Blockholders, Market Efficiency, and Managerial Myopia

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Introduction

This paper addresses two questions:

– How can myopia be attenuated?
– Why do blockholders exist in the U.S.?


– But stock price concerns deter intangible investment

Porter (1992): “The nature of competition has changed, placing a premium on investment in increasingly complex and intangible forms – the kind of investment most penalized by the U.S. [capital allocation] system”

Graham, Harvey and Rajgopal (2005): 78% of CEOs would sacrifice long-run value to meet short-term earnings targets

This paper: blockholders as a solution

- Blockholders gather costly information about fundamental value
  * But information guides exit vs. loyalty ("voting with your feet" / "Wall Street Rule"), not voice
- Trade with liquidity investors, so prices reflect fundamental value rather than current earnings
- Therefore, managers take long-term decisions that maximize fundamental value
The Role of Blockholders

- Blockholders are prevalent in the U.S. and around the world (Holderness (2007)). What role do they play?

- Many U.S. blockholders lack significant control rights
  - La Porta et al (1999): 80% (90%) of large (medium) U.S. firms do not contain a 20% shareholder
  - Substantial legal and institutional barriers to activism (e.g. Becht et al (2006))

- Hirschman (1970): exit, voice and loyalty
- Admati and Pfleiderer (2006)
Outline of Presentation

- Analyze relationship between block size and financial market efficiency
- Introduce managerial decisions and study effect on real efficiency
- Endogenize block size
  - Social optimum
  - Private optimum
- Discuss empirical implications
  - Real
  - Stock price
- Second paper: multiple blockholders
Blockholder owns α, atomistic shareholders own 1 − α

\[ t = 1: \text{public signal } s \in \{s_g, s_b\} \text{ about } V \]
- If \( s = s_b \) ("bad signal"), \( V = X_h \) w.p. \( \kappa \), \( V = X_l \) w.p. \( (1 - \kappa) \)
- If \( s = s_g \), \( V = X_h \) w.p. 1

\[ t = 2: \text{blockholder exerts monitoring effort } e_B, \text{ cost } \frac{1}{2} c_B e_B^2 \text{ to generate signal } i \in \{i_g, i_b\} \]
- \( \Pr(i_g | X_h) = \Pr(i_b | X_l) = \frac{1}{2} + \frac{1}{2} e_B \)
- \( \Pr(i_g | X_l) = \Pr(i_b | X_h) = \frac{1}{2} - \frac{1}{2} e_B \)
Blockholders and Market Efficiency (cont’d)

- $t = 2$ continued:
  - Blockholder sells $0 \leq b \leq \alpha$
    - $b = 0$ if $i_g$, $\beta$ if $i_b$
  - Liquidity traders demand $u \sim U[0, n]$ where $n = \nu(1 - \alpha)$
  - Market maker sees $d = b + u$ and sets $P = E[V \mid d, s_b]$ as in Kyle (1985)

- $t = 3$: $V$ is realized. $\Delta X = X_h - X_l$

Nash equilibrium:
- Market maker’s prices are optimal given blockholder’s trading strategy
- Blockholder’s trading strategy is optimal given market maker’s pricing function
Trading: $\beta^* = \min\left(\frac{n}{2}, \alpha\right)$
- Assume $\alpha < \frac{n}{2}$ so $\beta^* = \alpha$

Monitoring: $e_B^* = \alpha \left( \frac{n-\alpha}{n} \right) \frac{\kappa (1-\kappa) \Delta X}{\kappa_B}$
- Effort is highest when $\alpha = 1 - \sqrt{\frac{1}{1+\nu}} < \frac{n}{2}$

Allowing purchases does not change the result
Proposition 1: Optimal $\alpha$ for market efficiency is bounded at $\bar{\alpha}$, where
\[ 1 - \sqrt{\frac{1}{1+\nu}} < \bar{\alpha} < \frac{n}{2}. \]
Efficiency rises (falls) in $\alpha$ for $\alpha < (>) \bar{\alpha}$

Optimal block size is finite, vs. Shleifer and Vishny (1986), Kahn and Winton (1998)

* What matters is not block size per se, but the associated trading volume: \( \min(\alpha, \frac{n}{2}) \)
Manager places weight $\mu \omega$ on $t = 2$ price and $\mu (1 - \omega)$ on $t = 3$ value

- $\omega > 0$ as takeover threat (Stein (1988)), reputational concerns (Hirshleifer and Thakor (1992), Scharfstein and Stein (1990)), manager sells at $t = 2$ (Stein (1989))

At $t = 0$, manager of a high-quality firm chooses $\theta \epsilon [0, 1]$

- At $t = 3$, $V = X_h + g\theta$
- W.p. $y\theta^2$, the firm emits $s_b$ at $t = 1$; else $s_g$

**Proposition 2**: If $\alpha < \bar{\alpha}$, $\theta^*$ is increasing in $\alpha$

- Effect is strongest for high $y$
Liquidity encourages investment, contrary to
  - Intervention models: liquidity facilitates exit vs. intervention (Bhide (1993))
  - Conventional wisdom: liquidity encourages selling upon weak earnings, rather than loyalty

Investment rises even though blockholder is not “long-term” and is only motivated by (private) informed trading profits

Optimal $\nu$ is bounded at
$$\frac{\alpha^2 \kappa(1 - \kappa) \Delta X}{1 - \alpha c_B e_B (1 - e_B + e_B \kappa)}$$

Endogenizing $\alpha$

- Social optimum $< \bar{\alpha}$, owing to monitoring costs
  - If $\frac{\partial \theta^*}{\partial \alpha}$ is low, financial efficiency does not affect real efficiency, echoing Stiglitz (1981)

- Private optimum: shareholder
  - Only enjoys $\alpha\%$ of rise in firm value: Shleifer and Vishny (1986)
    - * Consistent with Bhide (1993), government should not always promote dispersed ownership
  - Considers informed trading profits

- Privately optimal $\alpha$ may be too high or too low
Empirical Predictions

- Prediction 1: Blocks should be more prevalent in firms with abundant long-term opportunities that exhibit high information asymmetry
  - Suggests blockholders are useful in start-up firms, R&D-intensive firms, countries with inefficient capital markets

- Prediction 2: Higher blockholdings are associated with more long-term behavior
  - Cross-sectional approach may have difficulty in assigning causality
  - Cronqvist and Fahlenbrach (2006): appearance of certain blockholders increases investment; relationship is causal

- Prediction 3: Prices are more efficient for firms with larger blockholdings
  - Mispricing anomalies are less pronounced
Conclusion

- What is the role of a blockholder who cannot intervene, and if there is no effort conflict?
  - To encourage long-term investment, the first-order problem faced by many modern firms

- U.S. has not been defeated by Japan

- Limitations / extensions:
  - Interpretation of $\theta$
  - Paper focuses on blockholders as a solution to myopia. Causes of myopia ($\omega > 0$ and existence of $s$) are exogenous
    * Endogenize $s$: analyze optimal disclosure laws set by the government, and discretionary disclosure policy set by firm
    * Endogenize $\omega$: analyze of optimal mix of short- and long-term compensation
  - Multiple blockholders