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The effectiveness of institutional activism

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Abstract

Researchers examined earnings-forecast revisions and stock returns after release of the Focus List of poorly performing companies by the Council of Institutional Investors. Using Tobin's q as a measure of a company's ability to improve performance, researchers found significant and positive abnormal forecast revisions and post-release stock returns for companies with q greater than one. Findings support the proposition that institutional activism is effective for underperforming companies - but only those companies with the ability to respond to the challenge to improve performance.

We examined earnings-forecast revisions and stock returns after release of the Focus List of poorly performing companies by the Council of Institutional Investors. Using Tobin's q as a measure of a company's ability to improve performance, we found significant and positive abnormal forecast revisions and post-release stock returns for companies with q greater than 1. For companies with q less than 1, neither forecast revisions nor post-release stock returns were significantly different from zero. For the full sample of companies on the Focus List, regression analysis showed a significant positive relationship between forecast revisions and postrelease stock returns. These findings support our proposition that institutional activism is effective for underperforming companies-but only those companies with the ability to respond to the challenge to improve performance.

A subject of current debate is the effectiveness of institutional activism. Most event studies show little or no short-term effect on equity value when a large shareholder targets a company for a proxy proposal. For example, Karpoff, Malatesta, and Walkling (1996) found no stock market reaction to public announcements of shareholder-initiated proxy proposals. Also, Wahal (1996), investigating the effectiveness of proxy mailings of the nine most activist pension funds in 1987-1993, reported abnormal returns that were not reliably different from zero for the majority of sample companies.

Some authors have reported significant abnormal returns, however, for portions of their samples. Contradicting his main findings, Wahal reported a positive 2.7 percent announcement-period stock return on the letter date for a subsample of companies that, rather than being targets of a specific proxy proposal, were targeted for their poor stock market performance. Similarly, Strickland, Wiles, and Zenner (1996) reported a significant positive announcement-period reaction of 0.92 percent for the subsample of companies with whom the United Shareholders Association successfully negotiated an agreement.

Finally, tests using long-term (that is, one year or longer) returns are inconclusive at best. Karpoff (1998), who presented a survey of the literature on shareholder activism, found that only two of the seven studies that examined the long-term effectiveness of institutional activism reported statistically significant returns. Moreover, he questioned the reliability of those two studies because of the methodology used. One of the studies, Opler and Sokobin (1995), examined the long-term stock performance of companies on the Focus List published by the Council of Institutional Investors and reported both improved stock-

price performance and increases in accounting returns for companies subsequent to their appearance on the list. 1

The Council of Institutional Investors is an association of more than 120 large U.S. pension fund management firms and nearly 110 sustaining firms (interested nonmember parties, such as investment management firms and non-U.S. pension fund management firms) that addresses investment issues affecting the performance or risk of members' invested assets. CII establishes guidelines for effective shareholder-oriented corporate governance and provides a number of services to members. The annual publication of the names of underperforming companies on the Focus List is one of the member services. As one might expect, appearance on the list tends to focus the attention of all CII members on the poorly performing company. CII's intent is that the attention will lead to a collaborative effort by members to compel company managers to step up efforts to improve performance.

We tested the effectiveness of this presumed collaborative effort by examining changes in financial analysts' earnings forecasts and stock market returns for the companies on the Focus List on days surrounding release of the list. Although our sample of companies is essentially the same as that of Opler and Sokobin, our approach differs from theirs in several ways. First, our primary emphasis is on earnings-forecast revisions and their relationship to short-term, rather than long-term, postrelease stock returns. Second, we propose that the attention provided by inclusion on the list may be good news for some companies and bad news for others, depending on the specific company's ability to respond to the challenge to improve performance. If the underperformance is a result of lack of effort or poor decision making at a company that would otherwise be expected to perform satisfactorily, then the new attention may reinvigorate effort and performance. We coin the phrase "performance slack" to describe this situation. That is, a company has performance slack if it was expected to perform satisfactorily but is not doing so for some reason. If the company was not expected to perform satisfactorily (i.e., it has no performance slack), the new attention provided by the Focus List may not lead to an improvement in performance. Finally, we formally examined the relationship between the forecast revisions and market reaction at the publication of the Focus List.

