

THE STEWARDSHIP ROLE OF INVESTORS

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What is Stewardship and Is It Desirable?

The Merriam dictionary's definition of stewardship is "the careful and responsible management of something entrusted to one's care." Savers entrust their money to a mutual fund. The fund thus engages in stewardship by managing this money responsibly, generating returns for savers.

Many commentators are concerned that, to generate returns for savers, investors will take slices of the pie from other stakeholders – so stewardship is bad for society. For example, they may pressure managers to pay out spare cash in dividends, rather than investing it or increasing wages. This scepticism is particularly pronounced for *activist* investors, who try to influence how a company is run – potentially through public and confrontational channels. Carl Icahn publicly demanded that Apple pay out more cash to investors, an approach which lawyer Martin Lipton, a prominent opponent of activism, attacked in an article entitled "Bite the Apple; Poison the Apple; Paralyse the Company; Wreck the Economy." Author Peter Georgescu claims that "Terrorist activists might come in and strip out the cash, fire up to thousands of employees, ... stop training and flip the company in a number of years." Politicians take these concerns seriously – as they should do, if they are true. Democratic Senators Bernie Sanders and Elizabeth Warren backed a bill to constrain activist hedge funds.

A common theme running through this lecture series is that diagnosis precedes treatment. Before taking any action, it is critical to assess the evidence rigorously. The above quotes are only that – quotes, not backed up by any evidence. Commentators have the incentive to make their quotes as extreme as possible, such as calling activists "terrorists" who "paralyse the company" and "wreck the economy", for two reasons. First, extremity reduces the need to buttress the quote with evidence, by giving the impression that the point is so obvious that no proof is needed. Second, an extreme quote is likely to be tweeted, shared, and cited by others who agree with their viewpoint, since it makes the case in a strong way. Particularly given the current anti-business sentiment, strong anti-business quotes are likely to attract a following.

Shareholder Activism – The Evidence

So let's look at the evidence. A decade of research by professors Alon Brav (Duke) and Wei Jiang (Columbia), and their co-authors, shows that activist hedge funds create value not only in the short-run, but the long-run also. While hedge funds are not the only type of investor, Alon, Wei and their co-authors study them, since they are particularly accused of being short-termist.

Their first study found that, when an activist hedge fund makes a 13D filing (which is legally required if it acquires a stake of at least 5% and intends to influence control), the stock price increases by 7% - and importantly there's no long-term reversal.¹ Some CEOs are fired, which might explain not only the improvement in performance but also the opposition to investor activism. Poorly-performing executives do not like being held to account.

¹ Brav, Alon, Wei Jiang, Frank Partnoy and Randall Thomas (2008) "Hedge Fund Activism, Corporate Governance, and Firm Performance." *Journal of Finance* 63, 1729-1775.



But is this correlation or causation? Perhaps the hedge fund didn't cause the improvements, but predicted them and chose to acquire a large stake in anticipation. In support of their causal interpretation, the authors show that the improvements are stronger when the hedge fund employs hostile tactics; the improvements remain significant even when the hedge fund owned a significant position prior to filing the 13D; and the market response to the hedge fund subsequently selling is significantly worse if the fund had not carried out its stated agenda.

