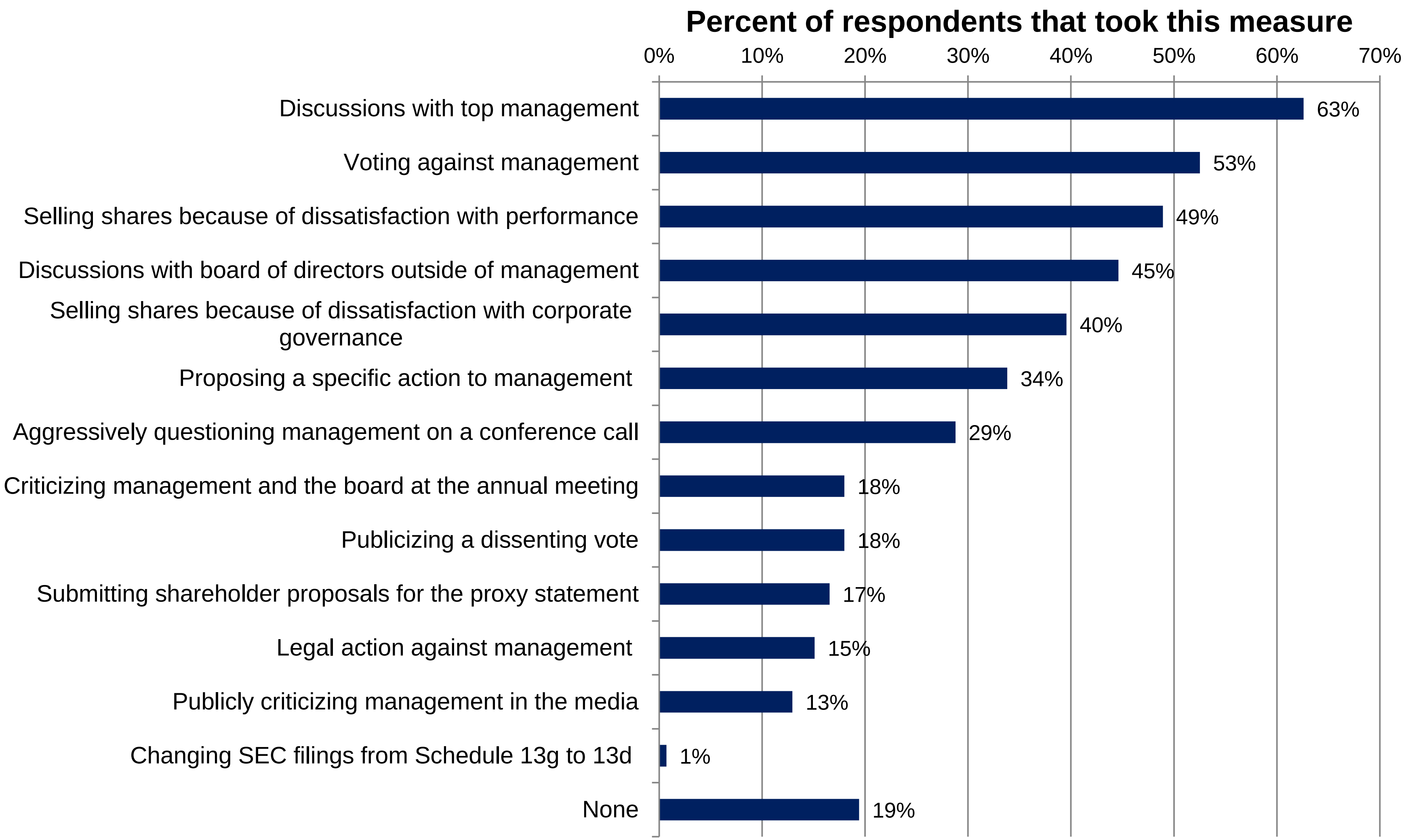

Main Findings

- Generally very high level of engagement by our respondents
  - Only 20% have not taken any corrective actions
- Investors use multiple channels to engage
  - Rely both on voice and exit
- Widespread use of behind-the-scenes engagement
- If we aggregate the two exit options into one:
  - Exit *at par* with discussions with management

Determinants of Voice Intensity

Determinants of Voice Intensity

- Voice Index
  - Sums the different voice dimensions an investor has taken in the past five years
  - Captures the breadth and intensity of voice
  - Can vary between 0 and 11, with a mean value of 3
- Determinants
  - Investor horizon
  - Stock liquidity
  - Size (Assets under Management)
  - Active investments
  - Investor location and type

