Trading as a Stewardship Mechanism

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This is adapted from my 22/2/19 response to the Financial Reporting Council's consultation on the Stewardship Code (full response at http://bit.ly/AlexSCode) and my 15/4/17 response to the Financial Conduct Authority's Discussion Paper on the UK Primary Markets Landscape (full response at http://bit.ly/AlexFCA).

1.1 The stewardship mechanism of trading (also known as monitoring or exit) involves undertaking detailed analysis of long-term factors to decide whether to buy, hold, or sell stocks – and ensuring that decisions to buy, hold, or sell are based on these long-term factors rather than short-term profits or performance.

1.2 Unfortunately, many policymakers, investors, and companies equate stewardship with engagement (also known as voice) and do not recognise the crucial role of trading.

1.3 Trading is a critical stewardship mechanism for a number of reasons. First, the decision of which stocks to buy is fundamental to stewardship:

1.3.i An investor can only engage with a company if it has a stake in it. Moreover, its effectiveness in engagement depends, in part, on the size of its stake. A larger stake gives an investor greater "skin-in-the-game" and thus *incentives* to engage; it also gives the investor more votes and thus *power* to engage.

1.3.ii An investor buying shares increases the stock price. If an investor buys shares because the company has invested in intangible assets (such as corporate culture, human capital, supplier relationships, and R&D capability), despite low short-term earnings, this has two benefits. *Ex post*, it increases that company's stock price and reduces the risk that the CEO is fired due to poor short-term earnings. *Ex ante*, a CEO is more willing to invest for the long-term, and focus less on short-term earnings, if she knows that investors will buy her stock based on long-term factors.

1.3.iii Holding a stake in Company A has a significant opportunity cost – it prevents the investor reallocating its limited capital to Company B and thus being able to engage with Company B. An investor must therefore make its purchase decisions very carefully. It should not hold a stock simply by default, because it is part of the index. Doing so prevents it from having a more concentrated stake in another company. Every stock it owns should be a conviction holding, which the investor holds either because it believes in the company's long-term strategy and purpose, or because it believes that it can improve its long-term strategy and purpose through engagement. Indeed, even if an investor has a positive holding of a stock, if it holds less than the benchmark, it loses from good company performance. It thus has disincentives to undertake productive engagement or informed voting.

1.4 There is already a major concern that supposedly "active" funds are actually closet indexers. A 2016 study by the European Securities and Markets Authority found that up to 15% of active funds may be closet indexers.[1] The study was replicated the following year by the investor group Better Finance, which found that 165 out of 1,015 funds were potential closet indexers. Regulators and the industry must recognise the importance of carefully considering which stocks to hold, otherwise closet indexing may become worse. This in turn will aggravate the problem of the "ownerless corporation" – companies being disparately held by investors with little skin-in-the-game and spread too thinly to monitor and engage with the stocks they hold.

1.5 Some investors may indeed decide to hold only certain stocks, but make these decisions in box-ticking manner. For example, some socially responsible investors may rely excessively on screens, even though a stock that fails to tick the box for one dimension may outperform on other dimensions. Other investors devote substantial resources to these decisions, yet these decisions are not currently recognised as stewardship.

1.6 Second, the decision of whether to sell or retain a stock is fundamental to stewardship:

1.6.i Some investors sell a stock as a knee-jerk reaction to low short-term earnings, even if these low earnings are due to long-term investment. *Ex post*, such selling reduces the company's stock price and increases the risk that the CEO is fired due to poor short-term earnings. *Ex ante*, the CEO focuses more on short-term earnings, because she knows that low earnings will lead to investor sales.

1.6.ii However, some investors deeply analyse a stock, looking beyond its short-term earnings towards its long-term value. This is what I mean by "monitoring". They will retain a stock, despite low short-term earnings, if these low earnings stem from long-run investment. Equally importantly, they will sell a stock, despite high short-term earnings, if these earnings stem from forsaking long-run investment. *Ex post*, such selling punishes CEOs who fail to invest for the long-term – hence it is also known as "governance through exit". For example, Ford announced record profits in 2015 followed by its second-highest profits in 2016. However, the stock price fell 21% over those two years due to concerns that Ford was investing insufficiently in electric cars and autonomous driving systems, contributing to Mark Fields being fired as CEO in May 2017. *Ex ante*, knowing that investors will sell their stake if the company has not invested sufficiently – even if short-term earnings are high – encourages the CEO to invest in the first place.