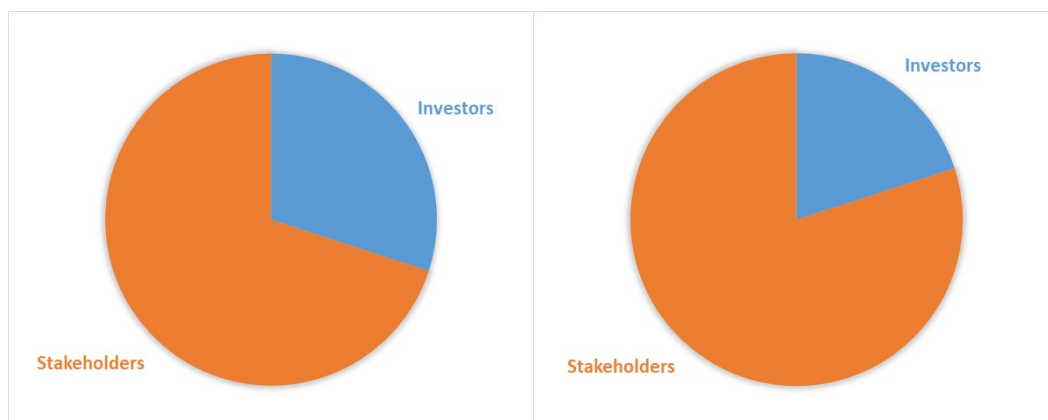
Not only does the stock price increase, but profitability does too. This finding is inconsistent with the common belief that hedge funds create shareholder value only by piling on debt. Even so, it might result from over-working employees, compromising product quality, or breaching long-term contracts. A second paper thus investigated its source.² It finds that plant-level productivity rises, which in turn stems from higher labour productivity. Interestingly, the rise in labour productivity is despite working hours not rising and wages not falling. Moreover, productivity also improves in plants sold by hedge funds – thus, such disposals are not asset stripping, but reallocating assets to buyers who can make better use of them.

Perhaps even more important for wider society is innovation. This is the smoking gun that hedge funds will fire if they are short-termist – R&D affects the bottom line today, and its benefits don't arise until many years in the future. A third paper found that hedge funds do cut R&D. However, despite the reduction in innovation input, innovation output actually improves, in terms of both the number and quality of future patents.³ Mirroring the result on sold plants, patents that are sold become more impactful at their new owner. Inventors who leave also become more productive at their new employer – and ones who stay within the firm also become more productive than investors who stay at firms not targeted by hedge funds.

That innovation rises despite R&D falling is important. Investment is critical for the modern firm, not only for its own long-term survival, but also its contribution to wider society. Equally critical, however, is for the debate to focus on investment output rather than input. Commentators often compare the level of investment across countries, assuming that high investment is necessarily a good thing. However, it takes no skill to simply spend money. Responsible companies do not invest willy-nilly; they do so judiciously. In the 2015/16 English Premier League, Leicester City invested far less money than Manchester City, but invested better because they won the league. Just as spendthrift behaviour is not clearly optimal in sports, selling non-patents and allowing non-core inventors to leave can allow a company to focus its innovation efforts on the ideas that are closer to its strength. It also allows those patents and inventors to create more value for society elsewhere.

The evidence thus suggests that investors exercise stewardship not by splitting the pie – generating returns for their savers by taking slices from stakeholders. Instead, they grow the pie, creating value – through improving productivity and innovation – which helps both stakeholders and investors alike.

