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SHAREHOLDER ACTIVISM AND INSTITUTIONAL INVESTORS

BY

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Introduction

In response to perceived anger of shareholders resulting from the combination of company failures, high termination payouts to “unsuccessful” executives and executive and director remuneration out of touch with pay rates elsewhere, there has been considerable political interest in extending shareholder rights (Australian Financial review, 31/05/04, 5-6/06/04, report by the Parliamentary Joint Committee on Corporations and Financial Services 2004 and Sarbanes Oxley, 2003).

At the same time there have been reported shareholders interventions such as that of institutional investors in the case of Alinta Gas (The West Australian 2004) which have led other shareholder groups to question whether intervention has been in the interests of all shareholders.

The range of issues which have engaged shareholders fall into two separate categories: Governance and performance issues and broader social and environmental issues. The motives, the means, the outcomes sought and in most cases the actors in these two categories are quite distinct. We explore these two groups below; however the focus of this paper is on activism in relation to governance and performance issues.

Activism in relation to Governance and Performance

Issues in governance and performance taken up by shareholders and reported in the financial press (eg. Financial Times, Dec 27, 2003 p2) have included campaigns to install independent chairmen or independent directors, campaigns against individual company’s pay policies (executive and director remuneration, incentive policies and severance packages) and active support for, or opposition to, company amalgamations or takeovers. In Europe activism, driven largely by US and UK pension funds, has also focussed on voting rights (Evans 2004). High profile campaigns such as those focussed on AMP, National Australia Bank , do catch the eye of the press. However, they affect a tiny proportion of listed companies directly. In this paper we seek to build a more comprehensive picture of the nature of shareholder activism activities related to governance and performance.

Agency Theory and shareholder activism:

In the wake of Berle and Means (1932) classic identification of the tension for the modern corporation between the interests of the dispersed owners and those of the corporate management Jensen and Meckling (1976) proposed Agency Theory as explaining the development of governance structures and processes in the corporation. Jensen and Meckling (1976:308) propose that in this agency relationship

the owner (shareholder) engages the agent (management) "...to perform some service on their behalf which involves delegating some decision making authority..." Our interest here is with the monitoring activity undertaken to ensure the services performed by the manager are in the interests of the shareholders. Jensen and Meckling argue that monitoring will be undertaken to the point where the marginal cost of monitoring equates to the increment to wealth which results from reducing the adverse activities of the manager (eg in the form of increased managerial perquisites or risk averse decision making).

The mechanisms of corporate governance, focussed on the Board of Directors, provide one avenue for monitoring the services performed by corporate management. At this level monitoring is the responsibility of the company directors appointed to the board, ostensibly by the shareholders. Jensen and Meckling argue also that security analysts activities, by virtue of their development of comparative advantage in monitoring firm performance through specialisation, reduce the agency costs.

The current spate of questioning of corporate governance processes and structures has been accompanied by suggestions that shareholders should become more actively involved in the monitoring process. This suggestion in one form focuses on opportunities for, and participation by, shareholders at the Annual General Meeting (AGM). This is reflected in recent focus on the activities of institutional investors both as monitors via "relational investment" activity, and as active shareholders willing to use the AGM to question and influence Board activity.

The Annual General Meeting as Shareholder Forum

CLERP 9 reflects, in a number of provisions, the view that shareholders should be able to actively address issues of corporate performance at the AGM. In particular the legislation addresses issues relating to advice of meetings, meeting procedures and to the opportunity for shareholders to vote on the remuneration report. CLERP 9 further emphasises the role of the retail investor by including a proposal (36) to convene, at national level, a group representing shareholders' interests. It appears this is envisaged to act as a consultative body relating to the interests of retail investors.

Southwood (2003) suggests that institutional investors may facilitate the coordination of wider shareholder activity designed to protect and enhance long-term shareholder value. He argues that growing concentration of institutional shareholdings provides the specialised resources of fund managers for effective monitoring and performance

analysis. This aids the use of voice rather than exit by this specific group. He also suggests that institutions may facilitate the coordination of wider shareholder activity designed to protect and enhance long-term shareholder value.

