



DOES THE COMPOSITION OF A COMPANY'S SHAREHOLDER BASE REALLY MATTER?

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THE INFLUENCE OF SHAREHOLDERS

Shareholders are not a homogenous group. They include a diverse mix of institutional and retail investors that differ in terms of investment horizon (long-term versus short-term), objectives (purely economic versus social objectives), level of activity (active versus passive), portfolio concentration, and size.

Most corporations dedicate significant time and attention to managing their shareholder base. A recent survey by the National Investor Relations Institute (NIRI) and the Rock Center for Corporate Governance at Stanford University finds that 91 percent of companies discuss shareholder composition at the senior-executive level; 75 percent discuss this at the board level. CEOs spend 4.2 days per quarter managing their shareholder base, and CFOs 6.4 days—considerable figures given the managerial responsibilities of senior leaders. Most companies (80 percent) believe that their stock would trade at a higher price if they could attract their “ideal” shareholder base. On average, companies estimate that their stock would rise 15 percent and share price volatility decrease 20 percent over a two to three year period if they had the right shareholders.¹

Furthermore, companies overwhelmingly prefer “long-term shareholders” to “short-term shareholders.” Ninety-two percent of companies in the NIRI/Rock Center study describe their ideal shareholder as having a “long-term investment horizon”—the most highly rated among all attributes surveyed. They describe long-term shareholders as having an investment horizon of at least 2.8 years. Respondents believe that investors with a short-term perspective distract from strategic decision making (65

percent) and focus on cost reduction (51 percent). A majority (57 percent) believes that a company whose shareholder base is dominated by short-term investors will have reduced market growth and/or reduced long-term growth (see Exhibit 1). Some prominent investor groups, too, share these concerns (see Exhibit 2).

There is little rigorous research, however, that conclusively demonstrates the impact that individual investor groups have on corporate decision making or that quantifies the premium (or discount) that specific shareholder groups add to corporate value. For example, one set of studies examines whether blockholders (shareholders that own at least 5 percent of a company's stock) leverage the size of their holdings to influence corporate decisions. Barclay and Holderness (1989) find that large share blocks trade at a 16 percent premium to open-market prices. This suggests that block ownership is *perceived* to have value, either because the acquirer believes block ownership will give it the influence needed to improve corporate outcomes or to extract some type of private gain from the corporation.² Still, research does not demonstrate that block ownership actually *translates* into superior performance. McConnell and Servaes (1990) find no relationship between block ownership by an outside investor and a company's market value.³ Mehran (1995) also does not find a relationship between block ownership and market value, or between block ownership and firm performance.⁴ It might be that some blockholders increase value by promoting a shareholder orientation, others detract from value by extracting corporate assets for personal benefit, and on average their impact is muted.

Another set of research examines the impact

of activist funds on corporate performance. Activists have a history of visible public campaigns to compel corporate change—with mixed results. Union-affiliated pension funds are active sponsors of shareholder-sponsored proposals, primarily relating to executive compensation, board-related matters, bylaw changes, and limits on lobbying and political spending.⁵ Despite this, their track record in terms of corporate impact is not substantial. Only a small minority of union-sponsored proxy proposals receive majority support.⁶ Similarly, there is little evidence that their activism increases shareholder value. For example, Barber (2007) examines all companies targeted by the California Public Employees' Retirement System (CalPERS) between 1992 and 2005 and finds only marginal short-term excess returns and no long-term excess returns.⁷

Activist hedge funds have a more successful track record of compelling change, but a similarly inconclusive impact on performance. Klein and Zur (2005) find that, among a sample of 151 funds between 2003 and 2005, almost three-quarters (73 percent) that pursued board representation were successful; all hedge funds in the sample (100 percent) that wanted the target company to repurchase stock, replace the CEO, or initiate a cash dividend were successful; and half (50 percent) were able to compel a company to alter its strategy, terminate a pending acquisition, or agree to a proposed merger.⁸ However, the impact of activist hedge funds on firm performance is unclear. Klein and Zur (2009) find that the stock prices of target companies exhibit abnormal returns around the announcement of an initial investment, but they find no subsequent improvement in long-term operating performance. By contrast, Bebchuk, Brav, and Jiang (forthcoming) find both positive short-term stock price returns and positive long-term improvements in operating performance.⁹

The mixed impact of activism on corporate performance might reflect the mixed value of the ideas of activists themselves.

