Blockholders, Market Efficiency, and Managerial Myopia*

Alex Edmans
Wharton School, University of Pennsylvania
aedmans@wharton.upenn.edu
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Abstract
This paper shows how blockholders can add value even if they cannot intervene in a firm’s operations. By trading, they can attenuate managerial myopia by making prices reflect fundamental value rather than current earnings. Blockholders have a strong incentive to acquire costly information on the cause of interim losses. If losses result from efficient long-term investment rather than poor firm quality, they retain their stake through the turbulence. This expected share price support encourages managers to exploit growth opportunities that reduce short-term earnings. The model thus justifies the prevalence of small blockholders in the U.S. who typically lack the control rights assumed by existing theories. Block size has a non-monotonic effect on firm value. A higher stake allows blockholders to sell more upon negative information, encouraging investigation. However, if block size is too high, excessive price impact reduces trading profits and thus monitoring incentives. Contrary to the view that the U.S.’s liquid stock markets and transient shareholders exacerbate myopia, this paper shows that they can increase investment through improving market efficiency. Hence the U.S. capital allocation system may be significantly more investment-friendly than commonly believed.

Keywords: Blockholders, market efficiency, myopia, short-termism, asymmetric information, investment, agency costs, Wall Street Rule
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*2428 Steinberg Hall-Dietrich Hall, 3620 Locust Walk, Philadelphia, PA 19104-6367. (215) 746 0498. I am deeply grateful to my advisors, Stewart Myers, Dirk Jenter, Gustavo Manso, and Xavier Gabaix for their support and guidance throughout this project. I greatly appreciate the comments of an anonymous referee, an associate editor, and the editor Cam Harvey. This paper has also benefited from input from Jack Bao, Florian Ederer, Isil Erel, Carola Frydman, Li He, Cliff Holderness, Adam Kolasinski, Pavitra Kumar, Robert Marquez, Anna Obizhaeva, Weiyang Qiu, Steve Ross, Jeremy Stein, Masako Ueda, Jialan Wang, and seminar participants at the 2007 Western Finance Association meetings, the 2006 CEPR European Summer Symposium in Financial Markets, the 2006 FMA doctoral tutorial, Berkeley, Boston College, Dartmouth, Duke, Maryland, MIT, Northwestern, NYU, UBC, UCLA, UNC, Wharton, and Yale. I acknowledge travel grants from the NYSE and the MIT Graduate Student Council.
“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.” – Porter (1992)

“[Institutional investors] implicitly praise or criticize management, by buying or selling, but seldom get involved more directly, even to the extent of a phone call. There is almost no dissent from the Wall Street Rule” – Lowenstein (1988)

1 Introduction

This paper analyzes how outside blockholders can promote efficient investment through their trading behavior. By gathering information about a firm’s long-term prospects and impounding it into prices, they encourage managers to exploit growth opportunities that increase firm value even at the expense of short-term losses. The model therefore addresses two broad research issues. First, it introduces a mechanism through which managerial myopia can be attenuated. Second, it demonstrates that shareholders can add significant value even if they lack the control rights to intervene in a firm’s operations, thus providing a rationalization for the prevalence of small transient blockholders in the U.S.

Many academics and practitioners believe that myopia is a potentially fundamental problem faced by the modern firm. In the last century, many firms attained leadership positions primarily through superior physical assets that generated cost efficiency. Nowadays, competitive success increasingly depends on product quality, which in turn stems from intangible assets such as human capital and R&D capabilities (Zingales (2000), Thurow (1993)). Building such competencies requires significant and sustained investment. Porter (1992) states that this is an issue of national importance, since the U.S.’s ability to compete successfully on world markets hinges critically on whether its capital allocation system can promote such intangible investment.

However, some managers may fail to exploit their firms’ growth opportunities. These failures typically do not result from a traditional effort conflict, but from the manager’s concern with the short-term stock price (Narayanan (1985), Stein (1988, 1989)). Intangible investment may depress interim financial performance and the stock price if outsiders cannot distinguish an investing firm from a low quality firm. Fearing this decline, the manager inefficiently forgoes investment opportunities. This problem has been frequently voiced by managers themselves: Graham, Harvey and Rajgopal’s (2005) survey finds that 78% of executives would sacrifice long-term value to meet earnings targets. Porter (1992) argues that underinvestment is a particularly severe issue in the U.S., since its liquid stock markets allow investors to sell upon weak financial results.

While previous papers have focused on various causes of myopia, this paper analyzes a solution: blockholders. Owing to their sizable stakes, blockholders have strong incentives to gather

\[1\] Throughout this paper, the effort conflict is broadly defined to include shirking, pursuit of private benefits, and managerial rent extraction.
costly information about the firm’s fundamental value, i.e., to learn whether weak earnings result from low firm quality or a sound long-term strategy. These incentives result from the blockholder’s ability to profit by selling her stake to liquidity traders if she discovers that the firm is of poor quality. If the firm is intrinsically sound, she does not sell. This attenuates the stock price decline caused by weak earnings and encourages investment ex ante. The Wall Street adage that the “market sells first and asks questions later” does not apply to blockholders: owing to their large stakes, they have the incentive to ask questions first and not automatically sell upon weak earnings.

While the blockholder’s information gathering is motivated by her private desire to profit from liquidity traders, it has real social benefits by improving management decisions. These benefits are particularly high for firms with moderately profitable opportunities. If there are few profitable projects, there is little need to encourage investment. If all projects are highly attractive and tangible, or if the manager is unconcerned by the short-term stock price, investment is efficient even without a blockholder.

Contrary to many existing papers, here block size has a non-monotonic effect on market efficiency and ultimately real investment. Up to a point, the larger the initial holding, the more the blockholder can sell upon negative information if there are short-sales constraints. These greater trading profits raise her incentives to gather information in the first place. However, trading profits depend not on block size per se, but the amount sold upon bad news. If the block becomes too large, market liquidity declines and the blockholder chooses to sell less than her entire stake because of price impact. Since her potential trading profits are lower, she acquires less information. This finite optimal block size is consistent with the paucity of substantial blockholders in the U.S. (La Porta, Lopez-de-Silanes and Shleifer (1999)).

The role of blockholders identified by this paper contrasts with prior models. Existing theories involve the shareholder adding value through disciplinary action: she intervenes to overcome an underlying effort conflict by firing a shirking manager, implementing a restructuring or overturning project choice. This paper shows that blockholders can play a significant role even if they are unable to intervene, and even in the absence of an effort conflict. Here, the blockholder cannot “voice” by intervening in a troubled firm but can only trade: i.e., choose between “exit” (selling her stake) and exhibiting “loyalty.”

The focus on long-term investment is motivated by its increasing importance in the modern corporation. At a firm level, Zingales (2000) argues that exploiting growth opportunities has surpassed traditional shirking issues as the key organizational challenge. While the recent rise

2There are numerous real-life examples of the “Wall Street Rule” being followed. Kahn and Winton (1998) cite the case of Fidelity Magellan, which sold substantial holdings of high-technology stocks in 1995, just in advance of a downturn in these stocks. More recently, Kirk Kerkorian sold his large holding in General Motors, after failing in interventionist attempts to effect changes.


4“Loyalty” is not a behavioral phenomenon in this paper. The blockholder retains her stake if and only if such behavior is individually profit-maximizing.
in equity-based compensation (Hall and Liebman (1998)) and the sensitivity of CEO turnover to the stock price (Kaplan and Minton (2006)) have likely attenuated effort problems, these measures also plausibly further induce myopia.

The focus on trading, rather than intervention, is also empirically motivated. While intervention may be plausible for overseas blockholders, who typically hold large stakes, the striking feature of many U.S. blockholders is that they are small. In addition, compared to their foreign counterparts, U.S. shareholders face substantial and institutional hurdles to intervention (see Becht et al. (2006) and Black (1990)). Both of these factors mean that U.S. blockholders typically lack the ability to intervene, and so existing models have difficulty in explaining the role that they play in corporate governance, and thus why they are so prevalent. This open question provides the second motivation for this paper.

These two departures from the literature lead to differences in the mechanism through which the blockholder adds value. In existing theories, she adds value by being an adversary of the CEO, exerting discipline by intervention. Here, the blockholder acts as an ally to the manager: her loyalty provides support to the share price upon weak earnings and encourages investment ex ante. This paper therefore provides a dynamically consistent reason for why the manager may wish to attract blockholders, for instance through dividend policy (Allen et al. (2000)).

These contrasting roles further lead to differences on the effect of liquidity on the blockholder’s value added. Since “voice” and “exit” are mutually exclusive, Bhide (1993) argues that market liquidity is undesirable as it allows a shareholder to leave rather than intervening. While “loyalty” and “exit” are similarly mutually exclusive, this dichotomy paradoxically leads to complementarities between them. If a blockholder has retained her stake in a firm with weak earnings, this is a particularly positive indicator of fundamental value if she could easily have sold instead. In short, the power of loyalty relies on the threat of exit. The core result of this paper, that blockholders promote investment, does not stem from simply assuming that blockholders always hold their stakes for the long run and ignore interim performance measures. In fact, it is most applicable to transient financial blockholders who are notoriously willing to sell stocks they deem to be fundamentally weak, unlike, for example, family owners who are unlikely to exit. This conclusion contradicts the widely held notion that the U.S.’s fluid capital markets induce underinvestment by allowing blockholders to sell easily upon poor financial results, and may help explain why predictions that the U.S. economy would be surpassed by Japan (Porter

5La Porta et al. (1999) document that 80% (90%) of large (medium) U.S. firms do not contain a shareholder who owns 20% of the votes (La Porta et al. (1999)). La Porta et al. estimate that a 20% stake gives effective control if the shareholder is an insider; the threshold is likely to be higher for outside shareholders. By contrast, when a blockholder is defined as a 5% shareholder, Holderness (2006) finds that 96% of U.S. firms contain a blockholder. Hence blockholders are prevalent in the U.S., but tend to lack control rights. Holderness finds that concentrated blockholders with board seats tend to be families; this paper focuses on financial blockholders who typically hold smaller stakes and have less frequent board representation.

6A manager may voluntarily attract an adversarial blockholder when raising financing for the first time, to signal quality or commit to value-maximization. However, ex post he may have an incentive to persuade the blockholder to leave. The dynamic consistency in this paper is similar to Zwiebel (1996) who shows how a manager may voluntarily wish to retain high leverage, even after financing has been raised. Unlike in Zwiebel (1996), this dynamic consistency does not rely on the presence of an external discipliner.
(1992), Thurow (1993)) have not been borne out. The U.S. capital allocation system may be significantly more investment-friendly than commonly believed, already containing a partial solution to the potentially significant problem of myopia.

As with block size, the effect of liquidity on the blockholder’s value added is also non-monotonic (for a given block size). If liquidity is very low, the blockholder cannot profit from informed trading. She does not monitor, and so no information is impounded in the stock price. If there is substantial liquidity, the blockholder becomes informed, but her trades are camouflaged by liquidity orders and so prices are again uninformative. To the extent that the U.S. capital allocation system deters investment, the principal cause is dispersed ownership rather than excessive liquidity. The shareholder trading facilitated by liquidity is only harmful if it is driven by short-run earnings. If shareholders are sizable, their trades are likely to be driven by fundamental value and so trading increases price efficiency. This leads to a benefit of mutual funds that does not rely on risk-sharing: they concentrate ownership, encouraging information acquisition. This benefit echoes Diamond’s (1984) theory of banks as delegated monitors. However, banks monitor to intervene and are concerned with downside protection owing to their concave claims. Blockholders’ monitoring affects the stock price and can support growth.

While the paper’s main result is that blockholders can encourage investment as well as effort, the corollary is that a key cost of the U.S.’s dispersed ownership is myopia. This has important policy implications. Previous papers argue that the main cost of dispersed ownership is shirking, in which case potential solutions are equity compensation and regulations against takeover defenses. If the main cost is myopia, these policies exacerbate the problem.

The core model does not require an effort decision for blockholders to add value. However, the trading mechanism analyzed by this paper can attenuate many other agency problems than myopia, such as shirking. Trading can encourage effort that does not pay off immediately, by impounding its effects into the interim share price. The blockholder’s beneficial effects on effort and investment interact. If the manager knows that the presence of blockholders will allow him to undertake long-term investments if the firm is successful, he exerts greater effort to ensure the firm’s success in the first place.