In the USA the Labor Department now encourages pension funds to communicate with and monitor corporate management (Gillan and Starks 2003). Gillan and Starks suggest that since the corporate scandals of 2001/2 institutional investors have become more active in doing so. Certainly CalPERS is a byword for active pension fund monitoring and intervention, although its activity substantially predated 2001.

Structure of Share Ownership

When considering the question of shareholder activism it is important to build a picture of share ownership; activism requires resources and, except for the quixotic, requires that there be a return on the resources used. The action by two former directors of Walt Disney Co. in “travelling the country” for three months to meet with shareholders and investors (Lazaroff 2004) in an unsuccessful bid to oust the chairman and CEO provides some indication of the resources needed.

The ASX Share Ownership Study (2003) found that 5.7 million Australians owned shares directly; if indirect ownership through vehicles such as managed funds and self managed superannuation funds are included this rises to 7.4 million people. Nevertheless shares listed on the Australian Stock exchange constituted only 20% of the total value of the investments held by these retail investors; given the low relative importance of shares as a component of the wealth of most of these investors it is questionable whether active involvement in monitoring those shares is a reasonable expectation.

The 2003 Survey results show that 38% of retail investors directly held a share portfolio valued at \$10,000 or less while only 20% directly held a portfolio of \$100,000 or greater. In the year to June 2003 (ASX media Release 30/06/03) retail investors accounted for only 18% by value of transactions. Institutional investors accounted for 78% by value of shares traded in 2002/3; “traders/market makers” accounted for the remaining 4% by value.

Are retail shareholders in the position to actively monitor and influence governance practices and performance through the AGM? Do the activities of institutional investors at the AGM and in other forums support the interests of retail investor as Southwood (2003) suggests?

For retail investors the impediments to activism are substantial. First there are information costs and what Williamson (1979) terms information impactedness (i.e. information available is complex and difficult to interpret). Retail investors would find it difficult and prohibitively costly to access the comparative industry and market information required to make judgments on relative firm performance and difficult to access the information required to make judgments on the adequacy of governance structures and processes.

Second there are the costs of orchestrating an intervention which will even be heard at the AGM. Australian Corporations Law imposes a minimum shareholder number/voting capital test on resolutions brought forward to the AGM. Shareholders are required to meet the cost of convening an extraordinary meeting. In some other jurisdictions such as the USA legal barriers to communication between shareholders have been relaxed (Daily, Dalton and Cannella, 2003) but restrictions remain in force in respect of seeking proxy voting authority.

The potential return to activism by the representative retail shareholder is likely to be very small indeed given the value of the shares held will, for over 80% of shareholders, be less than \$100,000 across all holdings. Indeed it is surprising to find that attendance at AGM's in Australia is reported to be around 40% while in the USA it can reach 70/80 % in some companies (Gillan and Starks, 2003). The annual pilgrimage implied by these figures is at odds with the usual characterisation of the AGM as a public relations platform for the corporation. Perhaps it is the tea and sandwiches which follow.

Examples of successful activism by retail shareholders are extremely rare despite the potential for individual disgruntled shareholders to grab the limelight and media attention briefly in their questioning of the Chairman at the AGM (McCabe and Nowak 1997). For the retail investor 'rational' apathy is a sensible course of action (Davies and Stapledon 1993). Exit from the corporation, via sale of the shares, remains the most effective option open to the retail investor.

Southwood (2003) and Gillan and Starks (2003), however, are among those who argue that activism of institutional investors may be an effective substitute for activism by the retail shareholder. Gillan and Starks (p17) conclude that institutional investors presence should lead to more informative prices, increased liquidity and lower monitoring costs for all investors.

Southwood (2003: 226) defines what he terms “shareholder engagement” as involving “any attempt to pursue shareholder objectives by “voice” without a change of control in the company”. This includes discussions with management, shareholder resolutions and the use of publicity.

