

THE NEED FOR SHAREHOLDER ACTIVISM VALUE ADDED AND LEGITIMACY

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Wilshire Associates, for many years a consultant to the Public Employees' Retirement System of the State of California ("CalPERS"), concluded that its principal's highly publicized activism was value adding. Michael Smith ends a study of CalPERS' targeted companies: "Overall, the evidence indicates that shareholder activism is largely successful in changing governance structure and, when successful, results in a statistically significant increase in shareholder wealth."^[i] Study of an annual list of underperforming companies compiled by the Council of Institutional Investors suggests that stocks of those companies have trounced stock-market averages in the year following their inclusion on the list. "The results of this study are broadly consistent with the view that coordinated institutional governance activism is effective."^[ii]

A recent study (which was the subject of a column in the *ECONOMIST*, August 16, 1996, p. 57.) has concluded otherwise: "The results of all these tests was negative. The authors conclude, flatly, that institutional action 'has no appreciable effect on firm performance. Even the most activist of institutions are apparently unable to achieve performance gains, in the aggregate.'"^[iii] These findings corroborate broadly those from an earlier study^[iv] by Sunil Wahal, assistant professor at Purdue University, which summarizes: "Collectively, these results cast doubt on the effectiveness of pension fund activism as a substitute for an active market for corporate control."

The existence of contrary research findings is the ultimate proof that corporate governance has come of age. It is important to understand what the studies tell us about institutional investor involvement. While shareholder activism appears to have many of the characteristics necessary for formal economic analysis, there is real question as to whether the available data supports broad conclusions. Put another way, both Daily and Wahal are driven to a statistically relevant definition of "activism". Daily considers whether performance was affected by (i) the proportion of stock held by institutions (on the assumption that institutions are superior monitors); (ii) the proportion held by public pension funds; (iii) the proportion held by "known activist" institutions; and (iv) the filing of shareholder proposals with particular companies. Wahal considers all firms targeted by nine major funds from 1987 to 1993. What these otherwise reasonable assumptions obscure is the intrinsic limitation on the kind and extent of "activism" that public pension funds can pursue. In fact, public pension funds have perilously slender political backing for effective initiatives and very little money to pay for them. That public pension funds are largely limited to form and not substance elicits Daily's characterization "that this activity may largely amount to "window dressing" "^[v] Reality eludes the formal studies. The involvement of public plans is essential, but their contribution is in creating a base on which others can take the necessary steps to add value. There are firms who do this; their investment performance is a matter of public record; the involvement of public plans is highly cost effective - if for no other reason than that they expend so little.

It is important to understand how activism has evolved as an acceptable activity for institutions. The confrontational involvement by shareholders in the governance of portfolio companies is a relatively recent development. Traditionally, investors followed the "Wall Street Rule" and sold holdings when they were disenchanted with management. During the hostile takeover period of the early 1980s critical fault lines in the conflicting interests between managers and owners were stretched to the point of being unignorable. The payment of a huge premium by Texaco to the Bass Brothers as "greenmail" for the repurchase of their stock (1983) had no business purpose whatsoever beyond entrenching management. Shareholders who disapproved had no remedy short of selling their holdings on the market at a price much reduced from that paid to the Bases; several shareholders resolved to do otherwise. This episode is credited with

stimulating the late Jesse Unruh, then Treasurer of the State of California, to found the Council of Institutional Investors. Activist shareholding has never been widespread. The basic economic problem of “collective action” is inhibiting. No potential actor is attracted by the proposition of acting all alone, exposing reputation and pocket book, only to gain the possibility of a return **pro rata** with other shareholders who risked nothing. Ultimately, this so-called “free rider” problem has seemed less serious to the largest investors who can console themselves that the aggregate returns are compensatory even though others get a “free ride”.

