

# Shareholder Activism: Background and Policy Lessons

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A recent article in Barron's highlighted the outsized returns generated by "activist investors" in 2009. The "shareholder activist" is an investor or investment manager who buys shares in a corporation with the intent of directly influencing management. While the "causes" pursued by activists differ widely, the dominant form of activism in 2009 related to corporate governance – existential questions about how to run a business. According to the research firm 13D Monitor – 13D is the SEC filing that must be made when an investor's ownership interest exceeds a 5% threshold – corporate governance activism yielded outsized returns. The share prices of large firms with these "shareholder activists" increased by 84.3% in 2009 relative to 16.1% overall increase for the S&P 500.

## How Do Activist Investors Generate Such Large Returns?

For decades academics have chronicled the "agency cost" imposed by the separation of a business' ownership and control. Contrast the diffuse ownership of the corporation with a sole proprietor's local pizzeria. Unlike the manager of the corporation, the owner-manager of pizza parlor owns all of the resources that he controls and bears the cost of every decision he makes. If he increases his leisure time, he pays for it through lost sales or wages paid to someone making pizzas in his stead. Each indulgence to make the workplace more appealing is financed directly out of his own pocket.

However, if after a period of years he sells 50% of the pizzeria to a local investor, his trade-offs change. Now, closing the pizzeria an hour earlier at night or buying an expensive new wood-burning oven costs

only half as much as it once did in terms of foregone personal wealth. As the proprietor's ownership stake in the firm declines, the moral hazard grows because he still internalizes 100% of the benefits of the leisure or new investment but pays a shrinking fraction of its cost.

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Corporate executives own very little of the firms they manage. This leads them to make decisions that may not necessarily be in the best interests of shareholders. Specifically, managers tend to award themselves perks like fancy offices, corporate aircraft, and higher wages. In addition to indulging in luxuries, managers often pursue corporate strategies that fail to maximize the value of the firm. Instead of increasing dividends, managers often approve investments that expand operations into non-core areas, or pursue mergers with limited synergies to increase the firm's economic clout and the manager's profile. Sometimes managers' pursuit of their own agenda is as simple as locating the company headquarters in an attractive place to live even if the expense of doing so (cost per square foot of rent, employee compensation to account for cost of living) cannot be justified by any corresponding increase in sales or productivity.

The key to arresting agency costs is greater involvement from active investors (other than mutual funds) who acquire large blocks of a firm's shares. Large shareholders do a better job of monitoring



corporate managers, as their presence significantly reduces a firm's investments, reduces corporate cash holdings, increases payouts to shareholders, reduces total top executive pay, and increases productivity. When one adds up all of these effects, the result is the type of share price performance chronicled by 13D Monitor.

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### **Policymakers Attempt to Address Wrong Problem**

Unfortunately, instead of treating agency costs for what they are – imperfectly aligned incentives – policymakers have tended to view corporate governance in the context of ethics and morality. The result has been more laws and regulation to guard against collusion and self-dealing, with special emphasis on the “independence” of appointments to corporate boards. The problem is that independent directors often lack the knowledge of the business to effectively oversee managers, are generally unable to provide strategic guidance, and tend to be compensated in ways that provides little incentive to devote the time and effort necessary to seek out viewpoints and data that differ from those of the CEO. For these reasons, independence has not been linked to better corporate performance.

In many ways, independence is the worst recommendation to address agency costs. Rather than a question of integrity or outright fraud, the issue boils down to appropriate financial incentives. Those best positioned to monitor management and provide strategic input are also the least likely to pass the “independence” test because of their large financial exposure to the actions of management. A board

comprised of directors with more “skin in the game” is likely to yield better results than an independent board.

This is the strategy of activist investors who use their block of shares and influence among other investors to elect self-interested candidates to the board.

### **Lessons Going Forward**

Shareholder activism is the last vestige of once vibrant market for corporate control that has been all but eliminated by legislation. In 1968, Congress passed the Williams Act to regulate the sale and acquisition of controlling positions in corporations. This Act discouraged bids by requiring public disclosure of their terms, creating a “free rider” problem that has protected incumbent management. Current law also prohibits mutual funds from holding positions in corporations greater than 5% of the assets of the fund or more than 10% of the voting stock of the corporation. As a result, these diversified funds accessed by millions of households are spread so thin that they’re generally unable to exert much influence on the governance of any one of their holdings. Finally, the hostile takeovers of the 1980s were met with a series of “business combination” laws passed by states that effectively prohibited takeovers not explicitly sanctioned by the board of directors.

Since the business combination laws were passed in the late 1980s, CEO pay has increased from 56 times the average worker’s wage to 262 times. If the value of the average company were rising in tandem, there might not be a problem with such developments. But over the ten years ending February 19, the S&P 500 is down 17%; on an inflation-adjusted basis, the index is down by 36% for the decade.

Policymakers often suggest ways to get more



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Americans to invest in stocks – the Obama Administration’s savings initiatives are the latest example – but tend to overlook how existing law disadvantages the undifferentiated mass of small shareholders. Few households will ever own enough of a corporation to affect its governance, but they will have to endure the low returns associated with the stock of poorly governed companies. Before pushing more people into equity ownership, lawmakers should do more to remove existing barriers that protect the “rents” of entrenched management at the expense of shareholders.