A shareholder’s private incentives to acquire a block may differ significantly from social incentives. Once she has built her stake, the blockholder only captures a proportion of the value gains from monitoring. In addition, if the blockholder cannot buy shares anonymously, free-riding by small shareholders will make it costly to establish her position in the first place. By contrast, the blockholder is motivated by informed trading profits, which do not enter the social welfare function as these are pure transfers from liquidity investors. Hence, the actual block size reached through private trading may be inefficiently too low or too high.

The paper closes with empirical implications. One set relates to real effects. The benefits of large stakes are especially strong in firms with profitable growth opportunities that exhibit information asymmetry, such as R&D-intensive companies. In addition, blockholders should increase firm investment, as found by Cronqvist and Fahlenbrach (2006), and deter earnings
manipulation (Burns et al. (2006)). These predictions particularly distinguish this model from theories focused on effort. A second set concerns stock-price effects, and is unique to a model where blockholders add value through trading. Blockholders should lead to an increase in price efficiency, for example by reducing event-drift anomalies.

This paper is organized as follows. Section 2 reviews relevant literature, and Section 3 introduces the basic model which links block size to financial market efficiency. Section 4 presents the core result of the paper by introducing managerial decisions and illustrating the impact on real efficiency. Section 5 generates empirical predictions, and Section 6 concludes. Appendix A contains proofs.

2 The Setting

The three options of “exit,” “voice” and “loyalty” were first studied by Hirschman (1970) in the context of dissatisfied customers. However, there have been few formal models analyzing the impact of shareholder exit on management decisions. A notable exception is a contemporaneous working paper by Admati and Pfleiderer (2006). While they follow the literature by analyzing an effort conflict, I consider long-term investment. These are fundamentally different agency problems: with myopia there is no intrinsic conflict between private benefits and firm value, and the problem is most severe if the manager is sensitive to stock prices. The focus on separate agency issues leads to blockholders adding value in different ways. As in intervention models, the blockholder in Admati and Pfleiderer exerts discipline, but through “exit” instead of “voice;” here, she is an ally of the manager and exhibits “loyalty”. While it is intuitive that liquidity is desirable if the blockholder exits to discipline an effort problem, the beneficial effect of liquidity on investment is less obvious. Indeed, conventional wisdom (e.g., Porter (1992)) is that the U.S.’s fluid capital markets necessarily exacerbate myopia.

A second difference is that Admati and Pfleiderer assume that the large shareholder is exogenously informed, and so the level of monitoring is fixed. This paper endogenizes costly information gathering and generates testable predictions on the effect of block size and liquidity on market efficiency, investment and in turn firm value. Both are shown to have non-monotonic effects.

The concept of investment increasing in ex post monitoring is shared by Edmans (2007a), who analyzes levered investment funds. Debt concentrates investors’ equity stakes, giving them incentives to find out the cause of interim losses. Therefore, debt can allow efficient liquidation of an incompetent fund manager who suffers short-term losses, without simultaneously deterring skilled managers from long-term trades that risk such losses. If low earnings result from interim turbulence in a long-term arbitrage trade rather than low ability, the fund is continued. While

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7Kahn and Winton (1998) do consider the possibility of blockholder exit. However, this does not add value, but merely leads to the blockholder profiting at the expense of liquidity traders. In Gopalan (2006), blockholder exit can add value by reducing the stock price and facilitating takeovers, but the incumbent management takes no decisions in his model.

6
Edmans (2007a) is a theory of capital structure, where the shareholder’s dollar investment is fixed and debt induces monitoring, this paper is a theory of ownership structure. There is no debt and the analysis focuses on the effect of blockholder size. In addition, there is no stock price mechanism in Edmans (2007a).

A large number of papers have analyzed the links between financial and real efficiency. In Holmstrom and Tirole (1993), increased market efficiency means that the stock price is a less noisy signal of firm value, thus allowing a risk-averse manager to be tied more closely to the stock price and ultimately leading to greater managerial effort. In their model, concentrated ownership reduces liquidity and thus market efficiency; they do not consider the blockholder as a potential monitor. This extension is particularly important if short-sale constraints deter non-shareholders from costly monitoring due to their reduced ability to trade on information. Moreover, in my paper the blockholder has information not held by other investors: in her absence, the stock price only reflects tangible information and tying the manager’s pay to it distorts incentives.

In Fishman and Hagerty (1989), as in this paper, managers fearing future misvaluation invest inefficiently ex ante. Their solution is for firms to invest in disclosure, to encourage speculators to gather information about fundamental value and impound it into the stock price by trading. In my model, the firm is already at maximal disclosure (since it is difficult to communicate the soft information that is particularly relevant to intangible investment) and monitoring is instead incentivized by large stakes. In Stein (1996), Baker, Stein and Wurgler (2003), and Jensen (2004), managers exploit current misvaluation by raising overvalued equity and investing inefficiently ex post.

An additional channel arises through the role of the stock market as an aggregator of information about the profitability of a firm’s investment opportunities. More efficient stock prices can guide management decisions: theoretical and empirical examples include Dow and Gorton (1997), Subrahmanym and Titman (1999), Goldstein and Guembel (2007), Dow, Goldstein and Guembel (2007), Chen, Goldstein and Jiang (2006), Durnev, Morck and Yeung (2004), and Luo (2005). In the present paper, instead of learning from the market to make subsequent investment decisions, the manager is more informed than the market and is concerned with its misvaluation of previous actions. The manager can plausibly learn from the market’s analysis of a given common information set as it accumulates multiple viewpoints. However, the manager is more informed with respect to “soft” information that is difficult to communicate to the market.

The role of blockholders analyzed in this paper may coexist with the functions analyzed by previous models. Using Holmstrom and Tirole’s (1993) categorization, interventionist blockholders gather “strategic” information about potential future operational improvements. The shareholders in my model gather “speculative” information about current values to guide trading. Hence this paper should be seen as complementary to existing research and particularly attuned to blockholders that cannot or do not wish to intervene.

A final strand of related literature concerns insider trading. Proponents argue that it can
increase the efficiency of stock prices, with consequent real benefits (e.g. Manne (1966)). The blockholder is likely to be significantly more effective than the manager at impounding fundamental value information into prices, for several reasons. First, unlike the blockholder who can trade freely based on her information, the manager is conflicted since the stock price is used to evaluate him. If he has negative private information, he is unlikely to reveal it by selling stock as the low share price may lead to him being fired. By contrast, the blockholder is an objective monitor. Second, conflicts may also arise because the manager has control over the information flow and investment decisions (Bernhardt et al. (1995)). He may release false negative (positive) information and subsequently buy (sell) shares, or sell his shares and take the incorrect investment decision. Third, the manager’s trading may be hindered by insider trading laws, wealth constraints (limiting purchases) or lock-ups of stock as part of incentive packages (limiting sales). This paper’s analysis also differs because the insider is automatically informed and so costly endogenous information acquisition is not an issue.

3 Blockholders and Market Efficiency

This section analyzes the effect of block size on monitoring and stock prices. The real consequences are analyzed in Section 4, where managerial decisions are introduced. Table 1 lists the key parameters in the model.

I consider a firm with one share outstanding. A blockholder owns \( \alpha \) units and atomistic shareholders collectively own the remaining \( 1 - \alpha \). \( \alpha \) is later endogenized in Section 4.3. All agents are risk-neutral and the risk-free rate is normalized to zero.

There are three periods in the core model, summarized in Figure 1. At \( t = 1 \), a public signal \( s \in \{ s_g, s_b \} \) is given about the firm’s \( t = 3 \) value \( V \). The signal can be interpreted as a public earnings announcement. Such signals are imperfectly informative about \( V \). If \( s = s_b \), \( V = X_h \) with probability \( \kappa \) and \( V = X_l \) with probability \( (1 - \kappa) \). If \( s = s_g \), \( V = X_h \) with probability 1. I refer to a firm with \( V = X_h (X_l) \) as a “high (low)-quality firm;” \( s = s_g \) is a “good signal” and \( s = s_b \) is a “bad signal.” Let \( \Delta X = X_h - X_l \).

At \( t = 2 \), the blockholder can choose to exert monitoring effort \( e_B \in [0,1] \), at cost \( \frac{1}{2} e_B^2 \).\(^8\). She will only monitor if \( s = s_b \), since \( s_g \) is already fully revealing. Monitoring increases the precision of the blockholder’s private information \( i \in \{ i_g, i_b \} \) of the firm’s fundamental value \( V \) as follows:

\(^8\)Monitoring need not require obtaining disclosures unavailable to other investors (e.g. through meetings with the CEO) but can be limited to analysis of publicly available information. Even though public information may be freely available, its analysis may be costly and require expertise. In practice, institutional investors employ large research staffs who deeply analyze public information to form their own financial projections and valuations. For example, after a drug has passed through early phases of development, it requires detailed analysis to estimate the probability that the drug eventually becomes launched, its future sales after launch and competitive response, and any cannibalization of the firm’s existing products. While boards are even more informed than blockholders, many researchers have documented that boards frequently fail to monitor. The blockholder in this paper should be thought of as monitoring both the board and management together.
The posterior probabilities that the firm is of high quality are thus given by:

\[
\begin{align*}
\Pr(i_g | X_h) &= \Pr(i_b | X_t) = \frac{1}{2} + \frac{1}{2}e_B \\
\Pr(i_g | X_t) &= \Pr(i_b | X_h) = \frac{1}{2} - \frac{1}{2}e_B
\end{align*}
\]

If \( e_B = 0 \), the private information is completely uninformative and the posterior equals the prior \( \kappa \); if \( e_B = 1 \), the blockholder knows fundamental value with certainty. There is then a round of trading. The blockholder either demands nothing (\( b = 0 \)) or sells \( \beta \) units (\( b = -\beta \)). The blockholder will sell if she receives signal \( i_b \) and holds otherwise.\(^9\) I assume \( \beta \leq \alpha \) owing to short-sales constraints, since this paper’s focus is non-interventionist financial blockholders such as mutual funds, pension funds and insurance companies, who very rarely take short positions. The results continue to hold if short sales are allowed but incur a non-zero cost.

Also at \( t = 2 \), liquidity traders appear and demand \( u \sim U[0, n] \), where \( n = \nu(1 - \alpha) \) and \( \nu \) is a liquidity parameter. In this paper, the term “liquidity” may refer to either \( n \) or \( \nu \), and it will be made clear to which it refers. As is standard, the volume of liquidity trades depends on the amount held by small shareholders \( (1 - \alpha) \), since liquidity trades often arise from selling by current investors.\(^10\) The competitive market maker sees total demand \( d = b + u \) and sets a price \( P \) equal to the conditional expectation of \( V \) given \( d \) and \( s \), similar to Kyle (1985).

### 3.1 Market Maker

I use the Nash equilibrium solution concept to solve for the blockholder’s optimal sale volume upon negative information (\( \beta \)) and the market maker’s pricing function (\( P(d) \)). If signal \( s_g \) is emitted, the market maker knows that the firm is of high quality, and so sets \( P = X_h \). (The remainder of this section considers the case where \( s = s_b \) and so “\( s_b \)” notation is omitted for brevity.) Upon seeing \( s_b \), the market maker has a prior \( \kappa \) that the firm is of high quality. After receiving order \( d \), he updates this prior to form a posterior \( \pi_d \). Let \( \beta \) denote the market

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\(^9\)The core analysis involves the blockholder selling or holding, since this paper’s focus is the Wall Street Rule: the shareholder exit that is widely believed to exacerbate myopia. The results are unchanged by allowing the blockholder to buy a fixed amount regardless of her initial stake. While the incentives to buy are unaffected by \( \alpha \), the ability to sell remains increasing in \( \alpha \), up to a point. Since the blockholder does not know ex ante whether her information will lead her to buy or sell, monitoring continues to be increasing in \( \alpha \), up to a point.