Most of the institutional shareholders have business relationships with portfolio companies that are commercially more significant than their trust responsibilities as shareholder. This has been accentuated due to the failure of the government (the Department of Labor, The SEC and the bank regulatory agencies) to enforce existing conflict of interest laws. Even privately owned firms like Fidelity with huge appetite and competency as owners are chary about being perceived as “activist” in a market place where much lucrative business is in the gift of top management of portfolio companies. Not only does Fidelity not want to be taken off of the short list of potential managers for a company’s pension fund but it does not want its analysts to have restriction on their access to management. Of the institutional investors, only public pension plans have the virtue of not being conflicted in interest. They have nothing that they want to sell to the market.

Ironically, of all the institutional investors, public pension plans are the least qualified to act as owners. The employees and executives of public pension systems are civil servants; typically, they have no private sector experience; they have chosen a non-commercial style of life and personal fulfillment. The former Controller of the State of New York and, under its Constitution, the sole trustee of its public employee pension plan, Ned Regan once said: “Nobody ever got elected to anything by beating the Dow Jones average, but one high profile losing investment could cost you your job.” There is no incentive for public pension officials to take chances. There is no opportunity for personal reward in the event of success; there is the certainty of criticism and the possibility of demotion in the event of failure. So public pension officials will preponderantly chose to “index” their equity portfolios. This means that they are permanent shareholders as the inexorable logic of indexing does not permit “cherry picking”^[vi]. It has been argued that the indexing mode of investment must be supplemented with “activism”. Put another way, the usual “prudent man” rule of investment is satisfied by the deliberation involved in choosing particular securities. When the choice is simply “the market”, the requirements of prudence are best met by a commitment and a competency to intervene with particular underperforming component holdings.”...[T]he trustees of a modern pension plan have a clear and specific duty to monitor all equity holdings, including an index fund. Given the lack of clear court direction as to the scope of this duty, by way of preventive law, trustees should be counseled to consider active investment strategies as an adjunct to indexing. That is, the heightened monitoring function inherent in active strategies should help trustees satisfy a duty to monitor the index when performance of the equity portfolio is measured as a whole.”^[vii]

Public fund equity holdings represent a little noted anomaly in American life. The country’s traditions are inveterate and unchanging in their opposition to government ownership of businesses that can be privately held. And yet, public pension funds, the agents of government, are now the holders of approximately ten percent of the entire outstanding capital stock of the country. When confronted directly with the problem of “back door socialism” in the Federal Employees’ Retirement Security Act of 1986 , the Congress prohibited any federal “person” from voting any of the shares in the pension scheme. State, county and city plans, thus, are an unfamiliar voice in American commerce - it is the voice of political concern in a business context. Trustees, who hold the legal power to act as owner of portfolio securities, are sometimes elected, more often appointed by the Governor or other executive, and sometimes elected by the membership. While their legal responsibility is purely economic, they are creatures of a political system. This may well account for the sensitivity of public plans to the notion of “activism”. In principle, there is broad agreement, but “the devil is in the details”.

The form that this “activism” takes is extruded and formed by the political process. The expenditure of public funds is the responsibility and prerogative of elected officials pursuant to a statutory and constitutional structure. The extent to which expenses of operating the pension system are considered as part of the “general funds” explicitly reserved for legislative disposition varies from state to state.^[viii] The tendency is marked, however, that elected officials jealously guard their prerogatives and will retain at least oversight over pension fund expenses. What state legislature is going to appropriate a blanket allotment of funds for “shareholder activism” by the pension system. This would be much criticized by the vigilant business lobbyists who would be quick to retaliate by threatening to move jobs out of state. One has only to ask the question - “Would the legislature trust the employees of the public plan to spend such sums wisely - or, at least, politically wisely?”^[ix] - to have it answered. No elected official is going to abdicate authority in an area which could threaten their careers. The pension system is, therefore, sharply limited in the funds that it has available for activism. This creates a kind of cognitive dissonance in considering the impact of high profile funds like the California Public Employees’ Retirement System when one juxtaposes the literally hundreds of billions of dollars under management (virtually 1% of the public markets) against the few thousands available for activism. Public systems in most instances have “soft dollars”^[x] available to fund desired programs, but legislatures are increasingly aware of this custom and will predictably accelerate efforts to bring these emoluments under government supervision.