Institutional Investor Activism

Davies and Stapledon (1993) consider the action of institutional investors as a form of internal monitoring. They note that by internal monitoring “is meant the exercise, or threat of the exercise, by shareholders of their powers under the corporate constitution to remove incumbent management with whom they are dissatisfied, or at the least change to secure a change in the direction of the company’s business policy.” (Davies and Stapledon 2003:64).

Davies and Stapledon note that institutional investor action can take two forms, general intervention seeking the adoption of policy which applies to all companies or a subset of them (eg audit independence, issues of non-voting shares etc) and particular intervention confined to the individual company.

Collective Activism –governance principles

The cost of general intervention can be spread through collective action. Davies and Stapledon (2003) cite examples of collective action in the United Kingdom under the aegis of the Institutional Shareholder’s Committee and the Institutional Fund Managers’ Association. Besides spreading the cost such action is frequently able to achieve implementation through established regulatory structures such as Stock Exchange Listing Requirements. The Australian examples of this collective action have been particularly strong. The Australian Investment Managers’ Association (AIMA) developed the influential Corporate Governance: A Guide for Investment Managers and Corporations (1995 and 1997) (known as the Blue Book). Its successor organisation, Investment and Financial Services Association (IFSA) has continued to exert strong professional pressure in relation to governance standards and listing requirements.

In introducing the guidelines AIMA put the position that the interest of major institutional shareholders is compatible with the interests of other shareholders (p13).The guidelines provide a blueprint for institutional investment activity.

They include the proposition that investment managers “should vote on all material issues at all Australian company meetings where they have the voting authority and responsibility”p9).

The guidelines also make a strong push for direct communication between institutional investors and both senior management and the board on issues of corporate performance and governance matters. The guidelines call for direct dialogue at a senior level of both the company and the institutional investor. Questions or concerns on governance issues and performance should be “answered or addressed in a business like manner” (p16). The guidelines suggest that a commitment to continuing communication might include “expert discourse, agreements or understandings about the process governing the dialogue and commitment to play a constructive role” (p16).

Theory tells us that one of the major impediments to collective activism for institutional investors remains the free rider problem; potential costs may not be spread across all beneficiaries in proportion to the benefits because there is no mechanism to ensure collective contribution to these costs. To develop a coalition of institutions the costs could be significant. Institutional investors are expected to weigh the cost of an intervention strategy against the potential (but uncertain) benefits they expect. In the case of action on matters of governance principle these benefits may appear to be very intangible.

In addition, the exercise of voice by institutions faces some of the barriers that confront the retail investor in relation to access to information, complexity of information, costs in mobilising support (eg in a proxy fight) and legal issues in some jurisdictions. These latter include regulations on insider trading, requirements for all shareholders to receive equal access to information, and obstacles to collective action including competition policy.

Activism at the level of the Corporation

Particular intervention is more likely to be approached in a competitive vein and requires a greater commitment in terms of costs on the part of the institutional investor. This latter form of action could include entering dialogue directly with management and or the board, preparing proposals, voting proposals or, as a last resort, calling an extraordinary shareholders’ meeting. Davies and Stapledon (1993:75), quoting Black and Coffee, suggest research in the United Kingdom found the overall pattern of direct institutional shareholder intervention can be characterised as “frequent dialogue, occasional informal intervention when a firm is in trouble and very infrequent formal intervention”.

Southwood (2003) proposes that influence is better achieved through consensual relationships, which manage issues to avoid escalation into conflict. This necessarily involves close relations and a commitment to the long term (“relational investing”).

ACTIVISM OF INSTITUTIONAL SHAREHOLDERS: AUSTRALIAN EXPERIENCE

Much of what is known about institutional investor activism is sourced from the financial press when high profile action has been taken. Davies and Stapledon (1993) noted that there has been little direct research in this area. This paper is able to report on Australian data .

The study reported here was undertaken with funds managers from a selection of Australian institutional investors. The study was a qualitative study. Data were collected in a series of semi-structured interviews with 17 senior Funds Managers from a range of institutions in the Australian Funds Management industry. The interviews, conducted in 1998/9. The data for this study were collected within in a study which explored directors’ perceptions of best practice corporate governance.

