

The Wall Street Walk when Blockholders Compete for Flows

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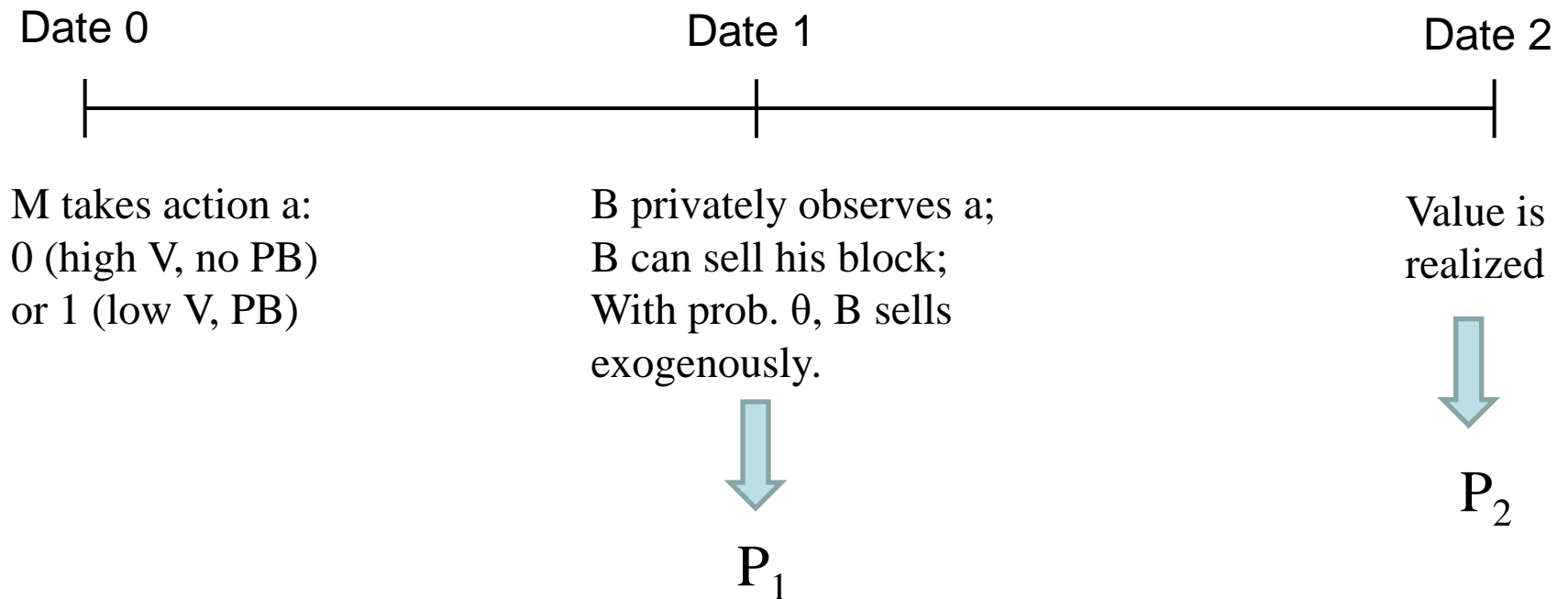


Overall

- Combine two well-known ideas:
 1. A threat of exit can be a form of shareholder activism (Admati and Pfleiderer, 2009; Edmans, 2009).
 2. Blockholders are often funds that care about future AUM
- **Main result:** Exit is often no longer a credible threat
- A new and very interesting insight

