Paper: "The Wall Street Walk: When Blockholders Compete for Flows"

Author: Giorgia Piacentino, Washington University in St. Louis, and Amil Dasgupta, London School of Economics

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Taking a Run at the Wall Street Walk

Examining the Actors, their Motivations, and the Consequences

GIORGIA PIACENTINO, Washington University in St. Louis

Blockholders who are dissatisfied with a firm's management can act on their dissatisfaction by selling their shares in the firm, exerting downward pressure on the stock price and thus punishing the manager. This is called "the Wall Street Walk," and it has been shown that it can discipline the manager: he avoids misbehavior to avoid such selloffs by blockholders. However, the identity of the typical blockholder has changed significantly over the last 30 years: professional money managers, such as mutual funds, hedge funds, and pension funds, are now the main blockholders. It is not obvious that they have the same incentives that previous blockholders had, which raises an interesting question: Do these professional money managers actually do the Wall Street Walk? Or does the Wall Street Walk fail to discipline management when blockholders are money management professionals? Since such intuitional investors hold almost 80% of public equity, this is a critically important question for understanding corporate governance today. In a research paper in *The Journal of Finance*, Giorgia Piacentino and Amil Dasgupta develop a model that demonstrates that money managers may be unable to discipline firm managers via the Wall Street Walk.

What would you do if you held the stock of a company and learned that its CEO was acting against your interests? For example, he was taking excessive perks or acquiring firms in unrelated businesses only to build a corporate empire for himself? Surely you would sell your shares, walking away from the company before the actions of management were made public and the price of your stock plummeted. By selling, you would be doing the Wall Street Walk.

Would you act the same way if you were a money manager investing on someone else's behalf? Would you still perform the Wall Street Walk? In this case, selling the stock could reveal that you made a bad investment decision—you invested in a company with a bad manager! So, you might decide not to sell the shares to avoid revealing that you had made a bad decision by investing in the company in the first place. In other words, you might not do the Wall Street Walk in order to maintain a good reputation with your investors.

Blockholder potential

Blockholders are shareholders who own upwards of 3% of a company's shares. They are typically more involved in the firm than small shareholders, so they have more information about managerial actions. Because they have more at stake, blockholders are motivated to maintain a firm's value and use their investment power to ensure that managers act in the best interest of shareholders. When blockholders are unhappy with managerial decision making, Blockholders are shareholders who own upwards of 3% of a company's shares.

The incentives of money managers are not aligned with those of their clients.

they can sell their shares, initiating the Wall Street Walk. Since blockholders are large, their selling can depress stock prices. This can be an effective punishment for misbehaving managers when executive compensation is linked to the market price of equity. The threat of the Wall Street Walk has been established as an important disciplining device to prevent managerial misbehavior—if a CEO is considering acting against shareholders' interests, he may think twice if he anticipates it will result in a Wall Street Walk, in which block sales lead to decreased compensation for him.

Nowadays, most blockholders are money managers, such as mutual funds, hedge funds, and pension funds. Many of these money managers are passive buy-and-hold investors who may not respond quickly to information about managerial misbehavior. This raises an important question for corporate governance: Is the Wall Street Walk a credible threat in firms with institutional blockholders?

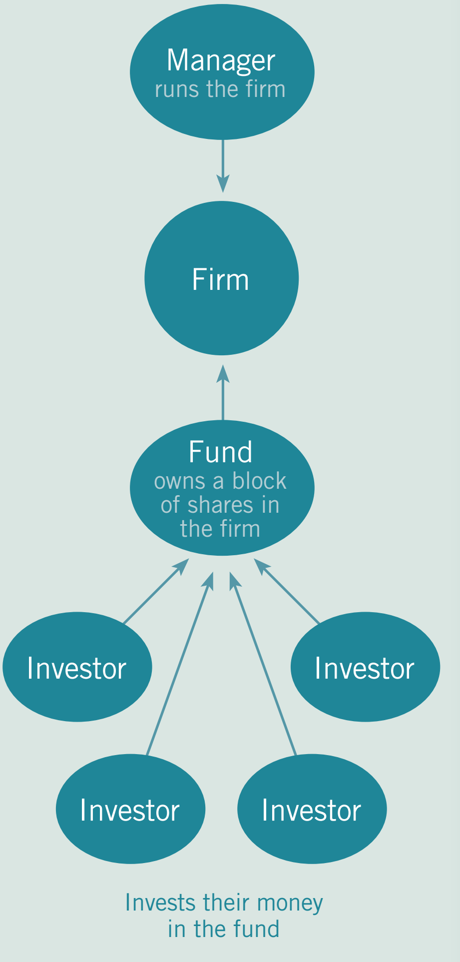
To address this question, Giorgia Piacentino of Washington University Olin Business School and Amil Dasgupta of London School of Economics developed a theoretical model. Dr. Piacentino describes the motivation for the research as follows: "In the last thirty years, the composition of shareholders has changed significantly in the United States. Before, shareholders were mainly rich individual investors who were trading shares on their own behalf. Nowadays, almost 80% of public equity is in the hands of mutual funds, hedge funds, and pension funds. They are not investing for themselves, but for others. Their incentives differ, and nobody has ever looked at how this affects the governance through exit."

The main finding of the paper is that the threat of exit is not an effective way for professional money managers to discipline corporate managers. The key to this result is the observation that investment professionals have different incentives than individual investors. Unlike individual investors, fund managers are not only concerned about portfolio returns, but are also concerned about maintaining a good reputation. A good reputation helps them to win new clients and to avoid losing old ones. When a blockholder cares about his reputation, he may turn a blind eye to underperforming management. This is because selling shares could reveal that he has made an unwise investment. Thus, money managers may retain underperforming shares, thereby sacrificing the disciplining of management. This finding overturns previous results that suggest the threat of blockholder exit acts as a governance mechanism.