\(^10\)Even though \( u \) is always non-negative in the model for clarity, liquidity trades can involve either purchases or sales since all of the model’s results hold up to a vertical translation of \( u \). Other papers where liquidity depends on the free float include Holmstrom and Tirole (1993), Bolton and von Thadden (1998), Maug (1998), Kahn and Winton (1998) and Faure-Grimaud and Gromb (2004).
maker’s conjecture about the amount sold by the blockholder upon negative information, and $\widehat{e}_B$ denote the conjectured monitoring effort. He therefore sets prices as in Lemma 1:

**Lemma 1** Upon observing signal $s_b$ and total demand $d$, and given conjectures $\widehat{\beta}$ and $\widehat{e}_B$, the market maker sets the following prices:

$$
\begin{align*}
P &= X_l + \frac{(1-\widehat{e}_B)\kappa}{1+\widehat{e}_B - 2\widehat{e}_B \kappa} \Delta X \text{ if } d < 0 \\
P &= X_l + \kappa \Delta X \text{ if } 0 \leq d < n - \widehat{\beta} \\
P &= X_l + \frac{(1+\widehat{e}_B)\kappa}{1-\widehat{e}_B + 2\widehat{e}_B \kappa} \Delta X \text{ if } d \geq n - \widehat{\beta}.
\end{align*}
$$

(1)

If $d < 0$, the market maker knows that the blockholder has sold and therefore sets prices according to the posterior if $i_b$ is received. If $d \geq n - \widehat{\beta}$, the market maker believes that the blockholder has not sold and thus $i_g$ was received. $0 \leq d < n - \widehat{\beta}$ is equally consistent with blockholder selling and no blockholder action, and so the posterior equals the prior $\kappa$.

### 3.2 The Optimal $\beta$ and Comparative Statics

Assume $i_b$ has been received and thus fundamental value is $X_l + \frac{(1-\widehat{e}_B)\kappa}{1+\widehat{e}_B - 2\widehat{e}_B \kappa} \Delta X$. The blockholder wishes to sell $\beta$. Given the market maker’s pricing function, the price the blockholder will receive on the traded stake will depend on liquidity trader demand $u$ as follows:

$$
\begin{align*}
P &= X_l + \frac{(1-\widehat{e}_B)\kappa}{1+\widehat{e}_B - 2\widehat{e}_B \kappa} \Delta X \text{ if } u < \beta \\
P &= X_l + \kappa \Delta X \text{ if } \beta \leq u < n - \widehat{\beta} + \beta \\
P &= X_l + \frac{(1+\widehat{e}_B)\kappa}{1-\widehat{e}_B + 2\widehat{e}_B \kappa} \Delta X \text{ if } u \geq n - \widehat{\beta} + \beta.
\end{align*}
$$

Her objective function is thus:

$$
\frac{\beta \Delta X}{n} \left[ (n - \max(\beta, \beta)) \left( \kappa - \frac{(1-\widehat{e}_B)\kappa}{1+\widehat{e}_B - 2\widehat{e}_B \kappa} + \max(\beta - \beta, 0) \left( \frac{(1+\widehat{e}_B)\kappa}{1-\widehat{e}_B + 2\widehat{e}_B \kappa} - \frac{(1-\widehat{e}_B)\kappa}{1+\widehat{e}_B - 2\widehat{e}_B \kappa} \right) \right) \right]
$$

The final term arises since the blockholder may choose to undercut the market maker’s conjecture ($\beta < \widehat{\beta}$): by selling less than expected, the blockholder may be able to “fool” the market maker into thinking that she has not sold, and thus receive the higher price of $P = X_l + \frac{(1+\widehat{e}_B)\kappa}{1-\widehat{e}_B + 2\widehat{e}_B \kappa} \Delta X$.

After applying the Nash conditions, the equilibrium is summarized in Lemma 2:

**Lemma 2** Upon observing $s_b$ and total demand $d$, the market maker sets the following prices:

$$
\begin{align*}
P &= X_l + \frac{(1-\widehat{e}_B)\kappa}{1+\widehat{e}_B - 2\widehat{e}_B \kappa} \Delta X \text{ if } d < 0 \\
P &= X_l + \kappa \Delta X \text{ if } 0 \leq d < n - \beta^* \\
P &= X_l + \frac{(1+\widehat{e}_B)\kappa}{1-\widehat{e}_B + 2\widehat{e}_B \kappa} \Delta X \text{ if } d \geq n - \beta^*.
\end{align*}
$$

(2)
Upon learning that fundamental value is \( X_t \), the blockholder sells

\[
\beta^* = \min \left( \frac{n}{2}, \alpha \right).
\]  

(3)

The blockholder exerts monitoring effort

\[
e_B = \beta^* \left( \frac{n - \beta^*}{n} \right) F, 11
\]

(4)

where

\[
F = \frac{k(1 - k)\Delta X}{c_B}.
\]

(5)

For the most part, this paper focuses on the interesting case when the short-sale constraint binds, i.e., \( \alpha \leq \frac{n}{2} \) (equivalent to \( \alpha \leq \frac{n}{\nu + 2} \)) so \( \beta^* = \alpha \). This means that the blockholder can sell her entire stake without being constrained by liquidity. Since \( \alpha < 1 \), \( n < 2 \) is assumed for this constraint to be meaningful. Monitoring effort is therefore highest when

\[
\alpha = 1 - \sqrt{\frac{1}{1 + \nu}} < \frac{n}{2}.
\]

(6)

For \( \alpha < 1 - \sqrt{\frac{1}{1 + \nu}} \), a larger initial stake raises the amount that the blockholder chooses to sell upon negative information, and thus the incentives to become informed in the first place. Simply put, the benefits of information are higher as the blockholder can make greater use of it. The binding of the short-sale constraint means that investors monitor their largest shareholdings more closely, which is consistent with reality. In the absence of such a constraint, investors would monitor all stocks equally regardless of their initial holdings: if they uncovered negative information about a stock they do not own, they could short sell.\(^{12}\) In previous papers where information is gathered purely to drive trading decisions (e.g., Faure-Grimaud and Gromb (2004), Holmstrom and Tirole (1993)), the potential monitor’s initial stake does not matter. In Van Nieuwerburgh and Veldkamp (2006), monitoring does increase in the investor’s holding, but because she is risk averse and wishes to reduce uncertainty, rather than a greater block expanding the set of feasible trading strategies.

However, a second consequence of a higher stake is that it reduces liquidity. From (4), this lessens monitoring incentives, as it is liquidity traders that allow the blockholder to profit from

\(^{11}\text{I assume that this does not exceed 1 to avoid having to write min(\cdot) functions throughout the paper.}\)

\(^{12}\text{Monitoring may be undertaken by investors without an initial stake if they can short sell, such as hedge funds. However, shorting a stock is significantly costlier than unwinding a long position. The results hold if short-sales are allowed but incur a non-zero cost: monitoring incentives remain increasing in } \alpha. \text{ Equity analysts are also potential monitors and can move prices even without trading. However, they have significantly fewer incentives to be accurate or impartial given their zero stakes; there is abundant evidence of equity analyst bias. Despite the actions of hedge funds and analysts, information asymmetry is an accepted feature of modern financial markets. Since hedge funds and analysts may be more effective in some firms than others, I later introduce an information asymmetry parameter } \gamma. \text{ I will show that the incremental role for blockholders is greater where hedge funds and analysts are less prevalent, such as small firms.}\)
trading on her private information. Hence the optimal $\alpha$ for effort incentives is less than the optimal sale volume of $n/2$, as shown in equation (6).

The level of monitoring is increasing in the variance in firm quality, captured both by $\Delta X$ and the closeness of $\kappa$ to $1/2$ (as this maximizes $\kappa(1 - \kappa)$). Monitoring naturally decreases in its cost $c_B$. All of these parameters also affect the sensitivity of $e_B$ to $\alpha$, since

$$\frac{\partial e_B}{\partial \alpha} = \left(1 - \frac{2\alpha - \alpha^2}{\nu(1 - \alpha)^2}\right) F.$$  

Since $\frac{\partial^2 e_B}{\partial \alpha^2} < 0$, the positive impact of $\alpha$ on $e_B$ falls as $\alpha$ rises; for $\alpha > 1 - \sqrt{\frac{1}{1+\nu}}$ it becomes negative.

It is straightforward to show both that the blockholder does not sell (hold) upon receiving $i_g$ ($i_b$). Selling in the absence of negative private information would drive the price down and reduce her portfolio value at $t = 2$ as well as $t = 3$. Hence, even a blockholder concerned with interim performance (e.g., a fund manager evaluated by both investors and her boss) will not sell purely on public information. If the blockholder faces the risk of liquidity shocks which force her to sell regardless of her information, this is likely to increase her trading gains, since the market does not know whether a sale is motivated by information or a liquidity shock.

The results of this subsection are summarized in Lemma 3 below:

**Lemma 3** Assume $\alpha \leq \frac{\nu}{\nu + 2}$ and take $\kappa$ as exogenous. Upon observing signal $s_b$, the blockholder exerts monitoring effort $e_B = \alpha \left(\frac{n - \alpha}{n}\right) \frac{\kappa(1 - \kappa)\Delta X}{c_B}$ and sells if and only if she discovers $V = X_l$. Monitoring effort $e_B$ is increasing in $\alpha$ if $\alpha < 1 - \sqrt{\frac{1}{1+\nu}}$, and decreasing in $\alpha$ if $\alpha > 1 - \sqrt{\frac{1}{1+\nu}}$. $e_B$ is increasing in $\nu$, $\kappa(1 - \kappa)$ and $\Delta X$, and decreasing in $c_B$.

### 3.3 Expected Prices

If $V = X_h$, the blockholder never sells, and so $d = u$. Thus $0 \leq d < n - \alpha$ with probability $\frac{n - \alpha}{n}$ and $d \geq n - \alpha$ with probability $\frac{\alpha}{n}$. Hence the expected price of a high-quality firm, if signal $s_b$ is emitted, is

$$E[P \mid X_h] = X_l + \left[\frac{n - \alpha}{n} \kappa + \frac{\alpha}{n} \frac{(1 + e_B)\kappa}{1 - e_B + 2e_B\kappa}\right] \Delta X$$

$$= X_l + \frac{\kappa\Delta X}{n} \left[n - \alpha + \frac{\alpha(1 + e_B)}{1 - e_B + 2e_B\kappa}\right] = X_l + E[\pi \mid X_h] \Delta X. \quad (8)$$
The derivative with respect to $\alpha$ is given by
\[
\frac{\partial E[P \mid X_h]}{\partial \alpha} = \kappa \Delta X \frac{1 + e_B}{n} \left[ \frac{1}{1 - e_B + 2e_B \kappa} - 1 \right] \\
+ \frac{\kappa \Delta X}{n} \frac{\partial e_B}{\partial \alpha} \left[ 2 - 2(1 - \kappa) \right] + \frac{\kappa \Delta X}{n^2} v \alpha \left[ \frac{1}{1 - e_B + 2e_B \kappa} - 1 \right].
\] (9)

The “trading effect” is the direct impact of $\alpha$. Recall the blockholder chooses to sell $\min \left( \frac{n}{2}, \alpha \right)$. If $\alpha \leq \frac{n}{2}$, an increase in $\alpha$ raises her equilibrium sale volume, which expands the region $n - \alpha \leq d < n$ where the market maker is certain that the blockholder has not sold. If the blockholder sells more upon finding negative information, even a moderate total order flow is inconsistent with blockholder selling, and thus raises expected firm quality. Simply put, if the blockholder trades more, her trading (or non-trading) impounds more information into prices.

The “effort effect” operates indirectly through $\alpha$ affecting $e_B$. This effect is positive if $\frac{\partial e_B}{\partial \alpha} > 0$, i.e., $\alpha < 1 - \sqrt{\frac{1}{1+\nu}}$. Increased effort raises the expected price: the more informed the blockholder, the more likely her decision not to sell results from high firm quality rather than unsuccessful monitoring.

The “camouflage effect” operates indirectly through $\alpha$ decreasing liquidity. Since liquidity camouflages the blockholder’s trades, this effect is positive if $\alpha \leq \frac{n}{2}$, as a fall in liquidity increases her effect on prices.

Now consider a low-quality firm. Using similar calculations,
\[
E[P \mid X_l] = X_l + \frac{n - \alpha}{n} \kappa + \frac{\alpha}{n} \left[ \frac{(1 - e_B) \kappa}{1 + e_B - 2e_B \kappa} \right] \Delta X
\]
\[
= X_l + \frac{\kappa \Delta X}{n} \left[ n - \alpha + \frac{\alpha(1 - e_B)}{1 + e_B - 2e_B \kappa} \right] = X_l + E[\pi \mid X_l] \Delta X,
\] (10)

where
\[
\frac{\partial E[P \mid X_l]}{\partial \alpha} = \frac{\kappa \Delta X}{n} \left[ \frac{1 - e_B}{1 - e_B + e_B \kappa} - 1 \right]
\]
\[-\frac{\kappa \Delta X}{n} \frac{\partial e_B}{\partial \alpha} \left[ 2 - 2(1 - \kappa) \right] + \frac{\kappa \Delta X}{n^2} v \alpha \left[ \frac{1}{1 - e_B + 2e_B \kappa} - 1 \right].
\] (11)

As in equation (9), the three terms in equation (11) represent the trading, effort and camouflage effects, but the signs of all effects are reversed.