Monitoring of Investments

Funds managers brought their investment analysts centre stage in the monitoring process.

// It is the responsibility of our analysts to have an ongoing view about how the company is performing in terms of corporate governance...// We have analysts who have experience in the market so it (monitoring) is a process which is through directors and a chain of directorships...and through the experience of individual analysts...we keep tabs...//

The bulk of funds managers were clear that there is direct and regular informal contact with the companies in this process.

//We visit companies...we visit them regularly.// Informal discussions between the analyst and the company...// ...our analyst would be speaking to a range of people...// We really do watch our companies and we go and see the management...// Sometimes the communication can just be by way of a phone call...//...meeting with the board and knowing the board members.//

Within this communication process there were clear processes to formalise and escalate contact where there were concerns felt.

//We prefer to communicate dissatisfaction with the company rather than fight them.// ...well we would move it to a more formal footing if things were continuing...//

//...head of our Australian Equities team may also become involved...follow that up with a letter to both the chairman and independent directors...// If there is sufficient justification we will go straight to the chairman of the board, if we can't get any further through the MD... correspondence exchanges where we set down what we think should be an approach to be taken//

From the interviews a dichotomy appeared to exist between those funds management organisations which sought to influence companies in which they invested and those who did not. The former also reported that this influence was exercised and could yield results. On the other hand those who did not seek to do so considered that this was a costly option which was a distraction from their role as investment managers. They opted, instead for what in the industry is termed the Wall

Street Walk, viz. quitting their shares if they had concerns about the direction of the firm. The dichotomy tended to be related to the volume of funds under management but this was only one factor; another factor was related to individual strategy. Some smaller funds managers would seek influence where their stake in smaller companies was relatively high.

// ...they are big parts of our portfolio...it is those companies which you need to form that association with the board// "X" is an example of where we were reasonably active in supporting the removal of some directors...we will get involved where we see we can tangibly add value.// ...its very difficult for us on our own to exert much influence....where we are talking of 50-150 ml. cap. we would think that we have a greater influence.//

For some, however, any involvement was a distraction

//...we know about financial markets more than we do about running businesses.// ...my primary focus is to beat the index and not change a company's way of doing things. I mean that is not my role.//It is not the role of an institution...//

Other funds managers, however, were clearly expressing a much more involved position, amounting to a relationship with the invested companies.

//And that is what is so important about forming that relationship. Right up front with companies when you invest in them so everyone understands one another.//...you develop a relationship with the management of the company and we are not trying to tell them how to run the business but...we are challenging them on their strategy...we are constantly feeding into the management of the company...// ...talking to the right seniority level...you need to have a dialogue at that level.//Using your relationship and trying tactically to move what is best...//...institutional investors can exercise some constraint over unacceptable practices.// ...institutional investors are asked for their opinions...// you want a good relationship with them so you are getting a good information flow in terms of helping you build your model and value the company...//

Public Activism: Voting the Shares/Using the Media

While a minority of the funds managers interviewed indicated that their organisation had a policy of voting on all issues at the AGM others indicated that they either voted issues that affected them or were even more haphazard than that with voting

dependent on other issues such as proximity. This response is interesting in the light of moves, especially in the USA to require institutional investors to vote their shares.

//Our policy is that we vote on all issues, all companies, all issues...any sort of resolutions... we actually have a policy in house here whereby ...we must as a discipline address those issues.// We are happy to vote...when we think we have a view which is meaningful and can have some influence...// We only vote when our shareholder value is affected...// ...typically you vote on Australian ones because you are kind of here but the idea that you are going to know enough...in a lot of places in the world...//...so I'd rather see it done on an optional basis.//

While a handful of contemporary high profile examples of governance and boardroom fights which had involved a number of institutional investors were discussed in the interviews, the fund managers were generally averse to joining battles which spilled over into the media.