Specifically, Hypothesis 1 states that the stock market reaction to release of the Focus List depends on whether the company has performance slack. Hypothesis 2 states that analysts account for performance slack when considering future cash flow estimations and revise their EPS estimates upward only for those companies with performance slack. Hypothesis 3 states that positive expected cash flow revisions lead to abnormal stock returns in the post-release period only for companies with performance slack.

Performance Slack

The companies in our sample were those whose equity performance over the year had been so inferior as to land them on the Focus List. Although the companies' stock market performances may have been uniformly poor, the companies were in all likelihood not equally endowed with the necessary attributes to improve their performance as intended by CH through publication of the list. These attributes would include competitive positioning, cost advantages, and/or growth opportunities. To test our hypotheses, we needed a measure that could distinguish between those companies in our sample that had more of these attributes from those with few or none. We needed a measure of performance slack.

We decided that Tobin's q is an intuitively appealing choice for this measure. Tobin's q is the ratio of a company's market value of debt and equity to the replacement cost of its assets. James Tobin originally introduced the variable q to explain aggregate capital investment. He argued that companies have incentives to invest as long as marginal q is greater than 1 (see Brealey and Myers 2000). Lindenberg and Ross (1981) hypothesized that the premium of market value over replacement cost indicated when q is

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greater than 1 may be the result of some company-specific factor. For example, a patent or proprietary production process could provide the company with an effective barrier to entry, or a superior brand image could provide it with a competitive sales advantage. Similarly, the company could enjoy competitive cost advantages derived from a superior location, economies of scale, or superior use of technology. In addition, Lang and Litzenberger (1989) showed theoretically that q > 1 is a necessary condition for a value-maximizing level of investment whereas q < 1 is a sufficient condition for overinvestment. Their findings imply that companies in the q > 1 group have valuable growth opportunities that companies in the q < 1 group do not and, therefore, have higher q values. Ultimately, however, whether the premium is derived from company-specific attributes or valuable growth opportunities, companies with q > 1 are better positioned to improve performance than companies with q < 1.

The presumptions behind publication of the Focus List are that the poor stock-price performance of the listed companies is the result of poor managerial performance and that CII members acting in concert as major stockholders can force the company managers to improve performance. Because only companies with q > 1 have the company-specific attributes and/or growth opportunities to produce the improvement in performance, we defined a company in our Focus List sample to have performance slack if its estimated Tobin's q was greater than 1 and considered it to have no performance slack if its q ratio was less than 1.

The Study

Our original sample consisted of all 138 companies placed on the Focus List between 1991 and 1995 for which CRSP reported stock returns. Of this total, 30 companies were removed because they did not have sufficient data in the Compustat files to compute Tobin's q and 5 more were removed because they did not have earnings forecasts in the I/B/E/S earnings-forecast database, leaving 108 companies in the sample.2

Stock Market Reaction. We computed abnormal returns as the difference between the actual return and an expected return generated by the market model;

$$A_{j,t} = R_{j,t} - (\hat{\alpha}_j + \hat{\beta}_j R_{m,t}), \tag{1}$$

where

$A_{j,t}$ = the abnormal return for company j on day t

$R_{j,t}$ = the rate of return for company j for day t

$R_{m,t}$ = the market return for day t

Following Patell (1976), we standardized and cumulated excess returns, a process that produced a normally distributed Z-statistic. Day 0 is the release date of the Focus List to the public. Table 1 reports the cumulative abnormal stock returns (CARs) surrounding release of the Focus List for the full sample, the q < 1 subsample (companies without performance slack), and the q > 1 subsample (companies with performance slack).