1.6.iii An investor may also sell not due to any company mismanagement, but because it has completed a successful engagement and wishes to take its limited capital to turn around another company. For example, after turning around Adobe, investor ValueAct then sold its stake and invested in Seagate. Contrary to popular belief, activist investors do not "pump-and-dump", i.e. push for changes that boost short-term profits at the expense of long-term value, and cash out before the value destruction arises. Large scale evidence by Bebchuk, Brav and Jiang (2015) suggests that activism creates even more

[1] ESMA (2016): "Supervisory Work on Potential Closet Index Tracking."

value in the long-term than the short-term.[2] Indeed, Adobe's shares rose even further after ValueAct's exit.

1.7 The role of investor selling is one of the most fundamentally misunderstood aspects of corporate governance. It is often viewed as the antithesis of stewardship but can be a key stewardship mechanism. Many critics argue that selling is short-termist and thus propose mechanisms to lock investors in for the long-term, such as more voting rights, loyalty dividends, or lower capital gains tax for investors who hold their shares for longer. These proposals confuse the *holding period* of an investor with its *orientation*. The former is how long an investor holds shares before it sells. The latter is the basis – long-term value or short-term profits – that triggers an investor to sell. We must thus distinguish between two terms that are frequently used interchangeably, but are critically different and must not be confused.

1.7.i "Patient capital" / "long-term investors". These terms are typically used to refer to investors with long holding periods, who are "committed" to the company for many years and will not sell them.

1.7.ii "Investors with a long-term orientation" or "investors with a long-term focus", which is the term correctly used in paragraph 4.3 of the FCA Discussion Paper. Critically, having a long-term orientation may not entail holding for the long-term.

1.8 The common argument against short-term investors (i.e. investors who do not hold for the long-term) is the following. They sell shares in a firm that has delivered poor short-term earnings. This pressures managers to increase short-term earnings (to avoid their shares being sold), by cutting investment. However, this argument critically confuses two quite separate concepts. What matters is whether shareholders *trade on short-term or long-term information*, not whether shareholders *hold for the short-term or long-term*. In particular, short-term trading can based on long-term information; selling in the short-term does not mean taking a short-term perspective (Edmans (2009)).[3]

1.9 This mistake is made even by leading investors. Vanguard CEO Bill McNabb argued "*Our favourite holding period is forever. We're going to hold your stock when you hit your quarterly earnings target. And we'll hold it when you don't. We're going to hold your stock if we like you. And if we don't. We're going to hold your stock when everyone else is piling in. And when everyone else is running for the exits*." Such a view is often heralded as being that of a patient investor.

1.9.i However, an investor who holds onto its shares for the long-term, regardless of how an enterprise is performing – whether it is creating value for society or exploiting it, or whether "we like you" or "we don't" – should not be called a patient investor. It is an irresponsible investor who is failing to monitor the firm. Similarly, an investor should not automatically "hold your stock when you hit your quarterly earnings target". It

[2] Bebchuk, Lucian A., Alon Brav and Wei Jiang (2015): "The Long Term Effects of Hedge Fund Activism." *Columbia Law Review* 115, 1085-1155.
[3] Edmans, Alex (2009): "Blockholder Trading, Market Efficiency, and Managerial Myopia." *Journal of Finance* 64, 2481-2513.

should investigate how it hit the target, and take action if the company did so by scrapping good investments.

1.9.ii What we want is *conditional* loyalty – a shareholder who stays with a firm, even if short-term earnings are low, as long as the firm is pursuing long-run value. We do not want *unconditional* loyalty – a shareholder who stays with a firm, regardless of whether it is destroying long-run value, as with Volkswagen's shareholders. Uber's customers recently deleted their accounts to discipline management[4]; similarly, shareholders who sell their shares in a non-purposeful company are exerting discipline rather than being short-termist. We should promote shareholders *with a long-term orientation*, not *long-term* shareholders.