Determinants of Voice Intensity

	Voice						
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Investor Horizon	1.30***				1.32**		1.45***
	(3.15)				(2.30)		(2.63)
Liquidity		-0.36**			-0.50*		-0.58**
		(-2.12)			(-1.90)		(-2.38)
Assets under Management			0.16		-0.08		-0.06
			(0.73)		(-0.26)		(-0.19)
Active Investments				0.01	0.02*		0.01*
				(1.43)	(1.86)		(1.74)
Exit						1.72***	1.42**
						(4.88)	(2.41)
US					0.15		0.43
					(0.20)		(0.56)
UK					1.45*		1.66*
					(1.78)		(1.77)
Continental Europe					-0.20		-0.27
					(-0.31)		(-0.42)
Hedge Fund					0.95		0.61
					(0.62)		(0.36)
Insurance Company					-1.61		-2.75*
					(-1.20)		(-1.80)
Mutual Fund					0.92		-0.17
					(1.16)		(-0.18)
Asset Manager					0.43		-0.41
					(0.51)		(-0.44)
Pension Fund					1.70*		0.90
					(1.73)		(0.85)
N	92	100	95	88	83	139	83
pseudo R-sq	0.025	0.008	0.002	0.006	0.093	0.048	0.112

Exit and Voice:
Complements or Substitutes?

Voice and Exit: Complements or Substitutes?

- **Complements**
  - Option to exit improves the effectiveness of voice
    - Edmans and Manso (2011))
    - Levit (2013)
    - Dasgupta and Piacentino (2014)
- **Substitutes**
  - Investors may lack expertise for intervention
  - Investors may have capital gains liabilities when exiting (Dimmock et al. (2013))

Voice and Exit: Complements or Substitutes?

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Impediments to Shareholder Engagement

Impediments to Engagement

- Some argue activism through voice by institutional investors is very rare
  - E.g., Black (1990); Bainbridge (2005)
- Extended policy debate on how institutional investors can be incentivized to be more active
  - ECGI Event (SEC; European Commission)
- What are the impediments to engagement?
  - Economic incentives (free rider problems)
  - Legal barriers
  - Conflicts of interest
  - Industry structure

Impediments to Engagement

Statement	Reasons for not conducting shareholder engagement:	Survey Method A		Survey Method B
		Mean Score	% 4 or 5 Score	% Top 4 Reason
(1)	Benefits from engagement not large enough	3.4	61%	26%
(2)	Too small of a stake in a firm	3.4	61%	47%
(3)	Limited personnel	3.4	54%	55%
(4)	Rules on "acting in concert" discourage coordination	3.3	44%	21%
(5)	Too many firms in our portfolio	3.3	45%	26%
(6)	Management or insider control of voting rights	3.2	45%	29%
(7)	Investors in our fund do not sufficiently reward engagement	2.8	36%	18%
(8)	Disclosure regulations discourage conversations	2.8	25%	8%
(9)	Holdings by other institutional investors not large enough	2.8	32%	16%
(10)	Engagement not considered part of our investment mandate	2.7	36%	21%
(11)	Engagement makes it more difficult to receive information	2.6	28%	18%
(12)	Regulation does not allow us to take a sufficiently large stake	2.5	22%	8%
(13)	Investment process is outsourced to other asset management firms	2.3	21%	11%
(14)	Corporate governance does not affect financial performance	2.2	19%	11%

Shareholder Activism Triggers

Shareholder Activism Triggers

Statement	Triggers for shareholder engagement:	Survey Method A		Survey Method B
		Mean Score	% 4 or 5 Score	% Top 4 Reason
(1)	Corporate fraud	4.5	89%	29%
(2)	Inadequate corporate governance	4.4	88%	79%
(3)	Excessive management compensation	4.4	88%	44%
(4)	Poor corporate strategy	4.2	89%	38%
(5)	Large diversifying merger or acquisition	4.1	82%	3%
(6)	Poor absolute financial performance	4.1	80%	24%
(7)	Poor financial performance relative to peers	4.1	79%	41%
(8)	Large related-party transaction by insiders	4.1	79%	32%
(9)	Socially "irresponsible" corporate behavior	4.1	72%	38%
(10)	Large equity issuance	4.0	82%	0%
(11)	Large negative earnings surprise	3.8	68%	6%
(12)	Uncooperative management	3.7	64%	6%
(13)	Suboptimal capital structure	3.7	68%	18%
(14)	Earnings restatement	3.7	68%	3%
(15)	Low payments to shareholders despite high cash holdings	3.7	71%	21%
(16)	Financial contributions to political parties or politicians	3.2	40%	6%
(17)	The threat of a major shareholder to sell shares	2.8	27%	6%

The Threat of Exit

Threat of Exit

- Shareholders can govern even if they do not actively intervene
  - Theory: Admati and Pfleiderer (2009), Edmans (2009), Edmans and Manso (2011)
  - Empirical: Parrino, Sias, and Starks (2003)
- A key assumption in exit models
  - Institutional investors *threaten* management with exiting the firm
- Challenge to this literature is that the *threat* of exit, by definition, is unobservable
  - Mechanism works through the threat of exit rather than exit itself (which will not happen if the threat is successful)