Public funds in most instances must rely on low cost initiatives like informal talks with corporate management^[xi] or the introduction of “shareholder resolutions” which a company is legally obligated to put in its proxy statement. The exquisite gloss that has developed over half a century with respect to Section 14 (a) 8 of the Securities and Exchange Act of 1934 generally limits resolutions to symbolic value. Resolutions must be advisory only. Specifically, companies are never obligated to include in their proxy any nominees for the board of directors other than those proposed by management. So the mode of involvement by public plans is almost a form of “kabuki” in which resolutions are proposed simply because they will surely be accepted by the SEC and therefore do not involve large attorneys fees, but where their meaning is otherwise. Activists have developed particular codas - for example, opposition to “poison pills” or suggestions to engage independent investment bankers - which are interpreted by the market place as the equivalent of a vote of confidence in the management. While shareholder meaning is quite clear, companies can and have ignored such expressions by a majority of their owners.

Aside from consultation with company managements, the filing of stylized resolutions and the generous access to the business press which has an inexhaustible appetite for “man bites dog” stories, public plans have few palatable activist alternatives. Wahal summarizes: “ Pension fund activism takes a variety of forms. These include active involvement in the regulation of institutional investors [sic], litigation against firms deemed to engage in activities that are detrimental to shareholder interests, withholding voters or voting against management’s nominees for boards of director (also known as the “Just Vote No” campaign) and, finally, formally targeting firms. . . Pension funds generally engage in two types of targeting. I refer to the first as proxy proposal targeting since it involves the submission of a shareholder proposal to be voted on at the firm’s annual meeting. I refer to the second kind of targeting as non proxy targeting since it does not include the submission of a shareholder proposal. Non proxy targeting is also referred to as “performance based targeting” by pension funds. . . The targeting is typically resolved either by the firm discussing its performance with the pension fund or by simply ignoring the fund.”^[xii] Daily relies exclusively on shareholder proposals as a “proxy” for activism: “The most direct and publicly accessible means for corporate governance activists to attempt to alter corporate policy or management practices is by way of the shareholder proposal. . .”^[xiii] She tests the extent to which “Governance related shareholder proposals will be positively associated with firm performance”, and finding none, concludes the inefficacy of activism.

Shareholder activism is replete with irony and paradox. Institutions are today the controlling shareholder of America’s businesses. Most institutions are foreclosed from activism because of their unwillingness to resolve conflicts of interest. Public pension funds, the most

prominent institutions free of conflict, are little qualified and structurally limited in how they express activism. And yet the public plans have been Moses in showing the way to the promised land, others play Joshua's role.

Adam Smith's pin factory illuminated with an eloquence that has transcended the centuries the virtues of specialization in a capitalist world. The opportunities of "activism" have not been lost on entrepreneurs.[\[xiv\]](#) What has made the opportunities exciting is the change in polarization of institutions and companies. Rather than being ill disposed to express dissatisfaction with managements, all institutions now are willing to avail themselves of a "confidential ballot" to vote against objectionable policies and - by that token - to show loss of faith in management. Thus, the Kabuki dance is more effective than one would credit in the American market not usually noted for its appreciation for subtleties. Prominent money managers have been willing publicly to require change in portfolio companies. The role of Michael Price in the Chase merger with Chemical Bank in 1996 is a leading example. Greenway Partners and U.S.Shoe is another example. Those willing to risk the establishment's disapproval have been able consistently to earn superior returns through activism.

How do they do it? The only way in which activism can be successful is if the activist successfully convinces management that it is in their interest to deal with him. Managements dealing with public funds know that they are dealing with a "paper tiger" - albeit a large and articulate one. "If CalPERS didn't exist, the Business Roundtable would have to invent them."[\[xv\]](#) We must recognize that the perception that management is being held accountable (notwithstanding that the opposite is in fact the case) is useful. It is useful to management as it legitimates their conduct and their pay; it is useful to the public pension executives as it vindicates the commitment of their time and the prestige of their fund. Reality is something different. The moving shareholder must be able - politically, financially and legally - to solicit proxies for the election of a non management candidate for the board of directors. Managements can be induced to change only by the realistic assessment that ownership wants change and is capable of causing it.