As shown in Panel A, the full sample had a significant 88-day pre-release average CAR of about -12.3 percent. This finding agrees with that of Opler and Sokobin, who found significant underperformance in the 48 months and 12 months prior to the list release date. The underperformance for the five days surrounding the list release was similarly negative and significant. Finally, Panel A provides no evidence

of postannouncement drift in the 88 days after the release of the Focus List. Thus, we cannot confirm for the full sample the improvement in post-release performance reported by Opler and Sokobin. These results suggest that inclusion on the Focus List is, on average, bad news but that it somehow halts the slide in stock value that led to the inclusion on the list in the first place.

Table 1.

Table 1. Market Response to Focus List Inclusion, October 1, 1991, to October 1, 1995

Window	Cumulative Abnormal Responses		Positive Responses	
	Mean CAR	Z-Statistic	Percent Positive	Z-Statistic
A. Full sample of 138 companies				
(−90, −3)	−12.33%	−7.60***	26.67%	−4.63***
(−2, +2)	−0.91	−2.89***	34.81	−2.73***
(+3, +90)	−0.18	0.16	51.11	1.07
B. Sample of 75 companies with q < 1				
(−90, −3)	−10.67%	−5.05***	29.33%	−2.92***
(−2, +2)	−1.08	−2.65**	32.00	−2.46**
(+3, +90)	−0.63	−0.44	49.33	0.55
C. Sample of 33 companies with q > 1				
(−90, −3)	−13.40%	−4.26***	21.21%	−3.00***
(−2, +2)	−0.54	−1.37	33.33	−1.61
(+3, +90)	+7.01	2.13**	63.64	1.88*

Note: For mean CARs, significance was measured as different from zero in two-tailed tests; for percentages of positive abnormal returns, significance was measured as different from 5 percent in two-tailed tests:

*Significant at the 10 percent level.
**Significant at the 5 percent level.
***Significant at the 1 percent level.

Results reported in Panels B and C suggest that a post-release improvement in stock price does occur but that it is limited to those companies with performance slack. First, both panels indicate significantly negative pre-release returns for the subsamples. But the similarities in the results of the two subsamples end there. The returns for the companies without performance slack were significantly negative for the five days surrounding the announcement period, whereas for companies with performance slack, the average announcement-- period CAR was not significantly different from zero. Apparently, market participants judge inclusion on the Focus List as bad news only for companies without performance slack. Furthermore, in the 88-day post-release period, the average CAR for companies with performance slack became a significantly positive 7.01 percent, whereas that for companies with no performance slack was an insignificant -0.63 percent. These event-study findings indicate that release of the Focus List starts the process of reevaluation for the included companies. For those companies with little chance for improved performance, inclusion on the Focus List is interpreted by the market as bad news initially but tends to stop the slide in stock performance indicated in the pre-release period. For companies with performance

slack, however, making the list not only stops the pre-release slide in equity values but also seems to mark an upturn in stock market performance, as indicated by the post-release average abnormal return. These findings are consistent with Hypothesis 1: Stock market reaction to release of the Focus List depends on whether the company has performance slack or not. In the next section, we focus on how the market's expectations for improved post-release performance are established for these companies.

Basis of Analysts' Forecast Revisions. To test whether analysts revise their expectations for future cash flows when the Focus List is released, we needed a proxy for those expectations. With their initial earnings forecasts, analysts help the market set the initial level of expected cash flow for each company. Similarly, revisions in those forecasts help the market revise its expectations for cash flow to some new level. We used reported earnings-- forecast revisions after the release of the Focus List as a proxy for changes in analyst expectations for future cash flow. Significant positive forecast revisions on release of the list will be consistent with an upward revision in the market's expectations for future cash flows. If these revisions occur only for the companies with performance slack, then Hypothesis 2 will be supported.