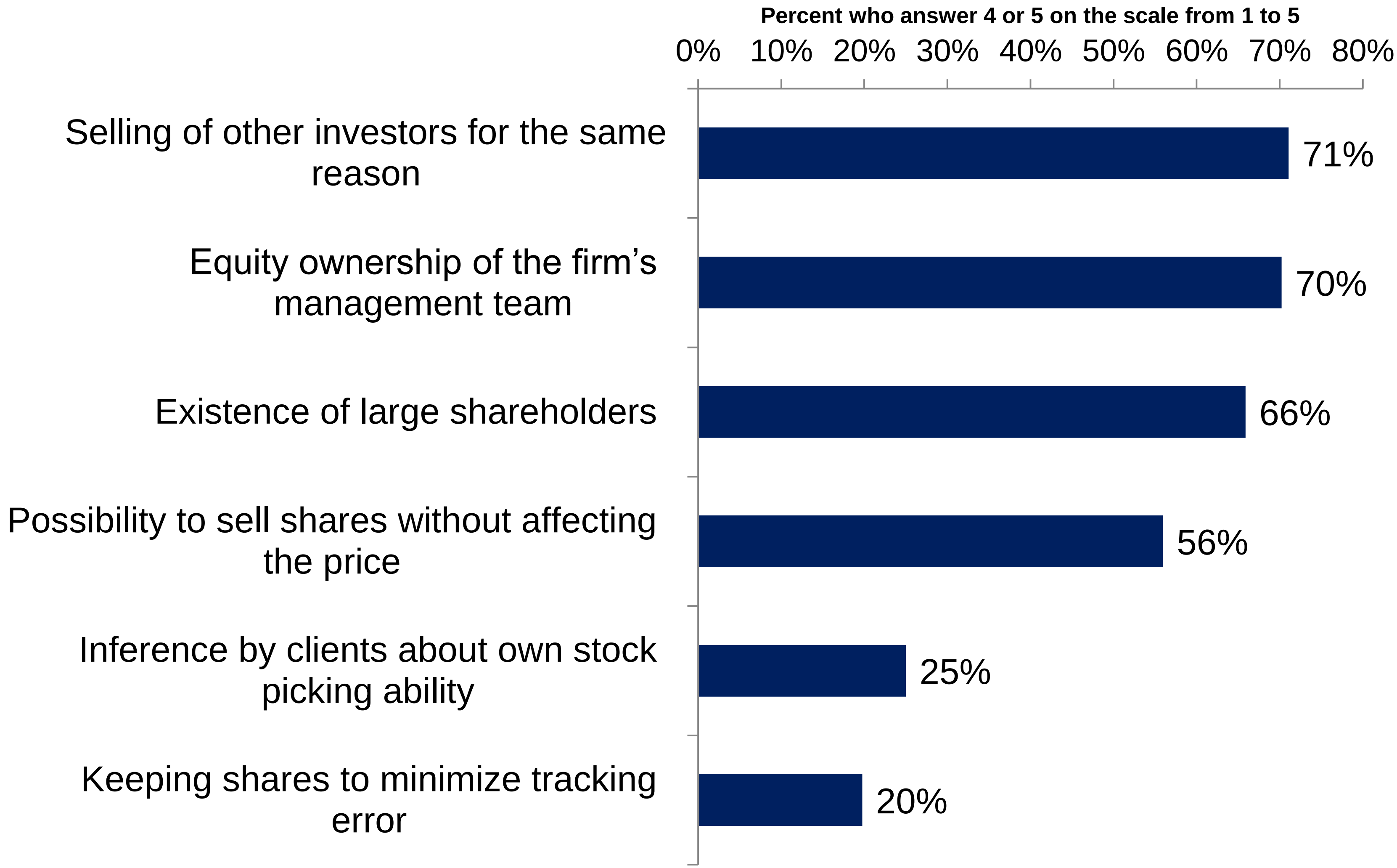
Threat of Exit

Does the Threat of Exit Work?							
No	34%						
Yes	41%	If Yes: Minimum Stake Size?					
		Does not matter	At least 0.5%	At least 2%	At least 5%	At least 10%	# Respondents
		19%	7%	21%	29%	24%	42
Don't know	25%						
# Respondents	102						

Determinants of Exit Threat Effectiveness

- Block size
  - Admati and Pfleiderer (2009); Edmans (2009); Edmans and Manso (2011)
- Liquidity
- Equity ownership by management:
- Selling by other institutional investors
  - Edmans and Manso (2011)
- Inference about stock picking ability
  - Dasgupta and Piacentino (2014)
- Tracking error considerations

Determinants Exit Threat Effectiveness



Conclusions

- Institutional investors use multiple channels to engage with companies
  - They rely on both exit and voice
  - But impediments to engagement nevertheless exist
- More long-term oriented investors intervene more intensively
- Exit and voice tend to be complements, not substitutes
- They believe the threat of exit is an effective mechanism of governance
- Many use proxy voting advisors and find their advice to be helpful

Thank you
for the opportunity to be here!