Analyses of the cost effectiveness of pension fund activism need to take into account the difference between "kabuki" and reality. While the public plans have made activism legitimate, it is only more specialized groups using the backing of the public plans who are capable on a sustained basis of creating value. Successful activism needs empowered leadership. In the cases where leaders are present, value has been achieved.[\[xvi\]](#)

Activism needs context. Shareholders can not - and should not even in the most euphoric flights think they can - manage portfolio companies. They have a proper role. There is an ownership agenda - perhaps best articulated by the legendary Benjamin Graham sixty years ago[\[xvii\]](#) which we summarized: " This agenda... contemplates the restoration to owners of the power to make the critical decisions about a corporation, to resolve the conflicts of interest inherent in the corporate form of organization, and to be the source of nominations for director."[\[xviii\]](#) There are companies that literally need the involvement of their owners in order to achieve acceptable results. Our experience has revealed patterns in corporate strategy and behavior that lead to poor performance and that can be corrected. The problems of most of our portfolio companies can often be traced to one of these recurring patterns, most often either (1) **over-conglomeration** and/or a (2) **loss of focus** after a period of intense growth and the departure of the founding generation. Another "symptom" of a corporation in need of medicine from shareholders is overcapitalization, which diminishes management's ability (and incentive) to evaluate risk.

In our view, the most disappointing performance by major companies over the past 10 to 20 years has been the result of promiscuous conglomeration. Put as simply as possible, Wall Street sells better than corporate America buys. Some of the most intelligent, creative and persuasive individuals in the country earn the highest compensation in the world by interesting CEOs in their ideas. Often these suggestions involve acquisitions or merger. The financial incentives are seductive. The larger the transaction, the larger the fee paid on its

consummation. The larger the combined corporation, the more prestigious the position of Chief Executive – and the higher the paycheck. Doing “something” is often seen as preferable to the company’s stand alone prospects.

These combinations seldom produce any long-term increase in value over the sum of the parts, as shown by Sears, Eastman Kodak, and Corning. More often, value is lost or destroyed, in AT&T’s acquisition of NCR. Without a strong and disciplined system of corporate governance, the executive who is responsible for making an acquisition will find it virtually impossible at a later date to conclude that it was a mistake. For example, Kay Whitmore who was in charge of the acquisition of Sterling Drug Company by Eastman Kodak, could not bring himself to divest it. It remained for his successor George Fisher to take this step, which was rewarded with a substantial increase in the market value of the stock.

It is often very difficult for loyal executives to oppose acquisitions or to suggest divestment. Board members, almost always selected by the CEO, always kept informed by him, and with compensation designed by him, are not often in a position to insist on an independent review. Divestment is a tough, even emotional process. A credible and objective outside perspective is useful. This is a role that conscientious shareholders can play well.

One of our most respected clients has said that a company can only be Wall Street’s darling once. Polaroid has never reacquired the price earnings multiples of the Edwin Land times; Litton Industries’ fabled record of improving consecutive quarterly earnings produced investor support never subsequently achieved; ITT has never regained the favor of the reign of Harold Sydney Geneen. When the individual who is most associated in the public mind with the “magic” of a particular company departs, its board faces a problem. The job description for the Number Two man in a company presided over by a genius invariably contains one requirement -- the ability to get along with the great man. Normally the same requirement applies to the directors. But this is not usually the quality that makes CEOs (or directors) successful. This was the case at Westinghouse, Borden, and Stone & Webster. A certain institutional inertia tends to envelop companies following the star’s departure. Here again is where an independent owner’s perspective can be valuable.