Finally, it has not been shown that companies whose shareholders have a predominantly “short-term” investment horizon perform differently than companies whose shareholders have a “long-term” perspective. Bushee (2004) finds that companies

with a high percentage of “transient” (short-term) investors have incrementally higher stock price volatility, while those with a high percentage of “quasi-index” (long-term) investors have lower volatility. However, he does not examine whether shareholder groups with various time horizons (short or long) have any impact on price levels or long-term corporate profitability.¹⁰ Others argue that a company's investment horizon is more likely to be influenced by the design of its executive compensation program (the mix of long- and short-term, fixed and at-risk incentives offered to management) than the investment horizon of shareholders. Shareholder investment horizon might influence the company's investment horizon (the number of years a company is willing to wait until a project becomes profitable) by exerting pressure on the board to alter the incentive structure offered to management.¹¹

WHY THIS MATTERS

1. Companies care greatly about their shareholder base. In particular, they prefer shareholders with a long-term investment horizon and ones that are non-activist. Still, there is little evidence that demonstrates that the composition of a company's shareholder base directly impacts corporate decision making, operating performance, or value creation. Does the composition of a company's shareholder base *really* matter?
2. Activist hedge funds garner considerable public attention. What substantive impact do they have on corporate activity, including strategy, investment, and management? Do activist hedge funds alleviate corporate complacency and therefore serve as a positive market catalyst for change? Or do they distract managers and board members from maximizing long-term returns by imposing a short-term perspective?
3. Corporate insiders prefer long-term investors, and yet their definition of “long term” is not particularly long: at least 2.8 years, on average, according to the NIRI/Rock Center survey. How long is long term *really*? How short is short term? Does a shareholder's investment horizon really impact the price he or she is willing to pay for a corporate security, and therefore a company's stock price more generally?

4. What impact does the investment horizon of a company's shareholder base have on the *incentives* that management has to perform? Can short-term market pressures be offset by long-term executive compensation awards? ■

¹ National Investor Relations Institute and the Rock Center for Corporate Governance, Study on How Investment Horizon and Expectations of Shareholder Base Impact Corporate Decision-Making (2014).

² Michael J. Barclay and Clifford G. Holderness, "Private Benefits from Control of Public Corporations," *Journal of Financial Economics* (1989).

³ Measured as market-to-book value. See John L. McConnell and Henri Servaes, "Additional Evidence on Equity Ownership and Corporate Value," *Journal of Financial Economics* (1990).

⁴ Hamid Mehran, "Executive Compensation Structure, Ownership, and Firm Performance," *Journal of Financial Economics* (1995).

⁵ See Stuart Gillan and Laura Starks, "The Evolution of Shareholder Activism in the United States," *Journal of Applied Corporate Finance* (2007); and Proxy Monitor, 2013 Proxy Season Review. Available at: <http://www.proxymonitor.org/Forms/2013Finding5.aspx>.

⁶ Results are not broken out by sponsor. However, among all companies in the S&P 500 Index in 2013, shareholder-sponsored proposals relating to board-structure and voting-related issues received only 44 percent support on average; proposals relating to social and political issues received 21 percent support; compensation 27 percent support; and other proposals 11 percent. In total, only 46 of 358 (12.8 percent) of shareholder-sponsored proposals passed. See Sullivan and Cromwell, 2013 Proxy Season Review (July 2, 2013).

⁷ Brad Barber, "Monitoring the Monitor: Evaluating CalPERS' Activism," *Journal of Investing* (2007).

⁸ April Klein, and Emanuel Zur, "Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors," *Journal of Finance* (2009).

⁹ Lucian A. Bebchuk, Alon Brav, and Wei Jian, "The Long-Term Effects of Hedge Fund Activism," *Columbia Law Review* (forthcoming).

¹⁰ Brian Bushee, "Identifying and Attracting the 'Right' Investors: Evidence on the Behavior of Institutional Investors," *Journal of Applied Corporate Finance* (2004).

¹¹ See: Lucian A. Bebchuk and Lars A. Stole, "Do Short-Term Objectives Lead to Under- or Overinvestment in Long-Term Projects," *Journal of Finance* (June 1993).