//A lot of these things get fixed prior to going to public meetings and doing what the Australian Shareholders Association does, which is basically berate directors publicly.// We prefer to communicate dissatisfaction with the company rather than fight them.//

It was noted however that in one high profile case, Coles Myer, that

// ...we got a lot of press... and fund managing companies ...and a few others got together and expressed extreme dissatisfaction about management and it turned out some changes were made.//

Collective activism

The above example relating to collective action relating to an individual company was an exception. The industry is competitive and each firm normally keeps its own counsel. However, activism at the collective level on issues of principle is well supported in the industry. Many of those interviewed referred to collective action on issues of principle through the auspices of AIMA and to membership by their own organisation of IFSA. The comments of one fund manager on the establishment of AIMA following the collapses of Quintex and Bond Corporation are indicative of the motivation for collective action by the industry. This motivation relates to issues of principle on governance but can be triggered by particular corporate collapses or a series of such collapses.

//...we have been fighting these battles individually, perhaps it would be more effective if we formed a group to debate these ideas...it was the start of institution

being a bit more consistent in what we thought about these sort of governance issues...//

Most of those interviewed referred to AIMA and IFSA when general issues of governance were discussed. They subscribe to a continuing role to this form of collective action on matters of governance principle.

//...AIMA and now IFSA have had their impact really in helping the institutions...and also to display to boards that institutional investors are important.//We have an opportunity to participate in the debate...to discuss with other institutions...But they are probably the bigger hotter issues.// It means that IFSA then has an ongoing role to play and they will usually involve themselves ... to express a view and be listened to// to the extent that they form a block and use it appropriately like AIMA/IFSA.//

Cost of Activism and the Wall Street Walk

Funds managers saw the decision to take an activist role, even at the collective level in terms of cost/benefit analysis. One manager commented in relation to the recent decision by his organisation to join IFSA

//But at the end of the day, forty five thousand dollars is a lot of money. So it is just a cost that we are going to have to assess in the future.//

All funds managers interviewed noted that the option to sell shares (the Wall Street Walk) rather than engage with the company was an option which is regularly adopted, while some saw that as their best option in almost all cases.

//Exit the shares...I mean in terms of the way we operate that is precisely what would happen.// We choose to sell, right.// We sell our shares, exit the register.// Wall Street Walk ...is always an option...as an active fund manager we may decide it is all too hard.// The first port of call is to buy and sell, when they are not an option then others are looked at.// ...if we don't feel we can support the management we don't try to fight them we will just sell the shares and go.// We take a fairly low cost approach where we look after clients interests by selling out if we don't like the corporate practices.//...time is always short in business...you just sell the stock.//

Respondents approached the decision to sell explicitly in terms of costs including time cost and as “the way we do things around here”. However often implicit was a cost/ benefit calculation which was made explicit for some.

We've got to do a cost/benefit analysis...we might just say lets not worry about it, lets just sell.// ...for the larger institutions that can't get in and out of their shares quite so easily...its incumbent on them to be more active in defending their investment.//

Discussion

Kahn and Winton (1998) model the alternative strategies open to institutional investors using the dichotomy, to trade or to intervene. The optimal decision, they

argue depends on the nature of the industry and product of the target firm, the potential for speculative gains, costs of information and of intervention, the size of the shareholding and the reservation prices of retail shareholders. Our analysis confirms that the trade or intervene dichotomy is a reasonable description of the broad decision context for a group of these firms. Where this is the case, fund managers' discussion of the optimal decision does refer to costs such as information and intervention costs, the size of the shareholding and the potential financial benefits.

However, it was apparent that some institutional investors have a stronger commitment to what we have termed Relational Investment, quite close to what Pozen (1993) terms “block expansionists”. The strategy followed by this group of funds managers includes the exertion of real influence on the composition of the board, and oversight of/comment upon corporate strategy; would align with the German/ Japanese model of investor dominance. The behaviour of these institutions and their impact on retail investors is expected to be consistent with the dominant shareholder of agency theory or “blockholdings” (Becht and Roell ,1999). Their interests will not always be consistent with those of the remaining, and specifically, the retail or minority shareholders. The Alinta example (West Australian 2004) is a case in point.