1.10 Selling is thus not always bad (nor always good). Instead, what matters is the information that it is based on, which is what we mean by the investor's *orientation*. If it sells based on short-term earnings, this is indeed damaging because the CEO then prioritises short-term earnings. However, if it sells based on long-term value, the CEO knows she will be held to account for long-term value. Indeed, Sir David Walker writes: "The second [misperception] is the notion that selling stock is evidence of short-termism… What matters is not whether an investor trades, but rather whether the trading decision is preceded by dialogue with the investee company relating to long-term strategic information or short-term information such as quarterly earnings updates."[5]

1.10.i This is why the stewardship mechanism of trading is also sometimes referred to as "monitoring". An investor should monitor a stock in detail to decide whether to buy it in the first place, and after it has bought it, whether to hold onto it or sell it. Just as an investor should never buy a stock by default, because it is part of the index, it should never retain an existing holding by default, simply because it already owns it. It should constantly monitor whether the company is creating long-term value.

1.11 The criticism of selling is surprising because it is generally accepted that divestment is a legitimate governance mechanism. Investors sometimes have *generalised divestment* policies, which will involve selling a company (or not investing in it) due to the industry or country it is in, or another criterion that can be applied across all companies such as insufficient board diversity. However, there may be even greater need for investors to engage in *specialised divestment*, based on firm-specific factors such as a company's contribution to society, intangible assets, and strategic direction. Customers can easily assess a firm's industry or country and organise boycotts, but are less likely to be able to evaluate these deeper issues. So large investors have a particular role in such evaluations, given their access to management and financial incentives to monitor.

1.12 How can we ensure shareholders trade on long-term information? By encouraging them to take large stakes. Gathering information on a firm's long-run investment and treatment of workers, suppliers, customers, and the environment is costly. Small shareholders have little "skin in the

[4] I am not taking a stand as to whether Uber's actions merited such discipline; merely emphasising that customers had the disciplinary device of "exit" available to them and that customer discipline is typically seen as desirable.
[5] Walker, David (2017): "Better shareholder stewardship is the key to greater productivity." *The Telegraph*, October 27, 2017.

game" and so will not bother to bear this cost; instead, they will base their trading decisions on short-term earnings, as this information is freely available – "the market sells first and asks questions later." In contrast, blockholders' large stakes give them the incentives to ask questions first and analyse long-term value (Edmans (2009)). If a firm has delivered low earnings due to investment, blockholders will not sell (and may buy more). <u>Informed blockholders insulate managers from the need to cater to short-term pressures, and free them to focus on long-term purpose</u>.

1.12.i Warren Buffett's strategy is to take large stakes in companies and allow them to build their brand for the long-term. Since management knows that Buffett will be basing his evaluations on long-term information, due to his large stake, they are free to build their brand rather than focusing on short-term profit. But, <u>Buffett is conditionally, not unconditionally, loyal. If the firm has not built its brand after several years, he sells his stock</u>. In sum, stake size, not holding period, is key.

1.13 While "monitoring" is recognised as a stewardship mechanism, it is often seen as valuable only to guide an investor's engagement decisions. Instead, monitoring plays a key role in ensuring that an investor does not engage in knee-jerk selling – but also that it does not engage in automatic retention simply because short-term earnings are high. It is crucially important to recognise this benefit of monitoring. If monitoring is seen only as a prelude to engagement, investors may only monitor in "intensive care" situations, where the company is underperforming and they are likely to take action. Instead, if investors accept that they should not retain an existing holding by default, then they will undertake monitoring routinely, as a matter of course. For example, the Investor Forum has recommended that companies hold Stewardship & Strategy Forums to discuss long-term issues with investors, and made a sample meeting agenda available on its website. While Rolls Royce held a successful one in 2016, uptake has been limited, potentially due to insufficient investor interest outside of "intensive care" situations. Emphasising the power of monitoring as a stewardship mechanism would encourage these regular dialogues between investors and companies about long-term issues.

1.14 However, it must be stressed that these regular dialogues are useful primarily for investors to understand the company, not to give investors regular opportunities to tell management what to do. As the Investment Association writes, "As shareholders they carry out an oversight role and focus on companies' long-term strategy and performance *rather than micro-manage company executives*"[6] (emphasis added.) Failing to recognise the role of monitoring in guiding trading may lead either to investors monitoring only in "intensive care" situations, or both monitoring and micro-managing regularly, distracting management from running the company.