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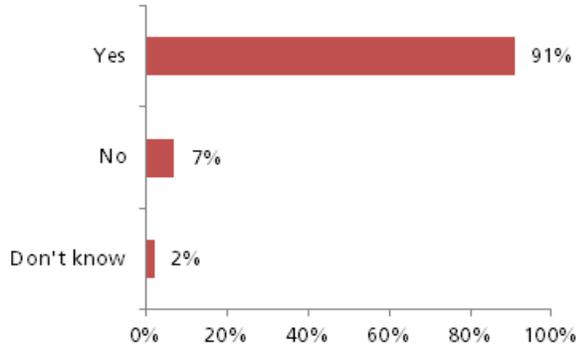
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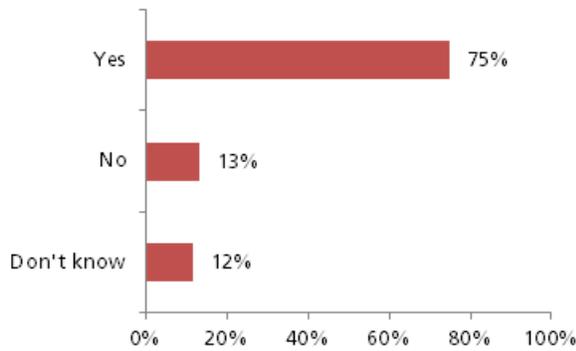
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EXHIBIT 1 — COMPANY PERSPECTIVE ON SHAREHOLDER COMPOSITION

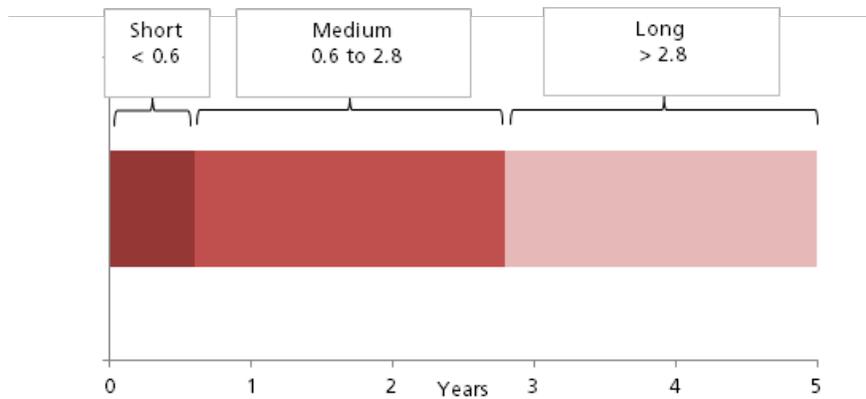
IS THE COMPOSITION OF THE SHAREHOLDER BASE DISCUSSED AT THE C-LEVEL OF YOUR COMPANY?



IS THE COMPOSITION OF THE SHAREHOLDER BASE DISCUSSED AT THE BOARD OF YOUR COMPANY?



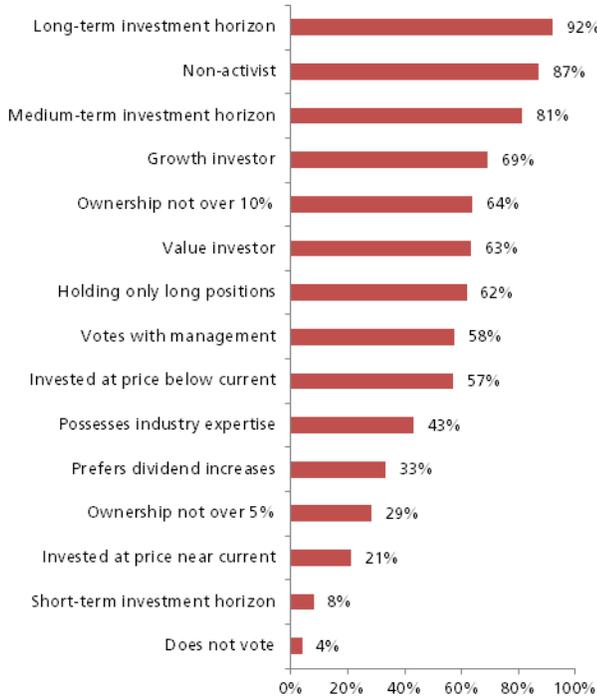
IN YOUR VIEW, WHAT ARE THE INVESTMENT HORIZONS OF THE TYPICAL SHORT-, MEDIUM-, AND LONG-TERM INVESTOR?



