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Shareholder investment horizons and the market for corporate control☆

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Abstract

This paper investigates how the investment horizon of a firm's institutional shareholders impacts the market for corporate control. We find that target firms with short-term shareholders are more likely to receive an acquisition bid but get lower premiums. This effect is robust and economically significant: Targets whose shareholders hold their stocks for less four months, one standard deviation away from the average holding period of 15 months, exhibit a lower premium by 3%. In addition, we find that bidder firms with short-term shareholders experience significantly worse abnormal returns around the merger announcement, as well as higher long-run underperformance. These findings suggest that firms held by short-term investors have a weaker bargaining position in acquisitions. Weaker monitoring from short-term shareholders

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could allow managers to proceed with value-reducing acquisitions or to bargain for personal benefits (e.g., job security, empire building) at the expense of shareholder returns.

JEL classification: G34; G23; G32

Keywords: Investment horizon; Mergers and acquisitions; Shareholder heterogeneity; Institutional investors; Short termism

1. Introduction

This paper is an empirical analysis of the impact of shareholder investment horizons on the market for corporate control. Our purpose is to investigate the claim that the U.S. corporate governance system myopically puts too much emphasis on the short term, leading to distorted investment decisions.[1] Mergers and acquisitions (M&As) are a good setting to study the influence of shareholder investment horizons on corporate decision making. An acquisition is an important investment decision likely to impact the shareholder value of the bidding firm. Receiving an acquisition offer is often a direct source of sizable gains for target firm shareholders. In addition, unsolicited acquisitions provide indirect gains by disciplining managerial actions ex ante (Jensen, 1993).

Investment horizons, as many other shareholder characteristics, are naturally hard to observe. The availability of data on institutional holdings provides a unique opportunity to infer investment horizon from actual portfolio behavior. Institutions constitute the biggest investor group in the U.S. equity markets and are usually portrayed as a pivotal investor group in takeovers (Useem, 1996). They are also investors whose portfolio policies are important, well defined, and professionally set up. Previous research has investigated the role played in acquisitions by different classes of shareholders (e.g., managers, institutions, blockholders) but has not addressed investment horizon per se.

Institutional investors have different portfolio horizons for many reasons. Different demographics or liquidity needs of final owners can imply strategies with different horizons. For example, employee-defined contribution plans usually have a long-term orientation, while retail open-ended mutual funds tend to be more short-term oriented because of frequent money inflows and outflows (Edelen, 1999). Agency problems inherent in delegated asset management also affect investment horizons. Shorter horizons could result from the inability to continuously gather capital to implement long-term strategies (Shleifer and Vishny, 1997) or from the incentives to trade on short-term signals if there is imperfect information about the portfolio manager's ability (Scharfstein and Stein, 1990; Dow and Gorton, 1997).

M&A events are strongly affected by agency problems existing between managers and shareholders. The effectiveness of the monitoring activities that can alleviate

[1]See Stein (1989), Porter (1992), and Noe and Rebello (1997).