The difference in expected prices between the two firm types is
\[
E[P \mid X_h] - E[P \mid X_l] = \frac{\alpha \kappa \Delta X}{n} \left[ \frac{1 + e_B}{1 - e_B + 2e_B \kappa} - 1 \right].
\] (12)
A greater difference represents increased market efficiency. Let $\pi$ denote the optimal block size that maximizes market efficiency, defined by $\frac{\partial (E[P | X_h] - E[P | X_l])}{\partial \pi} |_{\alpha = \pi} = 0$. ($\pi$ is different from the socially and privately optimal block sizes, which will be derived later). Equations (9) and (11) show that $\pi$ exceeds the level that maximizes effort, $1 - \sqrt{\frac{1}{1+\nu}}$. When $\alpha = 1 - \sqrt{\frac{1}{1+\nu}}$, the effort effect is zero, but the trading and camouflage effects remain positive (negative) for the high (low)-quality firm. However, $\pi$ is bounded below $\frac{\nu}{\nu+2}$. If $\alpha > \frac{\nu}{\nu+2}$ (i.e., $\alpha > \frac{\nu}{\nu+2}$), then $\alpha$ is replaced by $\frac{n}{2}$ in equations (8) and (10). $n$ drops out, and the trading and camouflage effects are zero, leaving only the effort effect.

Even considering only the benefits of blockholders and ignoring their costs, the optimal block size is a finite $\pi$. This result contrasts with intervention models such as Shleifer and Vishny (1986), Maug (1998) and Kahn and Winton (1998) where a larger block is always desired. In this model, it is not block size per se that matters, but the associated optimal trading volume: prices are a function not of $\alpha$, the entire stake, but $\min \left( \frac{\nu}{\nu+2}, \alpha \right)$. A large block increases information revelation only to the extent that there is sufficient market liquidity to allow the sale of an entire block. Put differently, the blockholder’s loyalty is less of a positive boost to the stock price if exit was difficult in the first place.

In reality, other market participants may be able to observe blockholders’ sales with a lag, by studying 13d or 13f filings. This would strengthen the blockholder’s impact on market efficiency. Since sales are only observed with a lag, the blockholder’s profits from informed selling are unchanged. However, her price impact is greater since her trade becomes visible.

The results of this subsection are summarized in Lemma 4 and Proposition 1 below:

**Lemma 4** The expected prices of a high and low quality firm, if signal $s_b$ is emitted, are as follows:

$$E[P | X_h] = X_l + \frac{\kappa \Delta X}{n} \left[ n - \alpha + \frac{\alpha (1 + e_B)}{1 - e_B + 2e_B K} \right] = X_l + E[\pi | X_h] \Delta X,$$

$$E[P | X_l] = X_l + \frac{\kappa \Delta X}{n} \left[ n - \alpha + \frac{\alpha (1 - e_B)}{1 + e_B - 2e_B K} \right] = X_l + E[\pi | X_l] \Delta X,$$

where $e_B$ is given by Lemma 3.

**Proposition 1** Market efficiency is maximized for a finite block size $\pi$, defined by $\frac{\partial (E[P | X_h] - E[P | X_l])}{\partial \alpha} |_{\alpha = \pi} = 0$, where $1 - \sqrt{\frac{1}{1+\nu}} < \pi < \frac{\nu}{\nu+2}$. Market efficiency is increasing in $\alpha$ for $\alpha < \pi$, and decreasing in $\alpha$ for $\alpha > \pi$.

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13I define “market efficiency” as the closeness of expected prices to fundamental value. An alternative definition is that the price equals expected fundamental value conditional upon an information set. Under this definition, the market is always efficient, regardless of $\alpha$. However, with a blockholder, this information set is richer and so prices are closer to fundamental value.

14In Bolton and von Thadden (1998) and Holmstrom and Tirole (1993), market efficiency (or the related concept of liquidity) is maximized with a zero block. They derive finite optimal block sizes as they trade off market efficiency against, respectively, intervention and monitoring costs. In this paper, the optimal block size is finite even focusing on market efficiency alone.
4 Blockholders and Managerial Decisions

4.1 Long-Term Investment

The previous section linked blockholders to increased financial market efficiency. This section demonstrates that the latter can in turn augment product market efficiency, and thus have real benefits, by addressing the potentially critical myopia problem. I thus illustrate a social benefit for information gathering that is motivated purely by the private desire to profit from informed trading.

The model is extended to allow for managerial decisions. The risk-neutral\textsuperscript{15} manager places weight $\omega$ on the $t = 2$ stock price and $1 - \omega$ on the $t = 3$ firm value, where $0 < \omega < 1$. Since this paper focuses on the solution to myopia rather than its cause, the concern with current stock price in particular ($\omega > 0$) is taken as exogenous. This is a standard assumption in the literature, motivated by a number of underlying factors;\textsuperscript{16} these are not explicitly modeled so that the analysis can focus on the myopia issue.

At $t = 0$, the manager of a high-quality firm can invest in a long-term project that unambiguously creates fundamental value, but risks interim turbulence. The most natural example is intangible investment that is expensed and thus difficult to distinguish from losses. Edmans (2007b) finds that stock prices do not fully react to superior employee satisfaction documented by Fortune magazine’s “Best Companies to Work For in America” survey. Since intangible investment is immediately valued even when publicly verified by a widely respected survey, this suggests that intangibles in general are not impounded into short-term prices. Let $\theta \in [0, 1]$ denote the amount of investment. $\theta$ boosts the firm’s $t = 3$ value to $V = X_h + g\theta$, but risks emitting signal $s_b$ at $t = 1$ with probability $y\theta^2$, where $0 < y < 1$ (otherwise, $s_g$ is given). $g$ measures the productivity of the investment project, and $y$ denotes the extent of information asymmetry between the firm and investors, i.e., the extent to which investors cannot distinguish a low-quality firm from a high-quality firm that is investing. The choice of $\theta$ does not involve a personal cost to the manager: there is no standard effort conflict.

At $t = 0$, the manager of a high-quality firm chooses $\theta$ to maximize

$$
J = (1 - \omega)(X_h + g\theta) + \omega y\theta^2 \left( X_l + \frac{\kappa}{n}(\Delta X + g\theta) \right) \left[ n - \alpha + \frac{\alpha(1 + e_B)}{1 - e_B + 2e_B\kappa} \right] + \omega(1 - y\theta^2)(X_h + g\theta). 
$$

Taking first-order conditions with respect to $\theta$ yields

\textsuperscript{15}Introducing managerial risk-aversion would strengthen the results, since the blockholder reduces the variance in the price of a high quality firm that emits $s_b$, as well as increasing its mean.

\textsuperscript{16}These include takeover threat (Stein (1988)), concern for managerial reputation (Narayanan (1985), Scharfstein and Stein (1990)), or the manager expecting to sell his own shares at $t = 2$ (Stein (1989)). A number of these factors, such as reputational concerns, are not a function of compensation policy and thus are difficult for the firm to control. Even if the manager’s sole objective is to maximize shareholder value, he will care about the stock price as it affects the terms at which the firm can raise equity at $t = 2$ (Stein (1996)).
\[
\frac{\partial J}{\partial \theta} = (1 - \omega)g \\
+ \omega(1 - y\theta^2)g \\
+ \omega y\theta \frac{\kappa}{n} g \left[ n - n + \frac{\alpha(1 + e_B)}{1 - e_B + 2e_B\kappa} \right] \\
- 2\omega y\theta (\Delta X + g\theta) \frac{\kappa}{n} \left[ n - n + \alpha - \frac{\alpha(1 + e_B)}{1 - e_B + 2e_B\kappa} \right].
\]

(14)

The first term represents the increase in long-term fundamental value. The second term reflects the rise in the \( t = 2 \) stock price if \( s_g \) is emitted. The third term stems from the higher stock price if \( s_b \) is emitted, since it may have been given by a high-quality firm now worth \( X_h + g\theta \). The fourth term is the only negative term, which results from the increased probability of giving \( s_b \).

**Lemma 5** Taking \( \kappa \) and \( e_B \) as exogenous, the manager chooses investment level \( \theta \) given by

\[
\theta(\kappa, e_B) = \min \left( \sqrt{\frac{(\Delta X)^2 + \frac{3g^2}{\omega A} - \Delta X}{3g}}, 1 \right),
\]

(15)

where

\[
A = \frac{yk}{n} \left[ n - n + \alpha - \frac{\alpha(1 + e_B)}{1 - e_B + 2e_B\kappa} \right] > 0.
\]

(16)

Assuming an interior solution, \( \theta \) is increasing in \( g \), and decreasing in \( \Delta X \), \( y \), and \( \omega \).

The amount of long-term investment is naturally increasing in its productivity, and decreasing with the cost of interim turbulence. The latter is positively related to the difference in value between high- and low-quality firms \( \Delta X \), the level of information asymmetry \( y \), and the manager’s concern for the current stock price \( \omega \). If \( g \) is high and \( \Delta X \), \( \omega \) and \( y \) are sufficiently low, \( \theta \) will be at its first-best value of 1.

**Lemma 6** Taking \( \kappa \) and \( e_B \) as exogenous, and assuming an interior solution, the sensitivity of \( \theta \) with respect to \( \alpha \) is

\[
\frac{\partial \theta(\kappa, e_B)}{\partial \alpha} = -\frac{g}{2\omega A^2 \sqrt{(\Delta X)^2 + \frac{3g^2}{\omega A} - \Delta X}} \frac{\partial A}{\partial \alpha},
\]

(17)

where

\[
\frac{\partial A}{\partial \alpha} = \frac{yk}{n} \left[ 1 - \frac{1 + e_B}{1 - e_B + 2e_B\kappa} \right] \\
- \frac{yk}{n} \frac{\partial e_B}{\partial \alpha} \frac{\alpha(1 - \kappa)(1 + e_B)}{\left[ 1 - e_B + 2e_B\kappa \right]^2} \\
+ \frac{yk}{n^2} \left[ 1 - \frac{1 + e_B}{1 - e_B + 2e_B\kappa} \right].
\]

(18)
If and only if $\alpha < \bar{\alpha}$, we have $\frac{\partial A}{\partial \alpha} < 0$, $\frac{\partial \theta(\kappa, e_B)}{\partial \alpha} > 0$, $\frac{\partial^2 \theta(\kappa, e_B)}{\partial \alpha \partial y} > 0$, $\frac{\partial^2 \theta(\kappa, e_B)}{\partial \alpha \partial \omega} > 0$, and $\frac{\partial^2 \theta(\kappa, e_B)}{\partial \alpha \partial \omega} < 0$.

A larger block raises the manager’s incentives to undertake positive-NPV long-term investment projects that risk interim turbulence, because the stock price fall upon emitting a bad signal is attenuated. Hence blockholders can add value, even in the absence of an underlying effort conflict and the ability to intervene, by promoting investment. The corollary to this result is that a key cost of dispersed ownership is myopia, rather than the shirking traditionally focused upon (e.g., Roe (1994)). This has important policy implications: if effort is the main problem, equity compensation and a more active takeover market are potential solutions. However, if myopia is the principal issue, such measures make it worse.

A higher $\alpha$ is more valuable for a firm with profitable investment opportunities for two reasons. First, raising $\alpha$ has a proportional effect on $\theta$: since $\theta$ is initially larger if $g$ is higher, the increase in $g$ is greater ($\frac{\partial^2 \theta(\kappa, e_B)}{\partial \alpha \partial y} > 0$). Second, the consequent uplift to firm value is a function of $g^\frac{\partial \theta(\kappa, e_B)}{\partial \alpha}$. However, if $g$ is very high, $\theta = 1$ and $\frac{\partial \theta(\kappa, e_B)}{\partial \alpha} = 0$: the investment opportunity is sufficiently attractive that the manager pursues it to the fullest extent even in the absence of a blockholder. In a similar vein, the impact of higher block size is greatest for moderate levels of $\omega$. If the manager is greatly concerned with interim performance, he will still act myopically even in the presence of a blockholder ($\frac{\partial^2 \theta(\kappa, e_B)}{\partial \alpha \partial \omega} < 0$). On the other hand, if stock price is not a concern, the manager invests efficiently in the first place. By contrast, the importance of a block is monotonically increasing in information asymmetry. Projects with high $y$ both suffer the greatest underinvestment (since $\frac{\partial \theta(\kappa, e_B)}{\partial y} < 0$) and are especially encouraged by a large shareholder (since $\frac{\partial^2 \theta(\kappa, e_B)}{\partial \alpha \partial y} > 0$).