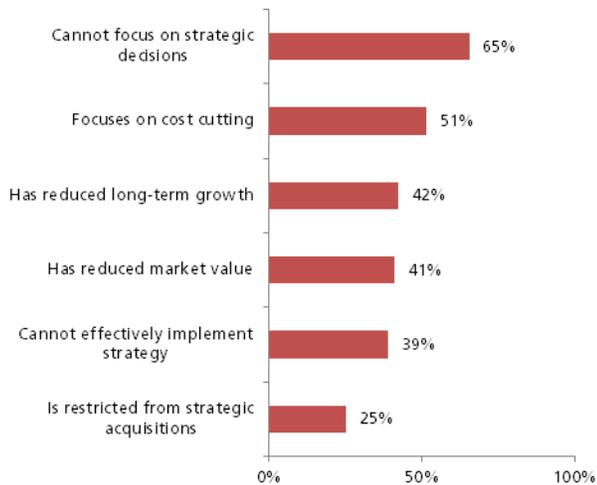
Note: The time horizon of "medium-term" investors is adjusted to avoid gaps.

EXHIBIT 1 — CONTINUED

TO WHAT EXTENT DO YOU AGREE WITH THE FOLLOWING STATEMENT: "THE IDEAL/TARGET SHAREHOLDER FOR OUR COMPANY IS CHARACTERIZED BY..." (AGREE OR STRONGLY AGREE ONLY)



TO WHAT EXTENT DO YOU AGREE WITH THE FOLLOWING STATEMENT: "A COMPANY WITH A SHAREHOLDER BASE THAT IS DOMINATED BY INVESTORS WITH A SHORT-TERM INVESTMENT HORIZON..." (AGREE OR STRONGLY AGREE ONLY)



Note: 57 percent of respondents agree or strongly agree with the statements "has reduced long-term growth" and/or "has reduced market growth."

Source: National Investor Relations Institute and the Rock Center for Corporate Governance at Stanford University, Study on How Investment Horizon and Expectations of Shareholder Base Impact Corporate Decision-Making (2014).

EXHIBIT 2 — BLACKROCK LETTER TO ALL COMPANIES IN THE S&P 500 INDEX

Dear Chairman or CEO,

As a fiduciary investor, one of BlackRock's primary objectives is to secure better financial futures for our clients and the people they serve. This responsibility requires that we be good stewards of their capital, addressing short-term challenges but always with a focus on the longer term.

To meet our clients' needs, we believe the companies we invest in should similarly be focused on achieving sustainable returns over the longer term. Good corporate governance is critical to that goal. That is why, two years ago, I wrote to the CEOs of the companies in which BlackRock held significant investments on behalf of our clients urging them to engage with us on issues of corporate governance. While important work remains to be done, good progress has been made on company-shareholder engagement. I write today re-iterating our call for engagement with a particular focus on companies' strategies to drive longer term growth.

Many commentators lament the short-term demands of the capital markets. We share those concerns, and believe it is part of our collective role as actors in the global capital markets to challenge that trend. Corporate leaders can play their part by persuasively communicating their company's long-term strategy for growth. They must set the stage to attract the patient capital they seek: explaining to investors what drives real value, how and when far-sighted investments will deliver returns, and, perhaps most importantly, what metrics shareholders should use to assess their management team's success over time.

It concerns us that, in the wake of the financial crisis, many companies have shied away from investing in the future growth of their companies. Too many companies have cut capital expenditure and even increased debt to boost dividends and increase share buybacks. We certainly believe that returning cash to shareholders should be part of a balanced capital strategy; however, when done for the wrong reasons and at the expense of capital investment, it can jeopardize a company's ability to generate sustainable long-term returns.

We do recognize the balance that must be achieved to drive near-term performance while simultaneously making those investments – in innovation and product enhancements, capital and plant equipment, employee development, and internal controls and technology – that will sustain growth.

BlackRock's mission is to earn the trust of our clients by helping them meet their long-term investment goals. We see this mission as indistinguishable from also aiming to be a trusted, responsible shareholder with a longer term horizon. Much progress has been made on company-shareholder engagement and we will continue to play our part as a provider of patient capital in ensuring robust dialogue. We ask that you help us, and other shareholders, to understand the investments you are making to deliver the sustainable, long-term returns on which our clients depend and in which we seek to support you.

Yours sincerely,
Laurence D. Fink
Chairman and Chief Executive Officer, BlackRock

Source: *The Wall Street Journal*. Available at: <http://online.wsj.com/public/resources/documents/blackrockletter.pdf>.