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Do small shareholders count? ☆

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ABSTRACT

We hypothesize that age similarity among small shareholders acts as an implicit coordinating device for their actions and, thus, could represent an indirect source of corporate governance in firms with dispersed ownership. We test this hypothesis on a sample of Swedish firms during the 1995–2000 period. Consistent with our hypothesis, we find that compared with shareholders of differing ages, same-age noncontrolling shareholders sell more aggressively following negative firm news; firms with more age-similar small shareholders are more profitable and command higher valuation; and an increase (decline) in a firm's small shareholder age similarity brings a significantly large increase (decline) in its stock price. The last effects are more pronounced in the absence of a controlling shareholder.

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1. Introduction

The corporate finance literature suggests that dispersed shareholders leave the company at the mercy of the managers who can expropriate from the firm's owners at will. This literature stresses the role of controlling shareholders as the main monitors of managers and, therefore, as key determinants of firm value (Holmstrom and Tirole, 1993; Bolton and von Thadden, 1998a, 1998b; Kahn and Winton, 1998;Noe, 2002; Faure-Grimaud and Gromb, 2004). In general, small noncontrolling and non-strategic shareholders are assumed not to monitor, as each small shareholder has little power and no incentive to engage in monitoring. At the same time, standard asset pricing models predict that the actions of every shareholder, including those of the small shareholders, could affect the price of the stock (Hong, Kubik and Stein, 2004).

While we are not aware of any study that explicitly shows how small shareholders can directly condition the behavior of the manager and the firm's corporate policies, small shareholders as a group could play a critical role. Suppose that a large number of small shareholders coordinate the timing of their stock sales. Such action undoubtedly has a strong effect on the stock price, an effect that could last for a while and, hence, would

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certainly get the attention of the manager, especially when his compensation is strongly linked to the stock price. Given that the cost of coordination among many small shareholders is prohibitively high, this channel of corporate governance has been left largely unexplored by the literature. We argue that such coordination could arise unintentionally if small shareholders have common features that drive their information processing and stock sales. Thus, a high degree of similarity among the firm's current small shareholders could translate into correlated selling behavior that resembles the behavior of a large shareholder, even without deliberate coordination. That is, small shareholder similarity could lead small shareholders to also have a role in disciplining managers, even if these shareholders are neither more strategic nor more capable of monitoring management than usually assumed. For instance, these shareholders could be noise traders who happen to react to news in the same way without any underlying model (behavioral setting), or they could be rational traders who happen to interpret news in the same way (differences of opinions setting).

This paper tests whether such unintentionally coordinated actions constitute a channel through which small shareholders as a group can discipline managers. The basic threat for managers is that if they disappoint a large group of similar small shareholders, those shareholders would take a "Wall Street walk" by selling the stock at the same time (effectively selling like a large shareholder would), bringing about a sharp drop in the stock price. The implicit threat of a shareholder sell-off makes it more expensive for equity-incentivized managers to engage in value-reducing activities. The crucial parameter here is the degree of coordination, which we conjecture to depend on the degree of similarity among noncontrolling shareholders.

Our argument hinges on managers' awareness of the degree of similarity among the firm's shareholders. In most countries this information is not directly accessible to the manager. In Sweden, however, Central Security Registry (Värdepapperscentralen AB, or VPC) collects data on holdings of Swedish companies. SIS Ägarservice AB uses semiannual snapshots of these data (as well as their own proprietary data on voting pacts, family connections, trusts, strategic shareholdings via foreign holding firms, etc.), and sells these data to firms and other interested parties.[1] This dataset contains information on practically all shareholders of all listed firms, including their age, location, and other demographic characteristics. We use this unique dataset of Swedish firms to test our hypotheses.

More specifically, using the Swedish dataset for the 1995–2000 period, we create measures of shareholders' similarity based on age, wealth, and location. While we do not know a priori which traits are more important, age seems a likely candidate, as different cohorts are exposed to different fads and investment climates. For example, shareholders who have lived through a long bear market may react differently to information than shareholders who have experienced only a stock market boom.[2] Age similarity is also related to the formation of social networks, which could facilitate the sharing of information and opinions and thus lead to coordinated actions. For each firm, we measure the degree of similarity across all its individual noncontrolling shareholders.

To show that our argument has support in the data, we need to perform the following sequence of tests. First, we must show that more similar individual shareholders do act in a coordinated fashion in their selling decisions, especially in response to bad news, which is essential to attract the attention of managers. Next, we must show that managers react to this information. That is, we must provide evidence that firms with more similar small shareholders exhibit higher profitability. Finally, we must show that the markets value the similarity of small shareholders, all else equal. We perform each of these tests. The results suggest that small shareholder similarity acts as a (hitherto unexplored) driver of corporate value creation.[3]

We start by showing that more age-similar small shareholders tend to sell less under normal conditions. This suggests that they tend to hold on to a stock longer. This makes them an identifiable and persistent group. At the same time, we show that firms with a higher percentage of age-similar small shareholders experience larger sell-outs following bad news. A negative surprise shock translates into 11% higher sales for stocks with above-median homogeneity of common shareholders. As predicted, this behavior is asymmetrical: Shareholder similarity does not play any role in shareholders' response to positive news, and buying behavior is not affected either. This is because share ownership itself introduces the asymmetry; that is, shareholders are more likely to sell than to buy. We do not find much effect of wealth similarity. In robustness tests we show that individual small shareholders tend to show more herding in their investment decisions with investors in their own age cohort than with investors from other cohorts. Overall, these findings suggest that age-similar small shareholders tend to react more aggressively to bad news about the firm and that this threat of unintentionally coordinated action is persistent.

Next, we relate small shareholder similarity to firm profitability and value. Here we must address the potential endogeneity of ownership structure (Demsetz, 1983; Demsetz and Lehn, 1985). Relying on the findings on

[1] For a small subset of large firms the information is distributed on a biweekly basis.

[2] In sociology this is described as generational theory. According to Karl Mannheim, generation affect an individual's consciousness in much the same way as social class or culture does. "Individuals who belong to the same generation, who share the same year of birth, are endowed, to that extent, with a common location in the historical dimension of the social process" (Mannheim, 1997 [1952], 35).This result in the formation of particular dispositions and "certain definite modes of behavior, feeling, and thought" (Mannheim, 1997 [1952], 36). Generational influence, therefore, determines how individuals perceive, experience and interpret the information about social world, which in turn affects the range of possible forms of behavior.

[3] While higher similarity of small shareholders seems to create value on average, we do not claim that it always helps companies. A pseudo-coordinated sale based on a wrong interpretation of news could hurt a perfectly healthy company.

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