In sum, blockholders are particularly valuable in firms for which motivating long-term investment is a “critical” issue. I define the “criticalness” of a problem as the potential increase in firm value attainable from solving the problem and achieving the first-best outcome. Criticalness is not only non-monotonic in the profitability of investment $g$ but also depends on many other factors. Investment is not a critical issue either if it is unimportant for firm value ($g$ is low) or efficient anyway ($g$ is high, $y$ and $\omega$ are low, or investment is contractible).

Thus far, $\kappa$ has been taken as exogenous. In equilibrium it depends on $\theta$: as $\theta$ increases, $s_b$ is more likely to be associated with a high-quality firm. Let the proportion of high-quality firms in the economy be $q \leq \frac{1}{2}$. This leads to Lemma 7 below:

**Lemma 7** Taking $\theta$ as exogenous, the prior probability that a firm emitting $s_b$ is of high quality is

$$\kappa(\theta) = \frac{q \gamma \theta^2}{q \gamma \theta^2 + 1 - q}.$$  

I can now derive comparative statics regarding the equilibrium investment $\theta^*$, allowing for the endogeneity of $\kappa$, $\theta$ and $e_B$. Proposition 2 below represents the main result of the paper. 

17
Proposition 2  The manager invests efficiently ($\theta^* = 1$) regardless of block size if the level of information asymmetry $\eta$ and the manager’s weight on the current stock price $\omega$ are sufficiently low, and the productivity of investment $g$ is sufficiently high. If $\theta^* < 1$, investment

(i) increases with the productivity of investment $g$.

(ii) increases with block size $\alpha$ if and only if $\alpha < \overline{\alpha}$. This increase is particularly large when the productivity of investment $g$ and information asymmetry $\eta$ are high, and the manager’s weight on the current stock price $\omega$ is low.

(iii) increases with the proportion of good firms in the economy $q$.

4.1.1 Does Liquidity Deter Investment?

In previous papers, where the blockholder’s value added stems from voice, liquidity may be undesirable as it allows her instead to exit (Bhide (1993)).\textsuperscript{17} Voice and exit are mutually exclusive and thus facilitating one hinders the other. For example, Aghion, Bolton and Tirole (2004) entitle their analysis “liquidity versus incentives.” Here, the blockholder adds value through retaining her stake through interim turbulence, increasing investment ex ante. Since loyalty and exit are similarly mutually exclusive, it might seem that liquidity is also undesirable in this model by encouraging exit. This is indeed the conventional wisdom: liquidity allows shareholders to sell upon weak earnings and thus makes managers even more concerned with short-term financial results. A number of commentators (e.g., Porter (1992)) attributed the alleged underinvestment of U.S. firms to liquid capital markets, and called for policy intervention to reduce liquidity.

This papers shows that liquidity can promote investment, and thus has very different policy implications. Although loyalty and exit are indeed mutually exclusive, this paradoxically leads to complementarities between them. The power of loyalty relies on the threat of exit. By making exit more feasible, increased liquidity renders loyalty more meaningful. In this model, the blockholder does not promote investment simply by being a “long-term” investor who never sells; instead it is the possibility of selling in the short-run that encourages the manager to make long-term decisions. Indeed, if market illiquidity compelled the blockholder always to hold for the long-run, she has no effect on stock prices and investment. The fact that she has not sold upon bad news is meaningless as she was unable to sell in the first place.

This marks an important distinction from intervention models. If the blockholder has no control rights, allowing her to sell in the short-term is desirable. In the absence of trading she has no effect, but the possibility of interim selling can promote long-term investment. By contrast, if the blockholder is interventionist and has the possibility of short-term selling, she may step in and force the manager to undertake myopic decisions. Therefore, not only is it

\textsuperscript{17}Bhide’s conclusion applies in particular to models where block size is exogenous and the blockholder chooses between either intervention or intentional exit. Maug (1998) shows that liquidity is desirable to allow block formation in the first place. Faure-Grimaud and Gromb (2004) demonstrate that liquidity encourages intervention as it allows the stock price to reflect these value gains and thus the blockholder to earn a return if she has to exit unexpectedly, due to a liquidity shock.
unnecessary for blockholders to have control rights in order to add value to a firm, but it may also be undesirable: to the extent that blockholders have short-term considerations, it may be better to deny them control rights else they induce myopia.

Shareholder trading has been argued to deter investment. However, it is only harmful if it is guided by earnings rather than fundamental value, but the conventional view lacks a theoretical framework to explain why investors would sell upon weak earnings. In an unbiased market, the stock price reacts immediately to public information such as earnings, and so there is no rational reason to exit upon short-term losses. Investors can only profit by trading on private information, and so trading is desirable as it impounds private information into the stock price: particularly if the trader has a large stake and so has acquired fundamental value information.

However, the optimal liquidity is finite. As shown in Section 3.3, with \( \nu \) fixed, increasing \( \alpha \) has a non-monotonic effect on the expected price and the optimal \( \alpha \) depends on \( \nu \). Similarly, fixing \( \alpha \), increasing \( \nu \) also has a non-monotonic effect on market efficiency, and the optimal \( \nu \) depends on \( \alpha \). Differentiating (8), the \( \nu \) which maximizes market efficiency, and thus investment, is bounded at

\[
\nu = \frac{\alpha^2}{1 - \alpha e_B(1 - e_B + e_B\kappa)}.
\]

Market efficiency depends on two factors: how much information the blockholder gathers, and the extent to which this information is impounded into prices. While liquidity unambiguously increases monitoring through augmenting trading profits, it also camouflages her trades and reduces their price impact. If there is zero liquidity, the blockholder does not monitor; if liquidity is infinite, the blockholder does not affect prices. The non-monotonic effect of liquidity contrasts with previous papers such as Holmstrom and Tirole (1993) and Faure-Grimaud and Gromb (2004), where augmenting liquidity always increases stock price informativeness. There is no camouflage effect as the informed investor’s trades are unbounded; here, the blockholder’s maximum sale is capped at \( \alpha \) due to short-sales constraints.

The optimal \( \alpha \) is therefore increasing in \( \nu \), and the optimal \( \nu \) is increasing in \( \alpha \). The U.S. stock market is believed to have high \( \nu \) and low \( \alpha \). It could therefore be argued that liquidity is “too high” given low \( \alpha \), leading to calls for reduced liquidity. However, low \( \nu \) and \( \alpha \), although mutually consistent, is undesirable as it is associated with low market efficiency. Instead, the current situation should be viewed as \( \alpha \) being “too low” given high \( \nu \), and so policy interventions should be directed towards increasing \( \alpha \). A high \( \alpha \) leads to blockholders’ trades being even more reflective of fundamental value, and reduces the likelihood that such trades are camouflaged. High \( \nu \) and \( \alpha \) are both mutually consistent and associated with high market efficiency.

4.1.2 Further Applications of the Investment Model

In the general model, \( \theta \) is any action that boosts fundamental value but risks of emitting the bad signal. Thus far, \( \theta \) has been interpreted as intangible investment and \( s_b \) as short-term losses, but there are many additional applications. \( s_b \) is any observable action or characteristic
that reduces outsiders’ assessment of firm quality since it is also consistent with a low-quality firm. Therefore, $\theta$ can represent fully observable investment for which the motive is unknown. The fundamental problem with investment is that the associated expenditures are difficult to interpret. An unexpected increase in cash outflows could mean that management is wasting resources (bad news about agency problems), expenditures required to support current activities are higher than expected (bad news about operating costs), or investment opportunities are unexpectedly favorable (good news) (Myers (1989)). For example, atomistic shareholders can costlessly observe from financial statements that a firm has increased R&D. They do not know whether this increase results from managerial excess, the failure of existing R&D efforts, or efficient exploitation of new growth opportunities. Upon observing significant investment for which the motive is unclear, the blockholder will gather information and trade accordingly.

Low $\theta$ can also represent the pursuit of myopic actions which boost the interim stock price (and thus reduce the risk of being interpreted as low quality) at the expense of long-term fundamental value, such as accounting manipulation\(^{18}\) or “milking” customer reputation through lowering product or service quality. Bergstresser and Philippon (2006) and Peng and Roell (2006) find that equity compensation encourages executives to manipulate earnings. Allowing the manager of a low-quality firm to undertake a value-destructive action that gives a probability of yielding $s_g$ would reinforce the results of the core model. In addition, low $\theta$ can represent overinvestment: pursuing visible negative-NPV projects to trick the market into thinking that the firm is of high quality (as believed to be prevalent in the recent Internet bubble). This is particularly the case if the level of investment is observable but the quality is not, as in Bebchuk and Stole (1993) and Bizjak, Brickley and Coles (1993). The model simply requires low $\theta$ to be detrimental to fundamental value, and is agnostic as to whether this involves underinvestment or overinvestment. The presence of a blockholder reduces the CEO’s ability to deceive the market about his firm’s quality, even in the short-run.

4.2 Managerial Effort

The core model involved no managerial effort decision, to illustrate how blockholders can add value even absent the effort conflict assumed in prior literature. It focused on the myopia issue owing to its perceived importance today, but the paper’s trading mechanism has far more general applications in attenuating other agency problems, including shirking. This sub-section extends the model to show that blockholders can also elicit effort without intervention.

All firms are now identical at time $t = -1$. The manager exerts effort of $e_M \in [0, 1]$ at personal cost $\frac{1}{2}e_M^2$. With probability $ze_M$, the firm becomes high quality, and then chooses $\theta \in [0, 1]$ at $t = 0$ as before. $\frac{1}{2} < z$ measures the effectiveness of effort. With probability $1 - ze_M$, the firm becomes low quality and there is no additional decision at $t = 0$. The manager knows that he will choose $\theta^*$ if his effort is successful. His objective function is thus given by

---

\(^{18}\)One direct cost of accounting manipulation is economically costly lawsuits (Peng and Roell (2006)). Goldman and Slezak (2006) also show that equity-based compensation induces manipulation, and assume that such activities consume corporate resources, thus eroding fundamental value.
\[
ze_M \left\{ \omega \left( X_l + \left( y\theta^2 E[\pi | X_h] + 1 - y\theta^2 \right) (\Delta X + g\theta^*) \right) + (1 - \omega) (X_h + g\theta^*) \right\} \\
+ \left(1 - ze_M \right) \left\{ \omega \left( X_l + E[\pi | X_i](\Delta X + g\theta^*) \right) + (1 - \omega) X_i \right\} - \frac{1}{2} e_M^2.
\]

He chooses initial effort level\(^{19}\)

\[
e^*_M = \min \left( z \left( \Delta X + g\theta^* \right) \left[ 1 - \omega E[\pi | X_i] - \omega y\theta^2 \left( 1 - E[\pi | X_h] \right) \right], 1 \right).
\]

If the solution is interior,

\[
\frac{\partial e^*_M}{\partial \alpha} > 0 \text{ if and only if } \alpha < \bar{\alpha}.
\]

Effort is naturally increasing in its effectiveness \(z\). If these parameters are sufficiently high, then effort is at its first-best level of 1 even for low \(\alpha\), and shirking is not a critical issue. Assuming an interior solution, effort is increasing in \(\alpha\) for two reasons. First, assume that \(\theta\) is not a choice variable. As shown in Section 3, higher \(\alpha\) raises the difference in the \(t = 2\) prices of high and low quality firms. Since the manager attaches weight \(\omega > 0\) to the stock price, effort incentives rise. In previous models, the principal monitors to find out \(e^*_M\); such monitoring is required since the \(t = 3\) outcome is not a sufficient statistic, but affected by luck as well as effort. In this paper, monitoring produces no additional information about \(e^*_M\) but instead allows the blockholder to learn the same information \((V)\) earlier. Thus the effects of effort are impounded into the \(t = 2\) share price, encouraging the manager to exert personally costly effort that only pays off in the long run. This effect is shared with Admati and Pfeiderer (2006), and is particularly strong for high \(\omega\) and \(z\), i.e., \(\frac{\partial^2 e^*_M}{\partial \omega \partial \alpha} > 0\) and \(\frac{\partial^2 e^*_M}{\partial \alpha \partial z} > 0\).