LENS views our portfolio companies from the perspective of a long term owner. We want the executives of those companies to receive excellent compensation; we want to be sure that they earn it. The only way in which a top manager is “worth” upwards of fifty times [\[xix\]](#) the compensation of a beginning level employee is by producing superior long term results for the owners. This means taking risks. Those risks can be accurately evaluated only in a truly market-driven context, with shareholder value as the goal.

In its magisterial analysis of world wide competitiveness in key industries, a recent study by the McKinsey Research Institute - **Capital Productivity** - sets forth the role that institutional investors should play: “There are two ways investors can improve their returns: by moving investments from low to high performing companies or by actively demanding higher performance from existing investments. *While these seem obvious, it was surprising in our case studies how often capital providers did neither.* Once investors do invest in a company, there are two clear implications for them: *Staying informed.... Taking action.* When company information reveals serious performance lags, greater pressure should be applied on managers to change their behavior. The ultimate sanction investors have is to remove management. In our cases, we saw multiple examples of corporate governance failing to force real change until or unless a firm’s performance had already substantially deteriorated....” [\[xx\]](#)

McKinsey concludes unequivocally that informed and effective ownership involvement is the most important element in explaining a corporation’s competitive success. “In our judgment, ownership is the most important factor in explaining why managerial goals may not be aligned with productivity and why inefficient players do not disappear. The clearest example is government ownership, as seen in the utility and telecom industries. In telecom in Germany, for

instance, the government, as both owner and regulator, had many competing objectives -- universal service for consumers, high quality and technological excellence, profits to subsidize the postal system -- that created no clear objective function for managers and provided little pressure on them to use resources productively.”[\[xxi\]](#)

Providing this “objective function” is primarily the responsibility of the accounting profession. Much could be written about the growing gap between Generally Accepted Accounting Principles and numerical expression of the value of an enterprise. Such is beyond this paper, which only aspires to express that GAAP figures are the foundation on which all else is based. I want to move to a new area that reflects the unignorable importance of large corporations in the political and social life of most of the countries in the world. Beyond their fundamental task of assuring that appropriate “objective functions” are defined and achieved by managements, corporate owners need to undertake a further responsibility. They need to help insure that “their” corporations function within society in ways that are compatible with the precepts of a free society. I will begin by suggesting three areas[\[xxii\]](#) within which shareholders should require accountability from their managers:

1. Obey the Law

In many instances, a corporation can make a cost/benefit calculation and conclude that it is cheaper to break the law than to obey it. This involves weighing the costs of compliance against the probability of getting caught, plus the costs of attorneys’ fees, lost time, and damages that would be awarded. It seems clear that corporations, in using this analysis, will ultimately run the risk of subverting the legitimacy of the societal base, that is, in turn, a necessary precondition for profitable corporate operations. Unhappily, in America today law breaking corporations are not discouraged by the government, by customers or by the market. Shareholder involvement is critical.

2. Disclose information about societal impact beyond the minimum requirements of law.

Full disclosure at the outset may result in fewer sales in the short term, but it will contribute to a society in which the legitimacy of corporate power is more generally conceded than when there are surprises. There are many recent examples - Dow Corning and silicone implants, most prominently - where companies learn the hard way that it is cheaper to disclose.

3. Dramatically reduce corporate involvement in politics.

Corporations need to have some say in the government process affecting them, but not so much that they undercut popular support for government in the process. In the United States, this problem is keenly demonstrated by the level of political action committee contributions, the menace of “soft dollars, the increase in the expense and use of lobbyists and the perception that government lacks the will and capacity to deal with large companies. “Already , some in the political process say the effect of soft dollars is corrupting... Corporations, who often give money to both parties to insure access regardless of who wins, say that soft dollars are a way to get their message before influential politicians. Some of the biggest soft-dollar donors are corporations with pressing issues in Washington. Telecommunications companies... \$4.6 million in soft dollars...Tobacco companies..\$4.6 million.”[\[xxiii\]](#)

The world owes much to the goods, services and wealth generated by large corporations. Owners have critical roles to play in assuring that their managers focus on attainable goals and that they function in a manner respectful of the on-going needs of society on whose health their continuing prosperity depends. Ownership without responsibility is not only bad ethics, it is bad business.