<u>Policies to Promote Loyalty / Restrict Short-Term Trading</u>

1.15 Related to the concerns with short-term shareholders are calls to restrict the liquidity of the stock market, for example through transaction taxes, a higher capital gains tax on short-term holdings, or "loyalty shares", which give shareholders additional dividends or voting rights if

[6] Investment Association (2018): "Stewardship In Practice."

they hold their shares for a minimum period. Over and above the arguments earlier in this section, there are numerous problems with such proposals:

1.15.i It deters new shareholders forming a large stake. Shareholders can only buy if other shareholders sell. While an obvious point, this seems to be virtually ignored in the criticism of selling. Indeed, Holderness and Sheehan (1988)[7] and Barclay and Holderness (1991)[8] find that trades of large blocks between investors lead to a significant increase in firm value, consistent with the block being reallocated to a more effective monitor. To encourage block formation, we need to facilitate selling for two reasons. First, if existing investors face disincentives to sell, there are fewer shares for new blockholders to buy. Second, if potential new investors know that they will be locked up for several years, they will be less willing to buy a large block in the first place.

1.15.ii Once the investor has formed its block, it is less willing to bear the costs of gathering long-term information if it knows that it will be unlikely to sell due to trading restrictions (Edmans (2009)). Instead, investors will simply accept a firm's high earnings and not bother to find out if they are instead driven by short-term manipulation.

1.15.iii It encourages only *holding* for the long-term, rather than *engagement* or *monitoring*. Investors can now outperform the benchmark by simply holding their stake to collect the loyalty dividend.

1.15.iv Once an investor has reformed a company, you would like it to take its capital and reform another company. Lock-ups would deter this. There is no gain in the investor staying after the reform, just as turnaround specialists' contract should not outlast the project.

1.15.v If an investor has to wait several years before receiving full voting rights, it will be unable to engage. Thus, such proposals may entrench management, and stifle good ideas. It would similarly be undesirable to force new employees to wait a few years before they can participate in employee town halls, or vote for employee representatives.

1.15.vi What matters is an investor's (conditional) holding period going forwards rather than in the past. That an investor has held shares for many years in the past does not imply that it will continue to do so in the future. Indeed, with a higher capital gains tax for short holding periods, an investor who has held shares for many years will be more likely to sell.

1.16 Often commentators discuss "Patient Capital" implying that impatient investors deprive firms of capital by selling their shares. This makes no sense. Investors sell their shares on the secondary market and have no effect on a firm's capital. All equity capital is patient capital -

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[7] Holderness, Clifford G. and Dennis Sheehan (1988): "The Role of Majority Shareholders in Publicly Held Corporations: An Exploratory Analysis." *Journal of Financial Economics* 20, 317–346.

[8] Barclay, Michael J. and Clifford G. Holderness (1991): "Negotiated Block Trades and Corporate Control." *Journal of Finance* 46, 861–878.

the firm is guaranteed the capital regardless of whether the investor subsequently sells it on the secondary market.

1.16.i This contrasts with virtually every other stakeholder. Banks can withdraw lines of credit, employees can quit, customers can stop buying, suppliers can stop supplying. All of these actions have direct implications on the firm, as they deprive the firm of credit, labour, customs, or supplies – whereas selling shares on the secondary market does not deprive the firm of capital. Stakeholders should absolutely have the right to terminate their relationship with the firm, despite the negative impact – and so shareholders should have the right to do so, particularly since the negative impact is lower.

1.17 It is indeed true that selling shares has an indirect effect on the firm by reducing the stock price. If the CEO's has short-term bonuses linked to the short-term stock price, he will be concerned with such sales. However, this problem is averted by giving the CEO equity with long holding periods. If the CEO cannot sell equity for 5-7 years, he will be less concerned with short-term falls in the stock price. See my blog post "Simplicity, Transparency, and Sustainability: A New Model for CEO Pay" (http://alexedmans.com/simplicity) for the arguments for long-term equity.

1.17.i Moreover, loyalty shares *exacerbate* the stock price decline upon selling. They reduce liquidity by making it less attractive for new shareholders to buy, thus increasing the negative price impact of any sale.

