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Crushed by a rational stampede: Strategic share dumping and shareholder insurrections ☆

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Abstract

In this paper, we develop a dynamic model of institutional share dumping surrounding control events. Institutional investors sometimes dump shares, despite trading losses, in order to manipulate share prices and trigger activism by "relationship" investors. These institutional investors are motivated to trade not only by trading profits but also by a desire to protect the value of their inventory and to disguise the quality of their own information. Relationship investor profit from targeting firms both by improving firm performance and by generating private information.

JEL classification: G23; G32; G34

Keywords: Strategic trading; Ownership structure; Corporate governance

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1. Introduction

Trade in the shares of a troubled firm is characterized both by institutional shareholder share dumping and share acquisition by relationship investors.[1] This pattern of trade in troubled firms cannot be completely explained without developing a dynamic model that incorporates both relationship investing and informed trading. This paper develops a dynamic model relating relationship investing and informed trading. In our analysis, one type of strategic investor, whom we refer to as the "institutional investor," is sometimes able to acquire private information about the quality of a firm's management.[2] Whether a given institutional investor really has private information, or rather, trades simply on market priors, is itself private information. Another type of strategic investor, whom we refer to as the "relationship investor," has no ex ante information endowment. However, in some circumstances a relationship investor can create value through activism. When management quality is good, activism does not create value; when management quality is bad, activism creates value. Institutional investors do not intervene in governance themselves, but instead follow the "Wall Street rule," expressing their preferences through trading. The problem for a given institutional investor is that, from the perspective of maximizing trading profits, she wants prices to be uninformative. However, uninformative prices may cause the relationship investor to abjure activism, which lowers the value of her portfolio. The relationship investor's problem is that he is never sure whether any given firm has poor management and thus needs a dose of activism. Direct communication between the institutional investor and the relationship investor is not incentive compatible: Because the institutional investor bears none of the costs of activism but she reaps buy-side profits from lowering the stock price, has an incentive to trigger activism by reporting adverse conditions even when they are absent. Thus, information transmission can occur through the observation of security prices.

In the first-period, the institutional investor and the liquidity investor trade and the marketmaker sets prices based on the pattern of their order flow. This first-period order flow, which reveals both net order quantities and trading volume, is observed by all agents, including the relationship investor. In the second period, the relationship investor, armed with the information from the order flow, then decides whether to trade and/or intervene in the second period. The institutional trader and the liquidity traders also decide the trades they will submit. The trading decisions of the institutional trader, relationship investor, and the liquidity trader determine second-period prices. Each first-period trade by an institutional investor has three effects; namely, it generates an immediate trading profit or loss, it affects the posterior beliefs of the relationship investor, and it affects the posterior beliefs, and

[1]See Parrino et al. (2003) for an empirical analysis of share dumping by institutional investors and see Webcomm.com (2002) and Byrnes and Laderman (1998) for examples of relationship investing in troubled firms following a stock price drop.

[2]We use "institutional investor" to refer to any investor who owns a stake sufficiently large that his trades affect prices and who lacks the ability to effectively intervene in the operation of the firm. Many pension funds, insurance companies, and large private investors could fall under this description.