Bocconi

STANDING ON THE SHOULDERS OF GIANTS: THE EFFECT OF PASSIVE INVESTORS ON ACTIVISM

Discussion

Università Bocconi
DEPARTMENT OF FINANCE

Hannes Wagner

December 2017

What the paper does

- Analyze the effect that passive investors have on shareholder activism
- Specifically, how activist campaigns and their tactics depend on the presence (and implied support) of passive investors (index funds)
- Data: 1) US index fund portfolio holdings, 2) US activist campaigns
- Identification strategy – use Russell 1,000/2,000 index cutoff to exogenously determine aggregate stake that passive investors hold in firm x
- Presence of passive investors
  - Unrelated to likelihood that firm is targeted by activists
  - Positive related to Likelihood that activist campaign features score relatively high on "aggressiveness" scale; relationship likely causal
- Conclusion: Passive investors appear to mitigate free-rider problems, help activists execute successful engagements

Findings and contribution

- Paper fits nicely into fast-growing literature on interaction between passive and active investors
- Economic magnitudes are impressive
- Identification strategy is credible
- Clear potential to make significant contribution
- I very much like the paper
- Consider including it in your PhD course syllabi

Issues worthwhile exploring more:

Are these effects permanent or transient?

Appel Gormley Keim 2016 JFE

"We find no evidence, however, that greater ownership by passive mutual funds is associated with more activism by non-passive institutions; instead, we find evidence of less activism by non-passive institutions, consistent with passive investors monitoring managers and reducing the need for activism by other investors [...] This magnitude is large given that a firm's likelihood of an activism event in a given year in our sample is, on average, only 1.6%."

Appel Gormley Keim 2017 (this paper)

"We find that the estimated effect of passive ownership on the likelihood of activism is statistically indistinguishable from zero. [...] These estimates differ slightly from those found in AGK who document a similarly small, but statistically significant [negative effect]."

Q: Will we find the paper's main effect if we re-visit the data in x years?

Table 9
Ownership by passive investors and hedge fund activism.
This table reports estimates of our instrumental variable estimation used to identify the effect of ownership by passive investors on the likelihood of hedge fund activism. Specifically, we estimate

$$Y_{it} = \alpha + \beta\, Passive\%_{it} + \sum_{n=1}^{N} \theta_n (Ln(Mktcap_{it}))^n + \gamma\, Ln(Float)_{it} + \delta_t + \varepsilon_{it},$$

where Y_{it} is an indicator equal to one if firm i experiences a hedge fund activism event in year t, as defined in Brav, Jiang, Partnoy, and Thomas (2008) and Brav, Jiang, and Kim (2010), scaled by its sample standard deviation, $Passive\%_{it}$ is the percentage of shares outstanding owned by passively managed mutual funds (as defined in Section 2.1 of the text) for stock i at the end of September in year t scaled by its sample standard deviation, $Mktcap_{it}$ is the CRSP market value of equity of stock i measured at May 31 in year t, $Float_{it}$ is the float-adjusted market value of equity (provided by Russell) at June 30 in year t, and δ_t are year fixed effects. We instrument *Passive%* in the above estimation using $R2000_{it}$, an indicator equal to one if firm i is part of the Russell 2000 index in year t. The data consist of firms in the two Russell indexes for which we obtain holdings data from Thomson Reuters Mutual Fund Holdings Database and which we match with data from the monthly CRSP file. The model is estimated over the 1998–2006 period using a bandwidth of 250 firms around the Russell 1000/2000 threshold, and polynomial order controls for *Ln(Mktcap)* of $N = 1$, 2, and 3. Standard errors, ε, are clustered at the firm level and reported in parentheses. The symbols * and ** indicate significance at the 10% and 5% levels, respectively.

Dependent variable =	Indicator for hedge fund activism event		
	(1)	(2)	(3)
Passive %	−0.131*	−0.130*	−0.162**
	(0.0721)	(0.0718)	(0.0805)
Bandwidth	250	250	250
Polynomial order, *N*	1	2	3
Float control	Yes	Yes	Yes
Year fixed effects	Yes	Yes	Yes
# of firms	1,654	1,654	1,654
Observations	4,415	4,415	4,415

Comment 2: Implication is that rising passive ownership contributes to increasingly hostile activist campaigns

—Seems possible but unlikely

"While there has been a long tradition of extensive shareholder engagement behind closed doors in the U.K, we have recently witnessed increasing willingness of U.K. institutional shareholders to seek a public forum for the right cause," he says, adding that the shift goes both ways: "If you look at the U.S., there is a trend away from a focus on proxy contests towards European-style settlements behind closed doors."

David Trenchard, formerly Knight Vinke

—What about markets where proxy fights are <u>not</u> the way to win?

- A paper I know well: Becht, Franks, Grant, Wagner (2017) RFS

What role do passive investors play outside the US? And – is the activist business model converging globally?

- Italy – most activist engagements in relative terms after US, but activism does not involve proxy fights
- Japan – most activist engagements in absolute terms after US, but US-style activism has mostly failed

Activist engagements relative to market size and takeovers

Region/Country	/Total number of activist engagements	/Activist engagements per 1,000 listed firms	/Unsolicited bids per 1,000 listed firms	/Activist engagements per year (avg)	/Unsolicited bids per year (avg)
Region					
Asia	214	3.2	0.5	19.5	2.8
Europe	381	3.4	2.1	34.6	20.5
North America	1,145	11.7	4.6	104.1	40.1
Countries with at least five activist engagements during sample period					
U.S.	1,125	19.6	5.8	102.3	31.4
Italy	42	13.3	1.6	3.8	0.5
Luxembourg	5	12.4	5.3	0.5	0.2
Netherlands	22	11.6	7.4	2	1.2
Germany	53	7.3	1.1	4.8	0.7
Switzerland	19	6.6	4.9	1.7	1.3
U.K.	165	6	4.1	15	9.9
Japan	184	4.9	0.7	16.7	2.5
Sweden	15	4.8	4	1.4	1.2

Comment 3 – Wolf Packs

- Much recent attention, including SEC in 2015, on wolf packs
  - activist engagements involving multiple funds for the same target firm
  - observable and hidden types
- We see higher success rates (outcomes, performance) for wolf pack activism.
- But causality is hard to establish
  - Do we see higher success rates for wolf pack engagements because hedge funds coordinate and hunt as a pack..?
  - …or do we see multiple funds in the same engagement but without coordination, rather like "if you go to a Grateful Dead concert, you're going to find a lot of Grateful Dead fans" (Phil Goldstein, Bulldog Investor, one of the targets of the SEC's 2015 inquiries)


THE WALL STREET JOURNAL.

MARKETS

SEC Probes Activist Funds Over Whether They Secretly Acted in Concert

Federal securities rules require shareholder activists to disclose joint campaigns

Comment 4 – What do we gain from IV?

Is it worth it?

Could you show direct, uninstrumented, estimation?

- Coefficients are the same? Different?
- IF SAME: I would be curious what effect of other shareholders is (active funds, hedge funds)
- IF DIFFERENT: Coefficient differences? Why? Is IV estimate potentially biased?
  - Please read Wei Jiang's 2017 RCF (polite) summary of IV estimates

Other comments

- Number of board seats sought – scale by board size?
- Table 7 – passive investors lead to higher probability of activist settling (which paper refers to as a sucess)
  - But no increase in «activist wins» and no decrease in «firm wins»
  - Why not? I am puzzled. Settlements may be okay but activists want to win

Conclusion

—Interesting question
—Excellent execution and tight paper
—Novel and interesting empirical findings
—I greatly enjoyed reading the paper