What's their motivation?

In the model, money managers' reputation concerns generate a conflict of interest between them and their clients. Absent reputation concerns, a money manager who observes a corporate manager's misbehavior simply exit, liquidating his shares to maximize capital gains. This would not only maximize the wealth of investors in the fund, but also imposes a credible threat on corporate management, preventing their misbehavior. However, in the real world, things are more complicated. The incentives of money managers are not aligned with those of their clients. Fund managers worry that divesting large blocks is a tacit admission that forming the block was not a good investment in the first place. This could cause fund investors to question the fund manager's stock-picking ability. This concern about the potential damage to professional reputation may cause the fund manager to pause before exiting a firm in which the manager is not maximizing shareholder value. "We showed that some fund managers will not be able to discipline corporate managers by exit," says Piacentino. "The intuition is that the fund managers are motivated not only by their direct profits, but also by their reputations. This may induce the fund manager to avoid exit. But then if the fund doesn't exit, the firm's manager will not be disciplined, so firm value will not be maximized. Our analysis focuses on how this motivational dynamic affects the corporate governance problem."

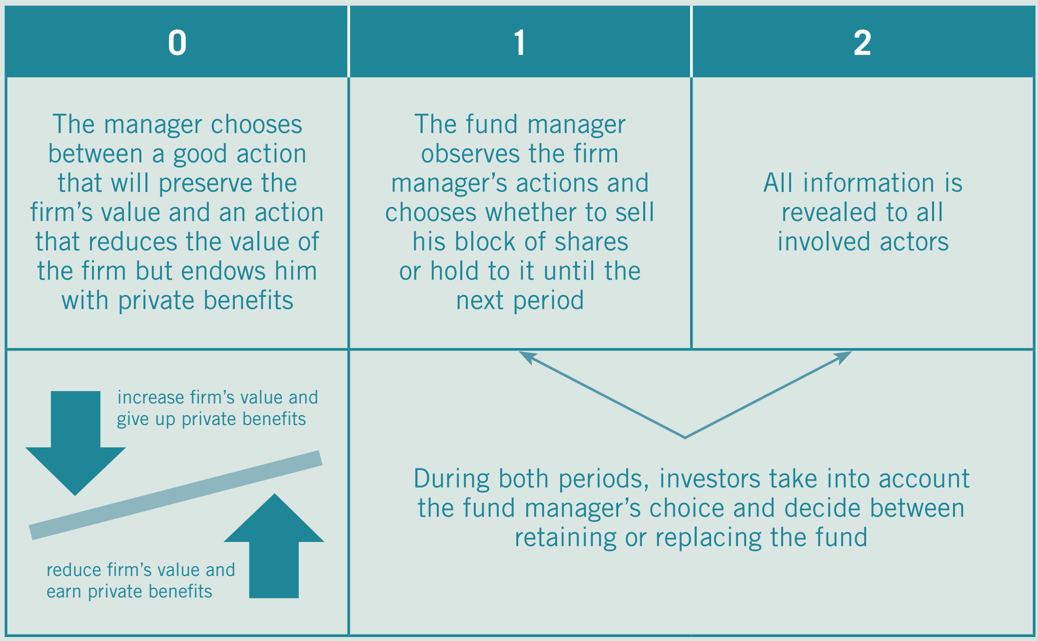
Figure 1



Mutual fund managers may act differently than hedge fund managers

Is there a way to discern whether a fund manager will be effective at governing via exit? Yes, by looking at the fees he charges the fund's clients. We demonstrate that funds, such as mutual funds, that derive only a small fraction of their fees from explicit profit-based compensation are less effective at governing firms than are funds, such as hedge funds, that derive a larger fraction of their fees from profit-based compensation.

Figure 2



According to the model, the fund manager will consider two components of fund income before deciding whether to exit. First, since the fund's profit from investing in the specific firm is usually calculated as a fraction of the return on investment, the fund manager must keep in mind the profitability of the firm in which he suspects mismanagement. Second, because the fund manager receives a payment from each client that is independent of fund performance, the fund manager is also interested in making sure that clients stay, something that requires the fund manager to have a good reputation for high ability. Thus, fund managers whose compensation is highly dependent on fund flows will care more about their reputations than they care about fund profits and will shy away from disciplining management. A fund manager whose compensation is linked more to fund profits (or return on investment) rather than to fund flows is more likely to discipline management by exiting a firm in which the manager is not maximizing shareholder value.

According to this theory, in mutual funds, where fund managers are not explicitly compensated based on return on investment but where fund flows are important, the fund manager will be relatively ineffective in using exit as a disciplinary device. By contrast, hedge funds, in which a significant fraction of compensation is based on return on investment, will be more effective in using exit as a source of corporate governance discipline. These are useful lessons for investors to keep in mind when deciding whether to invest in a mutual fund or a hedge fund, and also for individual investors who may want to consider which blockholders have major ownership in these firms and its implications for corporate governance.

Policy

Hopefully our result raises real-world stakeholders' awareness of the fact that the identity of their firms' blockholders is crucial for good governance. Stakeholders should encourage individual or hedge fund blockholders to increase firm value. Our research paves the way for future research on corporate governance, starting with the question of how stakeholders can ensure managerial discipline in a world in which upwards of 70% of shares are held by money managers. Can we alter money managers' fees to mitigate the problem, or should we not rely on blockholders to implement good governance?