Second, take into account the fact that \(\theta\) is a choice variable. This leads to an effect not featured in Admati and Pfeiderer. High \(\alpha\) allows the manager to select a greater \(\theta\) if the firm becomes successful. Anticipating this, he exerts more effort at \(t = -1\) to ensure success in the first place. In other words, the manager expends effort in launching a new product, not only because the first model will boost the firm’s fundamental value and share price, but also because it gives him the option to launch future models. This option to upgrade in the future is particularly valuable if the firm has a blockholder to allow such follow-on investments to be pursued.

The results for this subsection are summarized in Proposition 3:

**Proposition 3** The manager exerts the efficient level of effort \((e^*_M = 1)\) regardless of block size if the effectiveness of effort \(z\) is sufficiently high. If \(e^*_M < 1\), effort

(i) increases with block size \(\alpha\) if and only if \(\alpha < \bar{\alpha}\), and
(ii) increases with its effectiveness \(z\).

\(^{19}\)This formulation assumes \(\theta^*\) is independent of \(e_M\). In reality, raising \(e_M\) augments \(\kappa\) and thus \(e_B\), further increasing \(\theta^*\) which reinforces the effect in this equation. This effect is not included in the equation for clarity.
4.3 Optimal Block Size

Thus far, $\alpha$ has been taken as exogenous and the analysis has focused on the $\alpha$ that maximizes market efficiency. This subsection first analyzes the socially optimal $\alpha$ that maximizes firm value net of the costs of blockholders. I then show that the privately optimal $\alpha$, which is more likely to be observed empirically, may differ substantially owing to free-rider problems. Both analyses use the extended model involving costly managerial myopia with an effort decision.

The socially optimal $\alpha$ can be achieved (at least temporarily) in practice if the firm is owned by a founding entrepreneur who is taking the company public, a formulation used by Faure-Grimaud and Gromb (2004) and Kahn and Winton (1998). The founder will choose the shareholder structure that maximizes firm value, for instance by bringing in a blockholder prior to an IPO (Field and Sheehan (2004)). His objective function is given by

$$W(\alpha) = V(\alpha) - \Psi(\alpha),$$

where

$$V(\alpha) = e^*_M(X_h + g\theta^*) + (1 - e^*_M)X_l,$$

$$\Psi(\alpha) = \frac{1}{2c_B}(1 - e^*_M + e^*_Mg\theta^*)^2\left[\frac{n - \alpha}{n}\right] \kappa(1 - \kappa)(\Delta X + g\theta^*)^2.$$

There are two costs of blockholders endogenized by this model. The first is the indirect cost resulting from reduced liquidity, which is only suffered for $\alpha > 1 - \sqrt{\frac{1}{1+\nu}}$. This cost is contained within the $\theta^*$ and $e^*_M$ terms within $V$. The second is the direct cost of expected monitoring expenses, $\Psi(\alpha)$. This cost is borne for all levels of $\alpha$ and lowers IPO proceeds as the blockholder demands compensation for his expected monitoring. While the blockholder enjoys private benefits from monitoring in the form of trading profits, these come at the expense of small shareholders and thus cancel out in equation (20).\(^{20}\)

The marginal effect of raising $\alpha$ on firm value is

$$\frac{\partial W}{\partial \alpha} = \frac{\partial e^*_M}{\partial \alpha}(\Delta X + g\theta^*) + e^*_M\frac{\partial \theta^*}{\partial \alpha} - \frac{\partial \Psi}{\partial \alpha}. \quad (21)$$

The first two terms represent the effects of a higher block on managerial effort and long-term investment. These are positive for $\alpha < \bar{\alpha}$. Owing to the increased monitoring expenses captured by the third term, the socially optimal block size, $\alpha^*$, is less than $\bar{\alpha}$, the level that maximizes market efficiency. $\alpha^*$ is determined by the intersection of the benefit and cost functions. It thus decreases with the cost of information acquisition and rises with the magnitudes of $\frac{\partial e^*_M}{\partial \alpha}$ and $\frac{\partial \theta^*}{\partial \alpha}$, i.e., the criticalness of the investment and effort issues. (Recall that this is a different

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\(^{20}\)The objective function assumes that the liquidity traders in the model are the small shareholders who subscribe to the IPO. Hence the blockholder’s gains from informed trading do not appear in the objective function as they are pure transfers from atomistic shareholders. If some liquidity trades originate from investors outside the original shareholder base, the IPO proceeds and optimal $\alpha$ are both higher.
concept from the productivity of investment and effort, \( g \) and \( z \).

If \( \frac{\partial \sigma^*_M}{\partial \alpha} = \frac{\partial \sigma^*}{\partial \alpha} = 0 \), either because effort and investment are at their first-best levels regardless of \( \alpha \) (e.g., \( \omega = 0 \), or these decisions are contractible), or neither decision is important (\( g = z = 0 \)), efficient prices have no impact on managerial decisions. Therefore, monitoring is socially wasteful as it expends resources and does not increase total surplus, merely achieving wealth transfers to the blockholder from small shareholders. This result echoes Stiglitz (1981), who shows that increased financial market efficiency is alone insufficient to raise product market efficiency. The optimal block size is zero in these cases.

I now analyze a shareholder’s private incentives to acquire a block on the open market when ownership is initially dispersed. Assume that the shareholder buys \( \alpha \) at \( t = 0 \) and her purchase is perfectly observed. Selling shareholders will anticipate the increased firm value resulting from the imminent block formation. Per share, they will demand

\[
P_0 = e^*_M(Xh + g\theta^*) + (1 - e^*_M)Xl - \alpha \left( \frac{n - \alpha}{n} \right) e_B \kappa (1 - \kappa)(\Delta X + g\theta^*),
\]

where the first two terms represent expected firm value given block size \( \alpha \), and the third term denotes expected trading losses. Since the direct value of the block is \( e^*_M(Xh + g\theta^*) + (1 - e^*_M)Xl \), the blockholder’s overall payoff is

\[
\begin{align*}
\alpha & \left( \frac{n - \alpha}{n} \right) e_B \kappa (1 - \kappa)(\Delta X + g\theta^*) \\
+ & \left[ \alpha \left( \frac{n - \alpha}{n} \right) e_B \kappa (1 - \kappa)(\Delta X + g\theta^*) - \Psi(\alpha) \right] \\
= & 2\alpha \left( \frac{n - \alpha}{n} \right) e_B \kappa (1 - \kappa)(\Delta X + g\theta^*) - \Psi(\alpha).
\end{align*}
\]

The first term is the blockholder’s gain from buying shares at a discount at \( t = 0 \): existing shareholders will sell at a discount because they fear future trading losses against an informed investor. The second term is the actual realized trading gains, less the costs of information gathering. The shareholder’s private incentives to acquire a block are driven purely by her expected trading gains, and are independent of the social benefits which depend on \( \frac{\partial \sigma^*_M}{\partial \alpha} \) and \( \frac{\partial \sigma^*}{\partial \alpha} \). The crux of the misalignment is free-riding by small shareholders, which prevents the blockholder from sharing in the value creation, as in Grossman and Hart (1980). If the real benefits are sufficiently high, blocks will be inefficiently small. Consistent with Bhide (1993), government policies to encourage dispersed ownership in all cases may be misguided, since private incentives to acquire blocks are sometimes inadequate. Somewhat surprisingly, the privately optimal \( \alpha \) may be too high. If managerial decisions are not critical, monitoring effort is a deadweight cost which merely leads to the blockholder profiting from liquidity investors. Blocks may therefore form in the wrong stocks. For example, private trading profits are monotonically increasing in uncertainty (\( \kappa(1 - \kappa) \)) and liquidity \( \nu \), but blocks are most socially desirable where liquidity is moderate.
In practice, the presence of liquidity traders at \( t = 0 \) allows the block to form anonymously, as in Kyle and Vila (1991). In the extreme, she will be able to acquire shares for \( V(0) \), the expected firm value under dispersed ownership. This price is neither inflated by the prospective value creation, nor discounted by the expected trading losses. The blockholder’s payoff becomes

\[
\alpha [V(\alpha) - V(0)] + \alpha \left( \frac{n - \alpha}{n} \right) e_B \kappa (1 - \kappa) (\Delta X + g \theta^*) - \Psi(\alpha),
\]

compared to the social gains of

\[
V(\alpha) - V(0) - \Psi(\alpha).
\]

Private and social incentives still do not coincide owing to a second free-rider problem. Even if the blockholder can acquire her stake anonymously, she only enjoys \( \alpha \% \) of the increase in firm value, similar to Shleifer and Vishny (1986). Her incentives continue to be inflated by the potential trading gains, and so the privately optimal \( \alpha \) is again too high or too low.

Reality is likely to lie between the two extremes of equations (22) and (23). Therefore, the blockholder’s incentives are partially aligned with social objectives.

5 Empirical Predictions

The model generates a number of empirical implications. Many of these are quite different from the empirical observations that motivated this paper: the potential importance of managerial myopia in many firms and the prevalence of non-controlling blockholders in the U.S. Individual predictions are not intended to be exclusive tests of the model: while some are supported by existing empirical results, other models (involving effort and/or intervention) may generate the same prediction and new empirical tests would be needed to distinguish them. However, the combination of predictions appears unique to a model which features blockholder trading to promote investment.

These predictions naturally assume that other variables are held constant. To be consistent with the model, tests should exclude blockholders who never (or very rarely) trade on information, such as families or index funds. For brevity, predictions on the effects of block size assume that the market liquidity constraint is not hit. If block size becomes too large, the predicted relationships change direction.

**Prediction 1:** Blockholders should be more prevalent in firms with abundant long-term opportunities that exhibit information asymmetry.

From equation (21), the optimal \( \alpha \) is highest when the productivity of investment (\( g \)) and the manager’s short-term concerns (\( \omega \)) are moderate, and information asymmetry (\( y \)) is high.\(^{21}\)

---

\(^{21}\)Equation (21) refers to the socially desirable \( \alpha \). The privately optimal \( \alpha \) is most likely to be observed empirically. Since private and social incentives are partially aligned, predictions can be made using the social optimum, although the strength of the empirical relationship may be reduced by the two free-rider problems.
While the core model considers a single project for clarity, it naturally extends to multiple investment opportunities. Firms with abundant long-term opportunities may have some exceptionally profitable projects that would be pursued anyway, but likely also have moderate investments that require a blockholder to be implemented.

At least three types of firm satisfy these criteria, and thus should feature blockholders. First, firms with low equity analyst coverage exhibit high information asymmetry. Second, R&D-intensive companies feature both abundant growth opportunities and information asymmetry. Indeed, a number of empirical papers use R&D to measure information asymmetry *because* it proxies for growth opportunities, e.g., Bizjak et al. (1993) and references therein.

Third, many start-up firms have both features. Indeed, fledgling companies are commonly privately owned; while the advice and expertise provided by venture capital investors is a primary reason for this financing structure, the protection of a fledgling company from the demands of the stock market is another plausible advantage. When such firms go public, the venture capitalist often retains a large stake for a significant period.

**Prediction 2: Blockholders lead to long-term behavior.**

This prediction directly follows from Proposition 2. While Prediction 1 concerns firm characteristics that will attract blockholders, this prediction addresses the effect of blockholders on the firm. Long-term behavior can be measured by investment (R&D/sales or capex/sales), earnings management, or the capitalized value of growth opportunities (Tobin’s $q$). Burns et al. (2006) find that ownership concentration reduces the likelihood and severity of financial restatements. This is consistent with the model: firms with concentrated owners will have lower incentives to manage earnings (and thus are less likely to have to restate earnings later), since the blockholder will likely not be fooled by the inflated earnings announcement. On the other hand, dispersed quasi-indexing institutions are associated with more earnings restatements, likely because they trade on publicly announced earnings rather than engaging in monitoring.

