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Shareholder Activism and Institutional Investors

BY

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Abstract

The paper builds a picture of the motivation for, and impediments to, individual and institutional shareholder activism. We consider shareholder activism within agency theory and discuss the limitations of the annual general meeting (AGM) as a site for activism. We note that retail share ownership holdings are characteristically small. Institutional investor activism as a substitute for retail shareholder activism, to achieve informative prices, increased liquidity and lower monitoring costs, is discussed. We report Australian data on the practices of funds managers. We discuss a perceived dichotomy among institutional investors between those who are 'relational investors' and those who opt for a 'hold' or 'exit' strategy.

Introduction

In response to the 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 in Australia (Australian Financial Review, 2004 a, a b, Australian Parliamentary Joint Committee on Corporations and Financial Services 2004) and internationally (e.g. Sarbanes Oxley in the USA). At the same time, there have been reports of intervention by institutional shareholders. Examples include institutional investors in the case of Alinta Gas (Weir, 2004), and the National Australia Bank (Australian Financial Review, 2005a.). However, questions were asked of whether the institutional intervention in the Alinta case had been in the interests of all shareholders.

The issues which have engaged shareholders fall into two 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. The focus of this paper is on institutional investor activism in relation to governance and performance issues.

Issues in governance and performance, taken up by shareholders, and reported in the financial press, (e.g. Financial Times 2003, Australian Financial Review2004, a, b, 2005 a.) have included: campaigns to install independent chairmen or independent directors; objections to individual company's pay policies (executive and director remuneration, incentive policies and severance packages); objections to takeover defences (poison pills); and active support for, or opposition to, company amalgamations/takeovers. In Europe, activism driven largely by US and UK pension funds, has also focused on voting rights (Evans 2004). High profile campaigns focused on individual firms 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 motivation for, and impediments to, individual and institutional shareholder activism related to governance and performance.

In this article we discuss agency theory as the grounds for shareholder activism and consider the limitations of the AGM as a site for such activism. We then consider whether the structure of share ownership is conducive to activism by retail shareholders. Following that, institutional investor activism is discussed as a special case. We report Australian data, collected using semi-structured interviews, to throw light on the practices of funds managers. We conclude with a discussion of the practices of institutional investors and the theoretical considerations and practical issues the findings raise.

Agency Theory and shareholder activism:

In the wake of Berle and Means' (1932) classic identification of the tension between the interests of the dispersed owners and those of the corporate management, Jensen and Meckling (1976) proposed Agency Theory to explain the development of governance structures and processes in the corporation. In this agency relationship (Jensen and Meckling 1976 p.308) the owner (shareholder) engages the agent (management) "…to perform some service on their behalf which involves delegating some decision making authority…" Our interest 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 manager's adverse activities (e.g. increased managerial perquisites or risk-averse decisions).

The mechanisms of corporate governance focused 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. The AGM provides a site for shareholder oversight of their directors.

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 focuses on opportunities for, and participation by, shareholders at the AGM. This is reflected in recent focus on active shareholders willing to use the AGM to question board activity and actively use their vote on board-sponsored resolutions (Australian Financial Review 2005 a, c).

The Annual General Meeting as shareholder forum

The Commonwealth of Australia Corporate Law Economic Reform Program (CLERP 9), enacted in 2004, 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 provides the opportunity for shareholders to vote on the remuneration report although the vote is non-binding. CLERP 9 further emphasises the role of the retail investor by including a proposal (section 36) to convene, at national level, a group representing shareholders. It appears this is envisaged to act as a consultative body relating to the interests of retail investors.

Jensen and Meckling (1976) argue that security analysts, because they can develop comparative advantage in monitoring firm performance through specialisation, may reduce agency costs through their activities in the market. Southwood (2003) also argues that growing concentration of institutional shareholdings provides the specialised resources of fund managers for effective monitoring and performance analysis. This may result in the use of ‘voice’ for influence rather than ‘exit’ (through sale) by this specific group. He proposes, however, that institutional investors may facilitate coordination of wider shareholder activity to protect and enhance long-term shareholder value. Admati, Pfleiderer and Zechner (1994) point out, however, that there may be additional Agency problems between managers of institutional investors and their own shareholders/investors.