Following Brous (1992), we measured earnings-forecast revisions, FR, by using the following equation:

$$FR_{i,t} = \left[\frac{(F_{i,t} - F_{i,t-1})}{P_i} \right] 100, \tag{2}$$

where

$F_{i,t}$ = median current-year forecast in month t for the annual earnings per share of company i

$F_{i,t-1}$ = median EPS forecast in month $t-1$

$FR_{i,t}$ = earnings-forecast revision for company i in month t

P_i = stock price for company i six months before release of the Focus List

This simple equation is not sufficient, however, to provide a proof of Hypothesis 2. O'Brien (1988) showed that reported earnings forecasts systematically decrease until actual EPS are announced by the company. Furthermore, Brous reported that analysts update their forecasts for any specific company only every four or five months. These two findings imply that (1) forecasters are systematically overoptimistic when making their first earnings forecast for a company and (2) in any given month, only about 20 percent of forecasts are updated. Therefore, revisions in analysts' forecasts for any specific company tend to be serially correlated. For example, release of new positive information will cause the median earnings forecast to rise for up to four subsequent months as more analysts use the new information to update their forecasts. Obviously, to test our hypothesis that revised forecasts of cash flow are positive only for companies with performance slack, we needed a measure of the surprise forecast revisions after correcting for this serial correlation.

To isolate the surprise revisions, we used a modified version of the Ederington and Goh (1998) procedure, which is, in turn, a variant of the method pioneered by Brous. We started by randomly choosing 500 companies from the I/B/E/S data tape. For each of these companies, we randomly selected a 25-month period between January 1984 and December 1990 and, pooling the resulting data, estimated the following equation through use of a first-order Almon (1965) lag:

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$$FR_{i,t} = -0.093 + 0.085FR_{i,t-1} + 0.085FR_{i,t-2}$$
$$+ 0.081FR_{i,t-3} + 0.072FR_{i,t-4} + 0.058FR_{i,t-5}$$
$$+ 0.040FR_{i,t-6} + u_{i,t}. \tag{3}$$

The negative intercept in this equation indicates that, in the absence of new information, forecast revisions tend to be negative, which confirms O'Brien's findings. For instance, for a company with a P/E of 15, the negative intercept implies an average revision of −1.4 percent (15×0.093 percent) each month until actual earnings are reported. In addition, the positive coefficients on the lagged forecast revisions confirm Brouse's finding that forecast revisions tend to be followed by further revisions of the same sign. For instance, the estimated coefficients from Equation 3 indicate that a doubling of the median forecast in one month tends to be followed by an increase of about 8.5 percent

the following month, 8.5 percent two months later, 8.1 percent the third month after the original revision, and so on for six months.

We used the coefficients from Equation 3 and each company's past values of FR to calculate an expected forecast revision, $E(FR_{i,t})$. The difference between the actual revision in the consensus forecast in month t and its expected revision is our abnormal forecast revision, $AFR_{i,t}$.

Specifically,

$$AFR_{i,t} = FR_{i,t} - E(FR_{i,t}). \tag{4}$$

Finally, we cumulated the abnormal forecast revisions to obtain the full effect of the release of the Focus List on EPS forecast revisions. The four-month cumulative abnormal forecast revisions, $CAFR$, are given by

$$CAFR_I = \sum_i (CAFR_{i,t})$$
$$= \sum_i \left[\sum_{t=0}^{3} (AFR_{i,t}) \right]. \tag{5}$$

Table 2 presents the cumulative abnormal earnings-forecast revisions for the four-month period beginning in the release month and ending in the third month after the release of the Focus List. The results mirror our event-study results. The $CAFR$ for the full sample is positive but not significantly different from zero. Similarly, the average $CAFR$ for the sample of companies without performance slack is not different from zero. In contrast, the $CAFR$ for the sample of companies with performance slack is significantly positive at the 5 percent level. These results are consistent with Hypothesis 2: Financial analysts revise their cash flow estimates upward only for companies on the Focus List with performance slack.