Since $\alpha$ is endogenous, cross-sectional tests may have difficulty in assigning causality and thus distinguishing between Predictions 1 and 2; yet since both predictions are generated by the model, a correlation would be supportive. To address this issue, Cronqvist and Fahlenbrach (2006) use a time-series approach, tracking individual blockholders over time. This has the potential to test Prediction 2 in particular. They find that the appearance of certain blockholders in a corporation leads to a significant increase in investment. Their timing analysis suggests the relationship is causal, rather than a result of selection. One argument against their causal interpretation is that it is unlikely that blockholders can change corporate policies, given substantial barriers to intervention. This paper shows that causation is possible without intervention: the arrival of the blockholder allows the manager to pursue investment projects that he previously avoided owing to fears of interim turbulence. Similarly, one way to test Prediction 1 in particular may be to look at ownership structure when a firm undergoes an IPO. Field and Sheehan (2004) find that the percentage ownership of corporate blockholders is
significantly increasing in the ratio of R&D and advertising expenses to sales.\footnote{A number of empirical papers show that long-term behavior is increasing in institutional ownership, which is likely correlated with ownership concentration. These findings contradict conventional wisdom that institutional owners exacerbate myopia. Examples include Wahal and McConnell (2000) who show a positive association between institutional ownership and R&D, and Cadman and Sunder (2007) who find that institutional ownership leads to longer-horizon equity incentives for CEOs.}

Predictions 1 and 2 appear unique to a model where the blockholder’s principal role is to induce investment. They thus have the potential to distinguish this paper from existing theories focused upon effort. However, they also could be generated by a model where the blockholder intervenes to optimize investment. These explanations can be distinguished by examining the aforementioned evidence on barriers to intervention in the U.S., and through Prediction 3 below which is specific to a theory of blockholder trading.

**Prediction 3:** Blockholders increase price efficiency.

Proposition 1 states that prices reflect fundamental value faster in the presence of blockholders, not only because the blockholder herself has a large incentive to gather information, but also because other market participants infer information from her trading decisions.

Amihud and Li (2006) find that the price reaction to dividends is significantly smaller for firms with higher institutional ownership; their interpretation is that institutional investors have already gathered and traded upon the information that would be conveyed by the dividend change. While institutional ownership is likely correlated with blockholdings, it would be valuable to study the impact of blockholdings directly. Additional tests could involve measures of price efficiency, such as Hou and Moskowitz’s (2005) measure of the delay with which the stock price responds to information, and event-drift anomalies such as post-earnings announcement drift. As with Prediction 2, empirical tests will have to account for the endogeneity of $\alpha$: inefficient prices likely attract blockholders, weakening the positive relationship between block size and price efficiency generated by a simple comparative statics analysis.

**Prediction 4:** Blockholdings are positively correlated with pay-performance sensitivity.

From Lemma 6, the value of a blockholder rises with pay-performance sensitivity (for low $\omega$) since myopia becomes a greater concern. This relationship should be particularly strong in industries where investment is important. Hartzell and Starks (2003) indeed find a significant positive correlation between institutional ownership concentration and pay-performance sensitivity.\footnote{Contract theory approaches do not have an unambiguous prediction for this relationship. Blockholders may be substitutes for managerial equity alignment in inducing effort, implying a negative correlation (as argued by Mehran (1995)). They may also be complements. Hartzell and Starks’s interpretation is that external monitors are able to force firms to raise pay-performance sensitivity to efficient levels. This paper offers an alternative explanation for causation that does not assume intervention: the appearance of blockholders attenuates myopia and allows firms to increase equity pay to elicit effort.}

**Prediction 5:** Block size is increasing in market liquidity.
Increased liquidity $\nu$ augments the optimal trading volume in the absence of short-sales constraints, and thus raises the socially optimal block size. In addition, greater liquidity may allow a block to form anonymously, reducing the Grossman and Hart (1980) free-rider problem, and therefore increases the privately optimal block size also. Standard measures of liquidity are likely to proxy for $n$, upon which block size has a direct negative effect; $\nu$ can be derived using the relationship $n = \nu(1 - \alpha)$.

**Prediction 6:** Large blockholders do not constitute the prevalent shareholding structure.

This prediction follows from equation (21). In intervention models, such as Shleifer and Vishny (1986) and Kahn and Winton (1998), firm value rises monotonically in block size. In isolation, they predict that the prevalent shareholding structure should be one of highly concentrated ownership. In my model, even ignoring monitoring costs (e.g., assuming they are second-order compared to real investment), a larger block is only beneficial up to a point ($\pi$). This is consistent with the finding that, while blockholders are common in the U.S. (Holderness (2006)), substantial blockholders are rare (La Porta et al. (1999)).

**Prediction 7:** Blockholder sales are associated with stock price declines.

In the model, block sales to lead to stock price declines since they convey negative information. The timing of the decline depends on the observability of the sale. If it is directly observed at the time (e.g., in secondary distributions), the stock price should decline immediately with no long-horizon drift. Indeed, Scholes (1972) and Mikkelson and Partch (1985) conclude that the negative stock price reaction to secondary distributions is due to information, rather than the sudden increase in supply or a reduction in expected blockholder monitoring. Mikkelson and Partch (1985) further find that the negative price impact is increasing in the size of the block sold but not the blockholders’ initial stake. This result supports the model’s prediction that it is the amount traded that matters, not $\alpha$ per se. In addition, the stock price changes show that blockholder trades do affect market prices.

If the block sale can only be observed by the econometrician ex post via proxy filings, it should lead to negative long-horizon drift as the bad news eventually becomes public. Parrino, Sias and Starks (2003) examine sales by institutional investors: like blockholders, they are likely to be more informed than individuals. They find that institutions sell in advance of forced CEO turnover (a sign of severe firm problems), and that the stock price drifts downwards after such

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24 This prediction is distinct from the motivating empirical observation that most U.S. blockholders are unable to intervene. This paper identifies a mechanism through which non-interventionist blockholders can add value, but it is not obvious (from the observation alone) that large blockholders add less value through this mechanism than small blockholders.

25 An exception is negotiated trades between blockholders: since the purchaser is buying a large stake, she will undertake extensive due diligence to ensure she is not trading against unreleased information. Instead, such trades often lead to blocks being transferred to a more efficient monitor, and are consequently associated with price increases (Barclay and Holderness (1991)).
sales. In separate work, I am analyzing the profitability of a “follow the leader” trading strategy based on blockholders’ trading disclosures.

6 Conclusion

Many existing theories illustrate the potential benefits of having blockholders. These models are particularly applicable to shareholders who have the power to intervene, and firms where an effort conflict is first-order.

However, the dominant shareholding structure in the U.S. is one of small blockholders. Compounded with substantial legal and institutional impediments to intervention, the benefits of previous models may be difficult to obtain. Moreover, recent increases in managers’ equity alignment may both attenuate shirking and exacerbate short-termism. For many modern firms, the fundamental challenge is building core competencies through intangible investment.

This paper illustrates that blockholders can bring substantial benefits to a firm, even in the absence of control rights or a shirking issue – indeed, they can address the critical problem of managerial myopia. By gathering and trading on non-verifiable information, prices reflect fundamental value rather than current earnings. In turn, this increased market efficiency encourages managers to take positive-NPV projects that risk interim turbulence. Contrary to popular perception, the liquidity of the U.S. stock market may be beneficial to long-term investment. By increasing the feasibility of exit, the loyalty provided by a blockholder upon weak financial results becomes particularly effective in attenuating the stock price decline. In the 1980s and early 1990s, many commentators predicted that the U.S. economy would be surpassed by Japan, particularly in R&D-intensive industries, as its liquid capital markets are a deterrent to investment. Such predictions have not materialized, potentially as liquidity can have a positive effect on investment. To the extent that the U.S. capital allocation system can be improved, policies should be targeted at encouraging larger stakes, rather than reducing liquidity.

While the core model focuses on the effect of blockholders on myopia, the trading mechanism in the paper can attenuate many other agency problems, such as shirking. Even more broadly, the model can be interpreted as showing how any agent that gathers information about fundamental value and incorporates it into prices can improve real efficiency. This illustrates a social benefit of short-sellers (such as hedge funds) and equity analysts, although these actors also reduce the marginal role for blockholders.

The model generates a number of new empirical predictions, some of which I intend to explore in future research. Blockholders should be associated with more efficient prices and greater long-term behavior by firms. They are particularly valuable for firms with abundant long-term investment opportunities that exhibit information asymmetry.

As with all models, the analysis in this paper is incomplete. This paper’s goal is to illustrate how and under what conditions blockholders can be a solution to myopia. It therefore treats the
underlying causes of myopia (the manager’s alignment with the stock price, and the presence of the interim signal) as exogenous, using previous research to motivate their existence.

One possible extension would therefore be to endogenize the manager’s stock price concerns. Even if he is paid according to long-run value, the manager will care about the share price if he expects to raise equity in the interim. The model can therefore illustrate how financial slack can promote long-term investment; while Easterbrook (1984) argues that the need to raise capital can have disciplinary benefits on the manager, it can also lead to short-termism. A second involves endogenizing the presence of the interim signal. In Edmans (2007c) I explore this issue to illustrate a real cost of mandatory disclosure, over and above the expenses of gathering and disseminating information. Laws can only mandate the reporting of “hard” information, such as financial numbers, and have difficulty in alleviating information asymmetry with regards to “soft” information. Mandatory disclosures may distort managers' incentives towards targeting hard numbers at the expense of intangible investment, particularly if ownership is dispersed. Sometimes no information is preferable to incomplete information.

A third extension considers shareholder structure. This paper’s analysis has focused on a single blockholder, but empirically many firms are held by more than one blockholder. Edmans and Manso (2007) analyze the effect of multiple blockholders on stock price informativeness.
Table 1: Key parameters in the model

<table>
<thead>
<tr>
<th>Parameter</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>( \alpha )</td>
<td>Blockholder’s stake</td>
</tr>
<tr>
<td>( s_g )</td>
<td>Good signal, emitted by high-quality firms only</td>
</tr>
<tr>
<td>( s_b )</td>
<td>Bad signal, emitted by both firm types</td>
</tr>
<tr>
<td>( P )</td>
<td>( t = 2 ) stock price</td>
</tr>
<tr>
<td>( V )</td>
<td>( t = 3 ) realized fundamental value</td>
</tr>
<tr>
<td>( X_l )</td>
<td>Fundamental value of a low-quality firm</td>
</tr>
<tr>
<td>( X_h )</td>
<td>Fundamental value of a high-quality firm</td>
</tr>
<tr>
<td>( \Delta X )</td>
<td>( X_h - X_l )</td>
</tr>
<tr>
<td>( q )</td>
<td>Proportion of high-quality firms in economy</td>
</tr>
<tr>
<td>( e_B )</td>
<td>Blockholder’s monitoring effort</td>
</tr>
<tr>
<td>( c_B )</td>
<td>Parameter for blockholder’s monitoring cost</td>
</tr>
<tr>
<td>( b )</td>
<td>Blockholder’s order</td>
</tr>
<tr>
<td>( \beta )</td>
<td>Blockholder’s equilibrium sale upon learning ( V = X_l )</td>
</tr>
<tr>
<td>( u )</td>
<td>Liquidity traders’ order. ( u \sim U[0, n] )</td>
</tr>
<tr>
<td>( n )</td>
<td>Maximum liquidity traders’ order. ( n = \nu(1 - \alpha) )</td>
</tr>
<tr>
<td>( \nu )</td>
<td>Liquidity parameter</td>
</tr>
<tr>
<td>( d )</td>
<td>Total order. ( d = b + u )</td>
</tr>
<tr>
<td>( \kappa )</td>
<td>Market maker’s prior that firm is of high quality if ( s_b ) is emitted</td>
</tr>
<tr>
<td>( \pi )</td>
<td>Market maker’s posterior that firm is of high quality after seeing ( s_b ) and ( d )</td>
</tr>
<tr>
<td>( \bar{\alpha} )</td>
<td>Blockholder’s stake that maximizes market efficiency</td>
</tr>
<tr>
<td>( \omega )</td>
<td>Manager’s alignment with ( t = 2 ) stock price</td>
</tr>
<tr>
<td>( \theta )</td>
<td>Long-term investment choice</td>
</tr>
<tr>
<td>( g )</td>
<td>Productivity of long-term investment</td>
</tr>
<tr>
<td>( y )</td>
<td>Information asymmetry</td>
</tr>
<tr>
<td>( e_M )</td>
<td>Manager’s effort</td>
</tr>
<tr>
<td>( z )</td>
<td>Productivity of managerial effort</td>
</tr>
</tbody>
</table>

Figure 1: Timeline of model
A Proofs

Proof of Lemma 2

The blockholder’s objective function is

\[
\frac{\beta \kappa \Delta X}{n} \left[ \left( n - \max(\beta, \beta) \right) \left( 1 - \frac{1 - e_B}{1 + e_B - 2e_B \kappa} \right) \right. \\
+ \left. \max(\beta - \beta, 0) \left( \frac{1 + e_B}{1 - e_B + 2e_B \kappa} - \frac{1 - e_B}{1 + e_B - 2e_B \kappa} \right) \right].
\]