In the USA the Labour 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. 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’ 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 Australian Stock Exchange Share Ownership Study (2003 a) found that 5.7 million Australians owned shares directly; this rises to 7.4 million people if indirect ownership is included. Nevertheless, shares listed on the Australian Stock Exchange constituted only twenty per cent of the total value of all investments held by these retail investors. The study shows that thirty-eight per cent of retail investors held a share portfolio valued at $10,000 or less, while only twenty per cent held a portfolio of $100,000 or greater. In the year to June 2003 (Australian Stock Exchange 2003 b), retail investors accounted for only eighteen per cent by value of transactions while institutional investors accounted for seventy-eight per cent.

In the light of these figures we must ask whether retail shareholders are in a position to actively monitor and influence governance practices and performance through the AGM. A related question concerns whether the activities of institutional investors at the AGM and in other forums support the interests of the 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 for them to make judgments on relative firm performance. It will also be difficult for them to access the information required to make judgments on the adequacy of governance structures and processes.

Second, there are costs to orchestrating an intervention which will be heard at the AGM. Australian Corporations Law (Commonwealth of Australia, 2004) 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 jurisdictions such as the USA, legal barriers in place to restrict communication between shareholders have been relaxed (Daily, Dalton and Cannella, 2003) but restrictions remain in force in respect of seeking proxy voting authority.

At the same time, the potential return to activism by the representative retail shareholder is likely to be very small. Indeed, it is surprising to find that attendance at AGMs in Australia has risen from around forty percent to fifty percent (Australian Financial Review 2005 a) while in the USA it can reach seventy to eighty per cent 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 the attraction is the tea and sandwiches which follow the meeting.

Examples of successful activism by retail shareholders are extremely rare despite the potential for disgruntled individual shareholders to grab the limelight and media attention briefly (McCabe and Nowak 1997). Despite a recent upsurge in protest votes at the AGM on remuneration practices (Australian

Financial Review 2005, c. and d.), for retail investors ‘rational apathy’ is a sensible course of action in relation to the AGM (Davies and Stapledon 1993). Exit from the corporation, via sale of the shares, remains the most effective option open to the unhappy retail investor.

Institutional Investor Activism

Southwood (2003) and Gillan and Starks (2003) are among those who argue that activism by institutional investors may be an effective substitute for activism by the retail shareholder and should lead to more informative prices, increased liquidity and lower monitoring costs for all investors. Romano (2001, p.174), however, has reviewed the empirical literature on the impact of activism and concludes to the contrary that “such activism has little or no effect on targeted firm’s performance”.

Southwood (2003, p.226) defined what he termed ‘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. We have used this definition to guide our discussion of institutional investor activism.

Davies and Stapledon (1993) characterise the action of institutional investors as a form of internal monitoring. They define internal monitoring as “ 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 to secure a change in the direction of the company's business policy" (p.6). This provides a coercive rather than relational viewpoint.

Institutional investor action can take two forms: general intervention seeking the adoption of policy which applies to all companies or a subset of them (e.g. audit independence, issues of non-voting shares etc.): particular intervention confined to the individual company.

General Intervention and Collective Activism

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 Shareholders' 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 - Blue Book). Its successor, The Investment and Financial Services Association (IFSA) has continued to exert professional pressure in relation to governance standards and listing requirements. In parallel with this action by funds managers, non-profit and public sector superannuation funds have established the Australian Council of

Superannuation Investors (ACSI), which is now lobbying IFSA for further action (Australian Financial Review, 2005a.).

In introducing its Blue Book, AIMA argued that the interest of major institutional shareholders is compatible with the interests of other shareholders (p.13). They provide a blueprint for institutional investment activity, including the proposition that investment managers “should vote on all material issues at all Australian company meetings where they have the voting authority and responsibility” (p.9). The Blue Book also advocates direct communication between institutional investors, senior management, and boards on issues of corporate performance and governance matters. The guidelines call for direct dialogue at the 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” (p.16). 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” (p.16).

Theory tells us that one of the major impediments to collective activism for institutional investors remains the free-rider problem; the cost of developing an effective coalition may not be spread across all beneficiaries in proportion to the benefits because there is no mechanism to ensure contribution to these costs. Institutional investors will weigh the cost of collective activity 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. The record, nevertheless, provides considerable evidence of collective activity focused on governance principles.