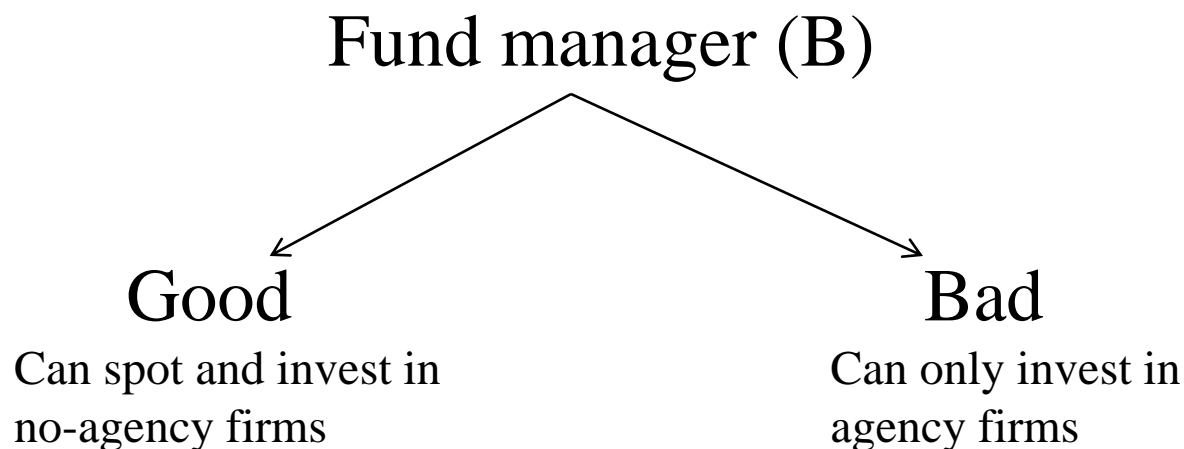
Overview of the Intuition

- Take the setup from Admati-Pfleiderer:
 - Players: Firm manager (M), Blockholder (B)



- M's payoff: $w_1 P_1 + w_2 P_2 + PB$

Overview of the Intuition



- Investors update their beliefs about B at $t=1$ and retain/fire B
 - Retention: continuation payoff π_G or π_B
- B's payoff: retention payoff ω + fraction α of liquidation value

Results

- B exits at $t=1$ \Rightarrow Investors learn that the fund manager is bad \Rightarrow Outflows \Rightarrow B does not get ω
- More generally:
 - Low α/ω \Rightarrow Exit is not a credible threat
 - High α/ω \Rightarrow Exit is a credible threat

Comments

1. What is the best application?
2. Motivating assumptions
3. Endogeneity of continuation payoffs
4. Endogeneity of portfolios
5. Strengthening empirical implications

Q1: Application

- Is mutual vs. hedge funds the best application?
- If our main goal is to explain why exit as a form of voice works better for HFs, there are other (more intuitive?) explanations:
 - HFs find it easier to trade contractually (think about index MFs at the extreme)
 - Easier shorting for HFs magnifies the threat of exit
 - Endogeneity of the organizational form

Q1: Application

- Suggestion: Focus your discussion on one class of funds at a time (hedge, pension, mutual)
- This will even the ground regarding between-class heterogeneity and allow to obtain more detailed predictions
- A lot of heterogeneity there:
 - Length of history, past track record, etc.
 - All of it shapes the trade-off between information effect from the exit and a loss of value from holding

Q2: Motivating Assumptions

- Key assumption:
 - Sale of the block is informative about the fund manager's ability
- Is there empirical support for it? Can be difficult:
 - Selection: if it is a negative signal, you are unlikely to sell
 - Reverse causality: you are more likely to sell the block if you expect outflows tomorrow
- Still, it is a crucial assumption for the theory, so any motivation would be nice
 - Perhaps case studies from the press...

Q3: Exogeneity of Continuation Payoffs

- In the model, continuation payoffs of investors are exogenous parameters, π_G and π_B .
- Is it without loss of generality? I am not so sure, because π_G and π_B can depend on the structure of the equilibrium
- **Example:**
 - Consider a repeated version of the same problem
 - At the beginning of every “period”, B forms a block in the new portfolio company. B liquidates it either in the middle (“exit”) or at the end of the “period”.

Q3: Exogeneity of Continuation Payoffs

- What can we say about π_G and π_B in this case?
- If the threat of exit is credible, then $\pi_B = \pi_G$.
- If the threat of exit is not credible, then $\pi_B \ll \pi_G$.
- But the equilibrium in a one-shot model depends on $\pi_G - \pi_B$!
 - Low $\pi_G - \pi_B$ lowers the importance of beliefs for B and makes the threat of exit more credible.
- Multiplicity of equilibria?
- Bottom-line: Maybe exogeneity of continuation payoffs is not innocuous.

Q4: Endogeneity of Portfolios

- Suppose that the threat of exit is not credible. What are rational responses of B?
 - Do not buy the block in the first place, because holding a block is costly (diversification, liquidity)
 - Share information with some other shareholders (i.e., “outsource” the threat)
 - Buy a bigger block to have more direct “say”
- It seems that there can be interesting implications for the portfolio structure of B.

Q5: Strengthening Empirical Implications

- Stock price reaction to exit
 - Different if exit is credible vs. non-credible threat
 - Very testable (e.g., MFs vs. HFs or HFs-activists vs. non-activists)
- Stock price reaction to a formation of a block
- Think broader about α/ω
 - Not only a compensation contract, but more generally information from exit vs. a loss from holding – length of history, past track record.

Conclusion

- The paper is very interesting
- The main economic insight is new and very neat
- It would be useful to refine more applications and empirical predictions, motivate the key assumption more, and think about endogeneity of continuation payoffs.