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Stock Returns and Cash Flow Revisions. We formally tested for a relationship between forecast revisions and abnormal stock returns by using ordinary least-squares regression analysis. Specifically, we regressed the stock market reaction, measured by the CAR, on the cash flow revisions, measured by the four-month CAFR. If cash flow revisions lead to abnormal stock returns, as stated in Hypothesis 3, the coefficient on CAFR should be positive and significant. Given our previous results, however, performance slack may overshadow forecast revisions in explaining postrelease abnormal returns. To control for this possibility, we included in the regression a dummy variable, Dummy q, that took the value of 1 when q was greater than 1 and zero otherwise.

Results for the cross-sectional regression analysis are presented in Table 3. The results for Model 1, in which the dependent variable is the five-day announcement-period CAR, show no relationship between cumulative abnormal returns and the independent variables CAFR or Dummy q. This result implies that at the release of the Focus List, the market does not use these particular variables to distinguish between the companies on the list. The result is consistent with our previous results. The results for Model 2, however, in which the dependent variable was the 88-day post-release CAR, show that both Dummy q and CAFR are significantly and positively related to the post-release cumulative abnormal return, with an adjusted R^2 of 0.10. These findings support Hypothesis 3: Post-release abnormal returns are driven by cash flow revisions, even after performance slack is controlled for.

Table 2.

Table 2. Analyst Response to Focus List Publication, October 1, 1991, to October 1, 1995

Sample	Mean CAFR (× 100)	t-Statistic	Standard Deviation	Observations
Full	0.275	1.02	0.03099	133
$q < 1$	0.031	0.16	0.03259	73
$q > 1$	0.142	2.24**	0.00354	31

Note: Reported are the mean cumulative forecast revisions, $CAFR_I = \Sigma_i(CAFR_{i,t})$, where

$$CAFR_{i,t} = \sum_i \left\{ \sum_{t=0}^{3} [FR_{i,t} - E(FR_{i,t})] \right\}$$

and P_i^* is the price per share one month prior to the list's release date. The mean abnormal, or surprise, forecast revision, $E(FR_{i,t} \mid FR_{i,t-j})$ with $j = 1.6$, is the expected forecast revision in month t.

**Significant at the 5 percent level in two-tailed tests.

Table 3.

Table 3. Cross-Sectional Analysis of Target Company's CAR, *AFR*, and Tobin's *q*

Variable	Model 1	Model 2
Intercept	−0.010	−0.005
t-Statistic	−1.931	−0.227
Dummy q	0.004	0.093
t-Statistic	−0.804	2.199**
CAFR	−0.130	2.135
t-Statistic	0.426	2.997***
Adjusted R^2	−0.01	0.106
F-Statistic	0.408	7.037***

Note: The dependent variable is CAR over the announcement period (−2, +2) in Model 1 and is CAR over the postannouncement period (+3, +90) in Model 2.

  **Significant at the 5 percent level in two-tailed tests.
  ***Significant at the 1 percent level in two-tailed tests.

Conclusion

We provided evidence that, contrary to much of the existing literature, actions by institutional investors do affect the equity values of the companies targeted. The effect is not the same, however, for all companies. Release of the CII Focus List generated an immediate negative stock market reaction for the companies in our sample. On publication of the list, financial analysts, however, increased their earnings estimates for companies with performance slack while not revising estimates for companies without performance slack. The increases in expected cash flows were followed by significant positive postrelease abnormal stock returns. For companies without performance slack, post-release stock returns were negative and insignificant. Finally, the regression analysis showed that post-release stock returns are significantly related to forecast revisions for the entire Focus List. Apparently, for this sample, the market expects the spotlight provided by release of the Focus List to produce positive results in companies with the ability to respond.

Footnote

Notes

1. See www.cii.org/focus.htm.

2. Tobin's q was calculated by using the Chung and Pruitt (1994) methodology.

3. We used post-release returns for parameter estimation because, by definition, the pre-release stock returns are poor for companies included on the Focus List and use of preannouncement returns for estimation could bias the results. As it turns out, when we estimated the parameters using the pre-release period, the results were not materially affected.

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