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 p.75), quoting Black and Coffee, suggest research in the United Kingdom found that 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 that manage issues to avoid escalation into conflict. This involves close relations and a commitment to the long term ('relational investing').

The exercise of 'voice' by institutions faces some of the barriers that confront the retail investor: access to information, complexity of information, costs in mobilising support (e.g. in a proxy fight) and legal issues in some jurisdictions. These last include regulations on insider trading, requirement for all shareholders to receive equal access to information, and obstacles to collective action, including competition policy.

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 primary data from an Australian study.

The Practise of Activism by Institutional Investors: Some Australian Evidence

Data collection and analysis

The study reports the perceptions of funds managers from a selection of Australian institutional investors. The research was undertaken in 1999 within a study which explored directors' perceptions of best practice corporate governance. The research adopted a qualitative research design; underlying this design was the use of fieldwork interviews by the researchers. The research is descriptive and inductive (Merriam 1988 pp.19-20).

The data reported in this article were collected through a series of semi-structured interviews with 17 senior funds managers from institutions in the Australian funds management industry. Content analysis procedures consistent with the grounded research approach (Strauss and Corbin 1990, Whiteley 2000) were used to identify themes and concepts. The analytical process is an iterative process providing for repetitive interrogation of the data and the emergence of meaning. The NUD.IST™ software package (Richards 1996) was used to manage the data.

Findings:

Collective activism and Governance Principles

Activism at the collective level on issues of principle is well supported in the funds management industry. Many of those interviewed referred to collective action relating to issues of principle through the auspices of AIMA and 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 institutions 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 for 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.//

Monitoring at the level of the Corporation

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

//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.//

The investment analyst plays a critical role in the information gathering involved in monitoring individual corporate performance.

// 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…//

Within this communication process, however, there were clear processes to formalise and escalate contact where concerns were 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//

Decision to Influence ('Voice') or to 'Exit'

From the interviews a dichotomy appeared to exist between funds management organisations which sought, at least as a first approach, to influence the companies in which they had 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 exert influence 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; namely quitting their shares in a firm where they had concerns about its performance/direction. The dichotomy to influence/not to influence was in some cases related to the volume of funds under management. 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 funds management organisations, however, the decision was related to overall portfolio management strategy and any involvement with corporations was seen as 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 or 'influencing' 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.//…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 either they voted on issues that affected them or they 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.//

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, but these were the exception. The industry is competitive and each firm normally keeps its own counsel. Fund managers were also 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;

// …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.//

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 exit or sell shares (the Wall Street Walk) rather than engage with the company was an option which is regularly adopted while, as noted above, 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’. Often implicit, however, was a cost/ benefit calculation which was made explicit for some.

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

Discussion

For the establishment of corporate governance principles, collective activity by the institutional investors, working through industry ginger groups such as the Investment and Financial Services Association, already has runs on the board. While the ‘free- rider’ problem remains real we found no indication that these funds managers resile from this activity.

Kahn and Winton (1998) model the alternative strategies open to institutional investors in relation to the individual corporation: to trade/to intervene. The optimal decision 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/intervene dichotomy is a reasonable description of the broad decision context for a group of these firms. In these cases, there is discussion of the optimal decision and in this they do refer to the size of the company, costs such as information and intervention costs, the size of the shareholding and the potential financial benefits. We would term these the ‘optimisers’, who make decisions on a case by case basis.

It was also apparent, however, 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 in such cases includes the exertion of real influence on the composition of the board and oversight of/comment upon corporate strategy. The effect of such behaviour and its impact on retail investors is expected to be consistent with the dominant shareholder of agency theory or ‘block holdings’ (Becht and Roell, 1999). Their interests will not always be consistent with those of the retail or minority shareholders. The Alinta example (Weir 2004) is a case in point.

There was a third strategy which some respondents identified. For this group the calculus is much simpler, involving only analysis leading to the decision whether to ‘hold’ or to ‘exit’. Their view of intervention is that it is 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 (1998) sense, who could provide the “ more informative prices, increased liquidity, and lower monitoring costs for all investors”, envisaged by Gillan and Starks (2003 p.17).

Our analysis suggests the need for further research with the aim of determining whether our categorisation is robust and the elements contributing to adoption of the alternative strategies.

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