ENDNOTES

[i] Michael Smith, "Shareholder Activism by Institutional Investors, Evidence from CalPERS," *Journal of Finance*, March 1996

[ii] Tim Opler and Jonathan Slobokin, "Does Coordinated Institutional Activism Work? An Analysis of the Activities of the Council of Institutional Investors", WP No. 95-5, October 1995, p. 19.

[iii] Catherine M. Daily et al., "Institutional Activism: Follow the Leaders?", submitted to the Business Policy and Strategy division of the Academy of Management, 1996, p. 31. In my view this study can be criticized for having created "straw men" - i.e. companies having the largest percentage of shareholding comprised of public pensions {considered to be the most "activist" category of investor - see infra} do not demonstrate better performance than the market. Ergo - activism does not create value.

[iv] Sunil Wahal, "Pension Fund Activism and Firm Performance," *Journal of Financial and Quantitative Analysis*, Vol. 31, No 1, March 1996.

[v] Daily, *op .cit. supra*, p. 33.

[vi] An early interpretation of the federal retirement law ERISA required that bankrupt and other marginal companies be left out of indices in which retirement funds could prudently invest. This ruling seems to be observed in the breach.

[vii] Richard H. Koppes, "An Ounce of Prevention: Meeting the Fiduciary Duty to Monitor and Index Fund through Relationship Investing," *20 Journal of Corporation Law*, No. 3, Spring 1995, p. 413,416.

[viii] In states as varied as California and Maine, recent referenda have removed the pension system from the state budget - as part of a poorly understood effort to balance the books.

[ix] It is hard, for example, to imagine the California legislature appropriating money to support CalPERS' opposition to the management of Lockheed, a large California based employer.

[x] In order to permit the delivery of brokerage services, both bundled with and separate from brokerage, security traders are free to use the credits - "soft dollars" - represented by the difference between purely trading and "full service" costs to buy investment related services, in which category most "activist" expenditures would probably fall.

[xi] Robert C. Pozen, "Institutional Investors: the Reluctant Activists," *Harvard Business Review*, Jan-Feb 1994, pp. 140,146 - " The costs of informal jawboning are limited to communications, travel expenses... and time... but the benefits can be dramatic."

[xii] Wahal, *op.cit.supra*, p. 4,5.

[xiii] Daily, *op.cit.supra*. p. 33.

[xiv] "Greenway Partners, the \$500 hedge fund, is known for lighting fires under tired managements. Run by Alfred Kingsley and Gary Duberstein, former lieutenants of Carl Icahn, its activism led to the breakup of U.S. Shoe last year, at a \$40 million gain to Greenway." **FORBES**, September 23, 1996, p. 236.

[xv] Attributed to NY attorney Bevis Longstreth, formally Commissioner of the SEC.

[xvi] See the Annual Reports of LENS available at <http://www.lens-inc.com>

[xvii] Benjamin Graham and David L. Dodd, *Securities Analysis*, [1st Ed.] McGraw-Hill, New York, 1934, pp. 510-511.

[xviii] Robert Monks and Nell Minow, *Power & Accountability*, Harper Collins, 1991 p. 256.

[xix] It bears mentioning that the present levels of CEO compensation have achieved the highest ratio with starting salaries ever measured in this country - several times greater than the twenty recorded in the text!

[xx] McKinsey, *op.cit.supra*. Section 6 - Implications - p 5,6. (*emphasis added*)

[xxi] *Ibid.*, 11-12.

[xxii] See David Engle, "An Approach to Corporate Social Responsibility", *32 Stanford Law Review* 1, Nov. 1979.

[xxiii] Leslie Wayne, "Loopholes Allow Presidential Race to Set a Record", *New York Times*, September 8., 1996, p. 1.