Study: Passive investors facilitate activists' ability to be aggressive

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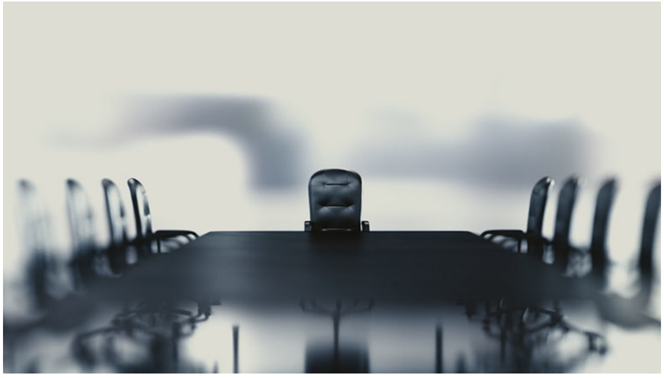

Change in board representation is a primary goal of activist investors who gravitate toward passive-ownership companies, found a team of researchers. Credit: Shutterstock

They follow one another in the stock market, often ominously perceived in the way dark clouds bring rain. Passive investors, such as investment-management companies, pension funds, nonprofit institutions and the like, provide a steady hand in ownership stakes of the larger corporations offering stocks. Then gather the activists—the change-makers, if not the rainmakers.

But there is a silver lining: The greater the passive investors' ownership, the more positive is the activists' effect on the corporations' big picture, according to the findings of three business-school researchers, including one from Washington University in St. Louis.

It is far from slash and burn. Todd Gormley, associate professor of finance at Olin Business School, and his co-authors found that the increasing numbers of passive investors is encouraging activism targeted at board makeup changes, proxy settlements and the sale of the business or its parts. The paper, "Standing on the Shoulders of Giants: The Effect of Passive Investors on Activism," was published online in late September ahead of print in an upcoming edition of The *Review of Financial Studies*.

"Most activists probably already knew the growing importance of passive investors," Gormley said. "This study probably will be more interesting to management—what role passive investors play when activists come along. If they didn't already know, when activists target their company, that's when they understand how important these passive institutions are."

Gormley and co-authors Ian Appel of Boston College and Donald Keim of the University of Pennsylvania, in previous studies, heard anecdotally from passive-investor institutions such as Vanguard, BlackRock and State Street how activists were adjusting their tactics in response to passive instititutions' increasingly large and important ownership stakes in most companies. Then the research team consulted the data.

The researchers analyzed 466 attempts, called campaigns, by activists to bring about change among more than 1,000 firms studied over a 2008-2014 window. A campaign could be as simple and minimal as filing a 13D report with the Securities and Exchange Commission indicating an intent to engage in activism, but not actually following up with any other actions, or as intense and expensive as seeking the sale of the company or initiating a proxy fight to replace directors on a firm's board.

The numbers broke down thusly: a 1 standard deviation—a 3 to 4 percentage point —increase in the share of ownership held by passive-investors was associated with a:

- 30 percent increase in campaigns to change board representation;
- 16 percent increase in the chance of a proxy fight settlement—that's twice as high

compared to a 7 percent average result of proxy fights under any conditions;

- 150 percent increase in the launch of a hostile proxy fight against incumbent directors on a board; and
- an 11 percent increase in the likelihood of selling the business to a third party, and a 6 percent increase in the likelihood of activists acquiring it themselves.

"Rather than talking about specific motives such as capital policy, the activists tend to keep their attention focused on the composition of the board when a larger proportion of a company's stock is held by passive investors," Gormley said. "The passive institutions have made it known publicly they aren't interested in supporting campaigns that seek goals they view as potentially harmful to long-term value, like ramping up payouts or leverage.

"Accordingly, activists don't focus on that as much, and instead focus their efforts on goals that are valued by passive investors, such as the quality and independence of board members and issues involving corporate control—for example, potential sales," he said.

In an age where there has been a 250 percent rise in passive ownership of equity funds since 1999, their research shows that activists have adjusted their tactics in response to this significant shift in the ownership structure of many firms.

The researchers put activists into four broad categories:

- campaigns seeking board representation (28 percent of the time in the study—and almost half that time they win);
- campaigns wanting policy changes to maximize shareholder value (20 percent);
- 13D filings with no explicitly stated or completed activist intent (14 percent); and
- all other campaign goals (38 percent, including 13 percent who sought to sell the business to themselves or a third party—and succeeding 2.4 percent of that time).
- Interestingly, some of those other campaign goals included modest hopes such as defeating a management proposal, adopting a shareholder proposal, removing an officer or enhancing governance structures in place. For every 1-standard-deviation increase in the percentage of passive ownership, these other campaign goals decreased by 28.8 percent.

So both the passive investors, and apparently the activists, agree: "If you have a good composition of the board, good governance follows," Gormley said.

More information: Ian R Appel et al. Standing on the Shoulders of Giants: The Effect of Passive Investors on Activism, *The Review of Financial Studies* (2018). DOI: 10.1093/rfs/hhy106

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