The Evidence for Trading/Monitoring as a Stewardship Mechanism

1.18 The criticism of liquidity first appeared in the early 1990s when commentators advocated the Japanese model of long-term illiquid stakes. The underperformance of Japan over the intervening 25 years suggests that this model is not the panacea previously thought. While this underperformance may be for many reasons other than liquidity, there is evidence on the direct effect of liquidity on firm value. This evidence is causal. Simply correlating liquidity with firm value is not proof that liquidity improves firm value, as it may be that higher firm value increases liquidity or a third variable causes both. These studies use the decimalization of the major U.S. stock exchanges in 2002 as an exogenous shock to liquidity. Before, prices were quoted in 1/16ths of a dollar; after, they were quoted in 1/100ths of a dollar. For example, if a stock used to cost $8 1/16 (= $8.0625) to buy and $8 to sell, post-decimalization it might cost $8.01 to buy and $8 to sell, significantly reducing the cost of trading.

1.18.i Fang, Noe, and Tice (2009) found that decimalization had a positive causal effect on firm value.[9]

1.18.ii Bharath, Jayaraman, and Nagar (2013) found that this positive effect was particularly strong in firms with large blockholders and in firms where the manager's wealth was

[9] Fang, Vivian W., Thomas H. Noe, and Sheri Tice (2009): "Stock Market Liquidity and Firm Value." *Journal of Financial Economics* 94, 150-169.

particularly sensitive to the stock price (i.e. the manager was particularly sensitive to governance through exit).[10]

1.18.iii Edmans, Fang, and Zur (2013) found that decimalization had a positive causal effect on block formation, and that governance through exit improves firm value.[11]

1.18.iv For further evidence, see the *Harvard Business Review* article "The Answer to Short-Termism Isn't Asking Investors To Be Patient."

The Role of Regulation

1.19 I use "regulation" to refer to regulation either by laws, codes, or market participants. How can regulators help ensure that investors make their buy, hold and sell decisions based on long-term value rather than short-term earnings?

1.19.i It should recognise monitoring and trading as a critical stewardship mechanism. All of the language currently refers to engagement, without recognising the importance of carefully considering which companies to buy and sell. This decision in fact precedes engagement, because an investor cannot engage unless it holds a stake.

1.19.ii An investor's stewardship policy should not only contain a policy of when and how to engage, but also a divestment policy describing what will cause it to sell a stock (e.g. the failure to invest in long-term intangible assets, or the failure to take action on climate change). Such a policy can be very powerful. The investor can then be held to account for only selling stocks in accordance with this policy, rather than because their earnings are low. Equally importantly, the investor can be held to account for ensuring that it does sell stocks in accordance with the policy (and if engagement fails to produce change) – rather than holding onto it because profits are high.

1.19.iii The investor should then report on the extent to which it has fulfilled its divestment policy. In the Activities and Outcomes Report, it should discuss all major divestments and explain why they are in accordance with the policy. It could also consider discussing all major holdings and explain why it has continued to hold onto these positions (subject to doing so not giving away its investment philosophy to competitors). It might also report the long-term performance of past divestments. This will hold it accountable for not undertaking short-sighted divestment but reward it for far-sighted divestment.

1.19.iv An investor must ensure that it has the resources and expertise to ensure that it is able to evaluate a company according to long-term factors. For example, for CEO pay, this means looking beyond a pay ratio and towards the extent to which CEO pay is linked to long-term value creation. Royal London Asset Management has an external advisory committee providing specialist expertise on these issues.

[10] Bharath, Sreedhar T., Sudarshan Jayaraman, and Venky Nagar (2013): "Exit as Governance: An Empirical Analysis." *Journal of Finance* 68, 2515-2547.
[11] Edmans, Alex, Vivian W. Fang, and Emanuel Zur (2013): "The Effect of Liquidity On Governance." *Review of Financial Studies* 26, 1443-1482.

1.19.v An investor must ensure that it takes large stakes in the companies that it invests in. This will ensure that it has incentives to deeply understand a company and thus base future trading decisions on long-term value. Note that large stakes help enhance engagement as well as monitoring.

1.19.vi The Code should recognise that measures such as “turnover” and “holding period” are nuanced. If it encourages asset owners to evaluate an asset manager according to these dimensions, it should not give the impression that high turnover and low holding periods are bad. What matters is the factors that lead to an investor selling. Low turnover and high holding periods can be bad if the investor is holding onto a stock regardless of whether it is creating long-term value for society.