Pie-Splitting

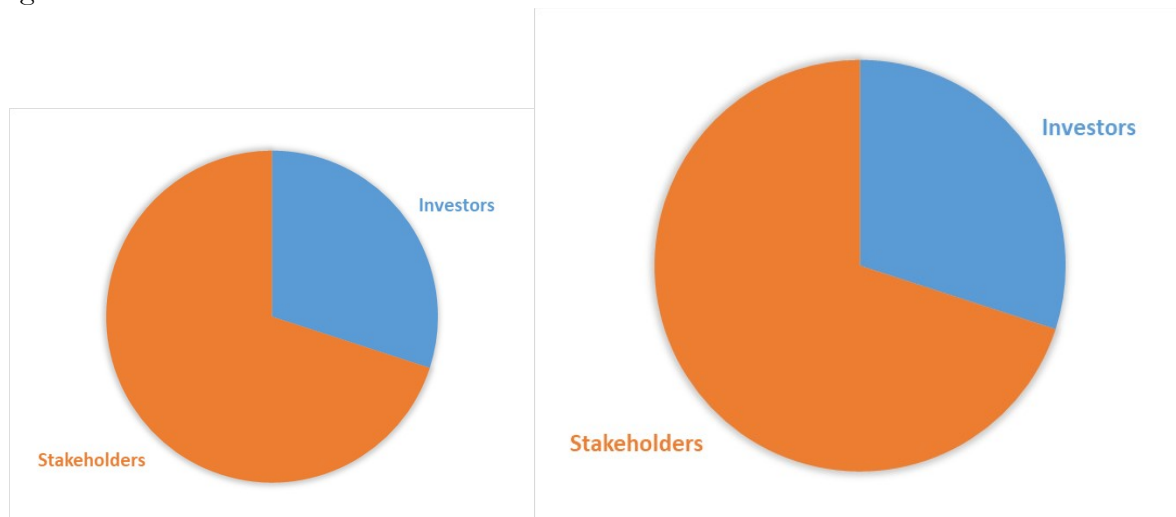


² Brav, Alon, Wei Jiang and Hyunseob Kim (2015): “The Real Effects of Hedge Fund Activism: Productivity, Asset Allocation, and Labor Outcomes” *Review of Financial Studies* 28, 2723–2769.

³ Brav, Alon, Wei Jiang, Song Ma and Xuan Tian (2018): “How Does Hedge Fund Activism Reshape Corporate Innovation?” *Journal of Financial Economics* 130, 237–264



Pie-Growing



While contrary to common wisdom, this evidence should not be too surprising. It is true that companies can increase profits in the short-term by taking from other stakeholders. However, as I've explored in the rest of this lecture series, particularly Lecture 1 ([Purposeful Business: The Evidence and the Implementation](#)), such actions quickly backfire and erode long-term value. The best way to increase long-term profits is to create value for society. Any investor that intends to be around for more than a few years will care about long-term performance, otherwise savers will soon walk away.



Let's go back to the definition of stewardship - "the careful and responsible management of something entrusted to one's care." As we explained, what is entrusted to investors is savers' money. However, investors can only manage savers' money responsibly by improving the long-term performance of the companies they invest in. We will thus move from a backward-looking definition of stewardship, concerning the savers who have entrusted their money to investors, to a forward-looking definition, concerning the companies that investors entrust their money to by buying their shares. We define stewardship as "an approach to investment that improves the value a company creates for society."

Monitoring

The type of stewardship studied by Alon Brav, Wei Jiang and their coauthors - activism - is a form of *engagement*, otherwise known as *voice*. Engagement involves trying to influence how a company is run. It can sometimes be in public and confrontational forms, but typically involves milder actions, such as voting for or against directors or pay packages, or meeting with management behind the scenes to make suggestions. Many policymakers and practitioners equate stewardship with engagement, and believe that engagement is the only form of stewardship.

However, there is a second, very important form of stewardship, known as *monitoring* or *exit*. Monitoring involves analysing a company deeply - looking beyond its short-term earnings to its long-term value, intangible assets, and strategy. Crucially, an investor uses such monitoring not only to guide it on how to engage with management (such a use would fall under the term "engagement", and is well recognised as a stewardship mechanism), but also on whether to retain or sell its shares, which is why it is also known as "exit".

The effects of exit are deeply misunderstood. Almost unanimous is the view that it forces companies to be short-termist. A *Harvard Business Review* article claimed that "If you give me \$100 but say that you have the right to take



it back or change the pattern of its usage with 24 hours' notice, it isn't nearly as valuable to me as if you say I can use it for 10 years for the purpose for which we agree it is intended before I am allowed to assist [*sic*] on any change in purpose or to ask for it back."⁴ This argument makes no sense, because when an investor sells his shares, he does so to another investor, not back to the company. The company still has the money it originally raised and does not need to change what it is used for.

Others recognise that selling does not deprive a company of capital, but instead argue that it lowers the short-term stock price and increase the risk that it is taken over or that the CEO is fired. The argument is as follows. If the company misses its quarterly earnings target, the investor sells her shares. The fear of such selling forces the firm to fixate on meeting the target, cutting investment to do so.

This argument has proven highly influential and led to several policy proposals to lock in investors for many years. France's Loi Florange doubles investors' voting rights after two years. Hillary Clinton proposed a sharply higher capital gains tax on shares held for fewer than two years. Toyota has a class of shares that gives investors "loyalty dividends" if they hold onto them for five years. Other proposals go further. Arguing that shareholders are irremediably short-term, they advocate reducing shareholder influence by putting other stakeholders on boards, or giving stakeholders equal priority with shareholders in terms of directors' fiduciary duties.