The objective function may have up to two local maxima. If \( \beta \geq \hat{\beta} \), the local maximum is

\[
\beta = \frac{1}{2} \left[ \hat{\beta} + \left( n - \hat{\beta} \right) \left( 1 - \frac{1 - e_B}{1 + e_B - 2e_B \kappa} \right) \right. \\
+ \left. \max\left( \frac{n}{2}, \beta \right) \left( \frac{1 + e_B}{1 - e_B + 2e_B \kappa} - \frac{1 - e_B}{1 + e_B - 2e_B \kappa} \right) \right] = \tilde{\beta}(\hat{\beta}).
\]

Depending on \( \hat{\beta} \), either local maximum can be the global optimum. Assume first that \( \beta = \frac{n}{2} \) is the global optimum. For this to also be a Nash equilibrium, the market maker’s conjecture must be correct and so we now revise her belief to \( \hat{\beta} = \frac{n}{2} \). We must check that the blockholder is still optimizing. The objective function is now

\[
\frac{\beta \kappa \Delta X}{n} \left[ \left( n - \max\left( \frac{n}{2}, \beta \right) \right) \left( 1 - \frac{1 - e_B}{1 + e_B - 2e_B \kappa} \right) \right. \\
+ \left. \max\left( \frac{n}{2}, \beta \right) \left( \frac{1 + e_B}{1 - e_B + 2e_B \kappa} - \frac{1 - e_B}{1 + e_B - 2e_B \kappa} \right) \right]
\]

Again, there are two local maxima. If the blockholder continues to set \( \beta = \frac{n}{2} \), the value of the objective function is

\[
\frac{\kappa (1 - \kappa) n \Delta X \bar{e}_B}{2(1 + \bar{e}_B - 2\bar{e}_B \kappa)} \quad (24)
\]

The blockholder may deviate to the second local maximum of \( \beta = \tilde{\beta}(\frac{n}{2}) \), i.e.

\[
\beta = \frac{n}{4} \left[ \frac{1 + e_B}{1 - e_B + 2e_B \kappa} + 1 - 2 \frac{1 - e_B}{1 + e_B - 2e_B \kappa} \right] < \frac{n}{2}.
\]

Under \( \beta = \tilde{\beta}(\frac{n}{2}) \), the value of the objective function is

\[
\tilde{\beta}(\frac{n}{2}) \frac{\kappa \Delta X}{2} \left[ \left( \frac{\bar{e}_B(1 - \kappa)}{1 + e_B - 2e_B \kappa} + \frac{1}{2} \left( \frac{1 + e_B}{1 - e_B + 2e_B \kappa} - \frac{1 - e_B}{1 + e_B - 2e_B \kappa} \right) \right) \right. \\
- \left. \frac{1}{4} \left( \frac{1 + e_B}{1 - e_B + 2e_B \kappa} + 1 - 2 \frac{1 - e_B}{1 + e_B - 2e_B \kappa} \right) \right]. \quad (25)
\]

Since

\[
\frac{1}{2} \left( \frac{1 + e_B}{1 - e_B + 2e_B \kappa} - \frac{1 - e_B}{1 + e_B - 2e_B \kappa} \right) - \frac{1}{4} \left( \frac{1 + e_B}{1 - e_B + 2e_B \kappa} + 1 - 2 \frac{1 - e_B}{1 + e_B - 2e_B \kappa} \right) < 0
\]

and \( \tilde{\beta}(\frac{n}{2}) < \frac{n}{2} \), (24) is lower than (25). The blockholder indeed continues to set \( \beta = \frac{n}{2} \), and so
\[ \hat{\beta} = \beta = \frac{n}{2} \] is a Nash equilibrium.

Now assume that \( \beta = \hat{\beta}(\beta) \) is the global optimum. For this to be a Nash equilibrium, we set \( \hat{\beta} = \beta(\hat{\beta}) \) so that the market maker’s belief is correct. Solving for the fixed point yields

\[
\hat{\beta} = \frac{n \left( 1 - \frac{1 - \hat{e}_B}{1 + \hat{e}_B - 2e_B\kappa} \right)}{1 + \frac{1 + \hat{e}_B}{1 - e_B + 2e_B\kappa} - \frac{2(1 - \hat{e}_B)}{1 + e_B - 2e_B\kappa}}.
\]

The objective function is now:

\[
\frac{\beta \kappa \Delta X}{n} \left[ (n - \max(\hat{\beta}, \beta)) \left( 1 - \frac{1 - \hat{e}_B}{1 + \hat{e}_B - 2e_B\kappa} \right) + \max(\hat{\beta} - \beta, 0) \left( \frac{1 + \hat{e}_B}{1 - e_B + 2e_B\kappa} - \frac{1 - \hat{e}_B}{1 + e_B - 2e_B\kappa} \right) \right].
\]

Under \( \beta = \hat{\beta} \), the objective function is worth

\[
\kappa \Delta X n \left( \frac{2\hat{e}_B(1 - \kappa)}{1 + \hat{e}_B - 2e_B\kappa} \right)^2 \left( \frac{1 + \hat{e}_B}{1 - e_B + 2e_B\kappa} - \frac{1 - \hat{e}_B}{1 + e_B - 2e_B\kappa} \right) \left( 1 + \frac{1 + \hat{e}_B}{1 - e_B + 2e_B\kappa} - \frac{2(1 - \hat{e}_B)}{1 + e_B - 2e_B\kappa} \right)^2 < \frac{\kappa(1 - \kappa)\hat{e}_B n \Delta X}{2(1 + \hat{e}_B - 2\hat{e}_B\kappa)},
\]

which simplifies to

\[
\frac{4\hat{e}_B(1 - \kappa)}{1 + \hat{e}_B - 2\hat{e}_B\kappa} \left( \frac{1 + \hat{e}_B}{1 - e_B + 2\hat{e}_B\kappa} - \frac{1 - \hat{e}_B}{1 + e_B - 2\hat{e}_B\kappa} \right) < \left( \frac{2\hat{e}_B(1 - \kappa)}{1 + \hat{e}_B - 2\hat{e}_B\kappa} + \frac{1 + \hat{e}_B}{1 - e_B + 2\hat{e}_B\kappa} - \frac{1 - \hat{e}_B}{1 + e_B - 2\hat{e}_B\kappa} \right)^2.
\]

The above is of the form \( 2ab < (a + b)^2 \), which is always true. \( \beta = \hat{\beta} \) is therefore not a Nash equilibrium. The blockholder will deviate to \( \beta = \frac{n}{2} \). Hence the only Nash equilibrium is \( \beta = \frac{n}{2} \).

If the short-sale constraint binds, the blockholder sells \( \alpha \) upon negative information, and therefore \( \hat{\beta} = \beta = \alpha \) is the Nash equilibrium. Therefore, in general, \( \beta^* = \min \left( \frac{n}{2}, \alpha \right) \) as in equation (3). The blockholder chooses effort level \( e_B \in [0, 1] \) to maximize

\[
\beta^* \left( \frac{n - \beta^*}{n} \right) \left[ \kappa - \frac{(1 - e_B)\kappa}{1 + e_B - 2e_B\kappa} \right] \left[ \frac{1}{2} + \frac{1}{2} e_B - e_B\kappa \right] - \frac{1}{2} e_B^2 e_B^2
\]

where the first term in square brackets is the profit per unit if the blockholder’s information is not revealed\(^ {26} \) (which occurs with probability \( \frac{(n-\alpha)}{n} \)) and the second term in square brackets is the probability of receiving \( i_b \) and thus choosing to sell. This simplifies to

\(^ {26} \)This term contains \( e_B \), not \( \hat{e}_B \), since the value of the stock (privately known to the blockholder) depends on how much effort she has actually exerted.
\[ \beta^* e_B (1 - \kappa) \left( \frac{n - \beta^*}{n} \right) \kappa \Delta X - \frac{1}{2} c_B e_B^2. \]  

(26)

Taking first-order conditions derives \( e_B \) as given by (4).

**Proof of Equation 6 (Blockholder’s stake that maximizes effort)**

The chosen effort level is

\[
e_B = \alpha \left( \frac{n - \alpha}{n} \right) F
= \alpha \left( \frac{\nu(1 - \alpha) - \alpha}{\nu(1 - \alpha)} \right) F.
\]

Taking first-order conditions with respect to \( \alpha \) gives the effort-maximizing block size as

\[
\alpha = 1 - \sqrt{\frac{1}{1 + \nu}}.
\]

From earlier, \( \alpha < \frac{\nu(1 - \alpha)}{2} \), i.e., \( \alpha < \frac{\nu}{\nu + 2} \). It can be easily shown that \( 1 - \sqrt{\frac{1}{1 + \nu}} < \frac{\nu}{\nu + 2} \forall \nu \), and so \( \alpha = 1 - \sqrt{\frac{1}{1 + \nu}} \) is consistent with the constraint. Hence the optimal block size is less than the maximum sale volume \( \frac{n}{2} \), owing to the negative effect of block size on liquidity \( (n = \nu(1 - \alpha)) \).

**Proof of Lemma 5 (Project Choice)**

The non-trivial case is \( \theta(\kappa, e_B) < 1 \). Let

\[ A = \frac{y \kappa}{n} \left[ \frac{n}{\kappa} - n + \alpha - \frac{\alpha(1 + e_B)}{1 - e_B + 2e_B \kappa} \right]. \]

Since \((1 - e_B)(1 - \kappa) > 0, \frac{1}{\kappa} - 1 > \frac{1}{1 - e_B + e_B \kappa} - 1 \). Since also \( n > \alpha \), this leads to \( A > 0 \).

Setting the first-order condition (14) to zero, and applying the quadratic formula, yields

\[
\theta(\kappa, e_B) = \frac{\Delta X \pm \sqrt{(\Delta X)^2 + \frac{3g^2}{\omega A}}}{-3g}.
\]

Since \( \theta \geq 0 \), we take the negative root. Applying the constraint \( \theta(\kappa, e_B) \leq 1 \), this leads to equation (15):

\[
\theta(\kappa, e_B) = \min \left( \frac{\sqrt{(\Delta X)^2 + \frac{3g^2}{\omega A}} - \Delta X}{3g}, 1 \right)
\]

For \( \theta(\kappa, e_B) < 1 \),

\[ \]
The signs of the derivatives with respect to $\Delta X$, $\omega$ and $y$ can also be immediately derived.

**Proof of Lemma 6 (Project Choice)**

Assume $\theta(\kappa, e_B) < 1$. Differentiating (15) with respect to $A$ yields

$$\frac{\partial \theta(\kappa, e_B)}{\partial A} = \frac{g}{2\omega A^2 \sqrt{(\Delta X)^2 + \frac{3g^2}{\omega A}}} < 0 \quad (27)$$

From the definition of $\bar{\alpha}$, $\frac{\partial A}{\partial \alpha} < 0$ if and only if $\alpha < \bar{\alpha}$. Applying $\frac{\partial \theta(\kappa, e_B)}{\partial A} = \frac{\partial \theta(\kappa, e_B)}{\partial A} \frac{\partial A}{\partial \alpha}$ gives the condition for $\frac{\partial \theta(\kappa, e_B)}{\partial \alpha} > 0$.

Differentiating equation (27) with respect to $g$ yields $\frac{\partial^2 \theta(\kappa, e_B)}{\partial \lambda \partial g} < 0$, $\frac{\partial^2 \theta(\kappa, e_B)}{\partial \lambda \partial g} = \frac{\partial^2 \theta(\kappa, e_B)}{\partial \lambda \partial g} \frac{\partial A}{\partial \alpha} > 0$ if and only if $\alpha < \bar{\alpha}$. The other cross-partials can be derived similarly.

**Proof of Proposition 2 (Equilibrium Project Choice)**

The equilibrium is determined by the intersection of $\theta(\kappa, e_B)$, $\kappa(\theta)$ and $e_B(\kappa)$. In $(\theta, \kappa, e_B)$ space, $\kappa(\theta)$ and $e_B(\kappa)$ are both planes, and thus intersect with each other along a line. This line intersects with the line $\theta(\kappa, e_B)$ at a single point, which represents the equilibrium. Since all three functions are increasing in all arguments, any parameter change which induces an upward shift in one function, without decreasing the others, raises $\theta^*$. Using the results of Lemmas 3, 6 and 7 generates the results of Proposition 2.
References


[53] Lowenstein, Louis (1988): “What’s Wrong With Wall Street? Short-Term Gain and the Absentee Shareholder.” Addison-Wesley, Reading


38