It appears that there is a second group at the other extreme, who view intervention as not consistent with their expertise and not part of their role. It is this group, along with those who pursue the optimal strategy in the Kahn and Winton sense, who could provide the “ more informative prices, increased liquidity and lower monitoring costs for all investors” envisaged by Gillan and Starks (2003:17).

In terms of corporate governance principles, however the collective activity of the institutional investors working through industry ginger groups such as the Investment and Financial Services Association that already have the runs on the board .

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3/9/2004

As Pozen (1993 :147) notes, “Since ...institutions are organised and paid as passive portfolio managers, they could not possibly become active in a large number of companies.”

They conclude that institutional investors presence should lead to more informative prices, increased liquidity and lower monitoring costs for all investors. (*p17)
Southwood provides a typology of shareholder engagement approaches p229.

Social and Environmental....

This paper looks at the theory underpinning the shareholder role within the system of corporate governance and the opportunities and pitfalls that shareholder activism entail.

Outcomes of institutional intervention are not consistent(Daily, Dalton and Cannella 2003

Institutional investors ; (article by Robert Pozen)

Charles Wohlstetter, former CEO of Contel said of institutional investors “people who have no proven skills in management, no experience in selecting directors, no believable judgment in how much should be spent for research or marketing – in fact, no experience except that which they accumulated controlling other peoples’ money.” (p140 HBR Jan/Feb 1994, Pozen,r.c..

Kahn and Winton (1998) model the alternative strategies open to institutional investors . Decisions involve to trade or to intervene. The decision depends on the nature of the industry and product of the target firm and the potential for speculative gains, small shareholder reservation prices , costs of information and of intervention and size of shareholding.

Who pays the cost of Institutional activism? Costs to clients

.

Group activity by institutional investors (see Pozen 1993)

Pozen sees 2 groups who advocate expansion of institutional activism, social activists who advocate these investors take an active role in addressing social problems and “block Expansionists who look to the German/ Japanese model of financial investor dominance / view board representation - This is the dominant shareholder of agency theory.. This latter may be inconsistent with the risk profile they are seeking and the liquidity objectives that flow from their clients needs.

NB the takeover as the alt for poor performer/ ensure minimum takeover protection – poison pill etc.

Institutional investors who have business relations with the corporation have a conflict of interest in taking monitoring action and are at the least less likely to do so openly.

Gillan and Starks (2003 p12) conclude “there is little evidence of improvement in long-term stock market performance or operating performance resulting from the activism.” (in the USA). Studies have found some change in real activities but have not established a causal link to shareholder activism.

Stakeholder theory:

Stakeholder theory would imply that the agency problem is not the specific preserve of the shareholders. From this perspective it is reasonable that the range of stakeholders seek to influence company performance .

Resource Dependent theory (see Daily, Dalton and Cannella 2003)

CSR ; “ The power and influence of (primary stakeholders) is increasingly being targeted by environmental and social activists and many shareholders themselves are turning into active lobbyists” to influence corporate behaviour on particular environmental or social issues (O’Rourke,A. 2003 p228).

History: O’Rourke (2003) notes along history of activism on social/environment issues in the US including a proposal to have Dow Chemicals stop producing napalm in 1970 and Nader’s campaign on product safety at General Motors in the 1970’s.

(note the North Ltd and Jabiluka mine and the North Ethical Shareholders group, 2002) see O’Rourke for further examples and successes – special interest groups etc. usually coalition of specialised ngo’s plus shareholders on issues which “catch

the imagination', CAN OFTEN BE DRESSED UP AS ALSO POSING LONG TERM RISK TO THE ORGANISATION.

Equal access to information – many issues between this and equal information. (eg research capability to interpret, gather additional info ...)

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Those involved have included institutional investors, activist individual investors and shareholder groups such as the UK Association of Pension Funds, the ABI and the Australian Shareholders' Association.

Southwood (2003: 226) defines what he terms "shareholder engagement" as involving "any attempt to pursue shareholder objectives by "voice" without a change of control in the company". This includes discussions with management, shareholder resolutions and the use of publicity.

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