The error in the popular argument is that it confuses the holding period of a shareholder with her orientation. The *holding period* is how long an investor holds shares before he sells. The *orientation* is the basis – long-term value or short-term profits – that triggers an investor to sell. *Short-term selling need not be based on short-term information.*

Take a company that is thinking about cutting investment to boost earnings, hoping to inflate its stock price. An informed shareholder, who looks beyond earnings numbers and analyses the company's intangible assets, would notice that the firm has mortgaged its future. She would sell her shares, pushing the stock price down. Anticipating this, the company will decide not to cut investment in the first place. Critically, short-term selling by shareholders need not entail short-term behaviour by managers. Instead, it disciplines it, which is why exit is a governance mechanism.

What matters is not whether shareholders hold for the long-term, but whether they trade on long-term information. We can ensure the latter by encouraging investors to take large stakes. Gathering information on a firm's intangible assets is costly, and not worth it if an investor owns only a small amount. Small shareholders have little "skin in the game" and so will base their trading decisions on short-term profits, which are freely available. Large shareholders – blockholders – do have incentives to gather intangible information. Doing so not only deters manipulation, but also actively encourages long-term investment. If earnings are low, "the market sells first and asks questions later" as the adage goes. Blockholders, due to their large stakes, have the incentive to ask questions first. If they find out that low earnings are due to investment, rather than inefficiency, they will not sell – and may even buy more. Blockholders thus shield firms from the vagaries of uninformed investors.

For these reasons, the focus should be on creating *large* shareholders, not *long-term* shareholders. This highlights the problems with lock-in schemes.

1. They discourage shareholders from building large stakes in the first place. If investors know that they will be locked up for several years, they will be less willing to buy a stake – just like the requirement to sign a five-year lease would deter many renters.
2. Lock-in hinders shareholders from building large stakes by making it less likely that other, smaller shareholders are willing to sell. Shareholders can only buy if other shareholders sell. Trades of large blocks

⁴ Martin, Roger L. (2017): "What if Investors Who Held Their Shares Longer Got More Voting Power?" *Harvard Business Review*, April 27, 2017.



between investors lead to a significant increase in firm value, consistent with the block being reallocated to a more effective monitor.⁵

3. Loyalty dividends encourage only holding for the long-term, rather than stewardship. An investor can outperform the market by simply waiting to collect the dividend. She will be less willing to gather long-term information if she knows that she will be unlikely to use this information by selling. If the investor has to wait two years before she has full voting power, she has limited “voice”, so engagement suffers also. Moreover, engaged investors are in short supply. Once an investor has successfully turned around a company, she should be able to take her capital and reform another company, rather than having to stick around afterwards.

The criticism of liquidity and short-term trading is not new, and the evidence does not support it. An influential 1992 *Harvard Business Review* article by Michael Porter advocated the Japanese model of long-term illiquid stakes.⁶ However, the intervening 27 years suggests that Japan is not the model economy previously thought. While Japan’s underperformance has many causes other than illiquidity, there is direct evidence on the benefits of liquidity. These studies use the decimalization of the major U.S. stock exchanges in 2002 to identify causation rather than mere correlation. Decimalization made trading cheaper and improved firm value⁷ – particularly in firms with large shareholders⁸ – suggesting that governance through exit was a key driver of the improvement. It also encouraged more blockholders to form in the first place.⁹

Embedding Stewardship

The evidence thus suggests that stewardship – through both engagement and monitoring – grows the pie, generating value for society and profits for investors. How, then, can investors implement stewardship? I recommend the same three-step approach for how companies can practice purpose, as described in Lecture 1.

The first step is for an investor to *define its stewardship approach*. Different investors may practice stewardship in different ways – some through confrontational activism, others through informed voting, and others still through monitoring and trading. Importantly, the stewardship policy should contain a policy that explains what will cause the investor to sell a stock – and it should ensure that it only sells if these criteria are triggered. The second step is to *communicate it externally* – not only the approach, but metrics that allow savers to evaluate whether it has put its approach into practice. For example, an investor for whom voting is a key stewardship mechanism should disclose its votes for and against, broken down by issue (e.g. directors, pay). It should also report the frequency with which its votes agree with house policy and/or proxy advisor recommendations, so that investors can assess whether it is voting in a one-size-fits-all manner. It should describe its key divestments and explain the extent to which they are consistent with its divestment policy.

The third step is to *embed it internally*. While Alon Brav and Wei Jiang’s research highlights hedge funds’ effectiveness in activism, engagement by other investors has more mixed results.¹⁰ Hedge funds’ effectiveness is likely due to four reasons. None of these are specific to hedge funds and they can be adopted by other investors (and many of the best ones do so); in addition, they apply to exit as well as voice:

⁵ Barclay, Michael J. and Clifford G. Holderness (1991): “Negotiated Block Trades and Corporate Control.” *Journal of Finance* 46, 861-878,

⁶ Porter, Michael E. (1992): “Capital Disadvantage: America’s Failing Capital Investment System.” *Harvard Business Review* 70, 65-82.

⁷ Fang, Vivian W., Thomas H. Noe and Sheri Tice (2009): “Stock Market Liquidity and Firm Value.” *Journal of Financial Economics* 94, 150-169.

⁸ Bharath, Sreedhar T., Sudarshan Jayaraman and Venky Nagar (2013): “Exit as Governance: An Empirical Analysis.” *Journal of Finance* 68, 2515-2547.

⁹ Edmans, Alex, Vivian W. Fang and Emanuel Zur (2013): “The Effect of Liquidity on Governance.” *Review of Financial Studies* 26, 1443-1482.

¹⁰ Yermack, David (2010): “Shareholder Voting and Corporate Governance.” *Annual Review of Financial Economics* 2, 103-125.



1. *Portfolio Concentration.* Activist hedge funds have large stakes in every company they invest in, and thus skin-in-the-game. Similarly, for a general investor (that is not an index fund), every stock should be a “conviction holding”, held because it either believes in its long-term story or believes that it can turn it around – rather than holding it by default because it is part of the index.
2. *Resources.* An investor should devote substantial resources to both engagement and monitoring, rather than viewing stewardship as a cost centre or optional extra. For example, an investor who intends to monitor a company’s ESG factors should ensure that it has adequate expertise. Royal London Asset Management has an external advisory committee to provide insights on such issues.
3. *Incentives.* Fund managers and stewardship departments of an investor should have strong incentives based on long-term performance, as I recommended for executives in Lecture 2 ([Executive Pay: What’s Right, What’s Wrong, and What’s Fixable](#)).
4. *Freedom from Conflicts of Interest.* Hedge funds rarely have business ties to firms, but some investors may do. An investor who manages a company’s pension fund may be reluctant to vote against management. Investors should have robust policies in place to manage such conflicts.

Who should enforce this? Not regulators, but savers. Savers, also known as asset owners, include not only citizens saving for retirement, but also institutions such as pension funds, who invest in asset managers. Asset owners ultimately regulate asset managers by choosing who to invest with. But, most asset owners — and the investment consultants that advise them — choose asset managers based on short-term performance and overlook stewardship. A 2016 Investment Association study found that little more than half strongly agreed they had stewardship responsibilities. Asset owners should understand that stewardship is in their long-term interest, demand it from asset managers, and ensure that their own fund managers are paid according to the long term. Doing so will develop a market for stewardship, which will be far more effective than legislating stewardship. It will ensure that asset managers undertake it out of intrinsic commitment rather than regulatory compliance.

The current mistrust in business has highlighted the need for company reform. But companies are owned by asset managers, asset managers invest on behalf of asset owners, advised by investment consultants. Reforming stewardship must be systemic rather than piecemeal. When every link in the chain, from asset owners through to companies, recognises its responsibility to think and act for the long term, business will start to regain the public’s trust.