

The real effects of long-term investors in listed companies

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Abstract:

To review the academic literature in finance on long-term investors, the role of shareholders, in particular institutional investors, is highlighted. Three points are broached: What is a long-term investor? What are the theoretically possible relations between an investor's investment horizon and corporate decisions? And what do we learn from empirical studies about the real effects of long-term investors in a firm? In conclusion, the various ways of fostering long-term shareholding are discussed.

For several years now, academics, the media, public authorities and professionals in finance have been paying closer attention to long-term investors. In France, the so-called Florange Act of 29 March 2014 has provided for generalizing the practice of one-share/two-votes under condition that the share has been held for at least two years. The main argument for this provision was to give more power to long-term shareholders. At a time when other European countries are preparing to adopt similar measures, what do we know about the role of long-term investors in firms and the actual effects of long-term investments?

This article reviews academic writings on long-term investors by focusing exclusively on shareholders, in particular institutional investors.¹ The state, the firm's founding families, other listed firms and insiders can be considered to be long-term shareholders, but they might have a quite different orientation from institutional investors.²

This article addresses three questions. First of all, what is a long-term investor? The answer is not evident. What past or current information is to be used to decide whether an investor wants to be involved in the firm's activities for a long time? Secondly, what are the possible relations between investment horizons and the decisions made by firms? From a theoretical viewpoint, the question of how the presence of long-term investors affects a firm entails making certain conditions explicit. Thirdly, what do empirical studies (many of them conducted in the United States) tell us about the actual effects of long-term investors on a firm? In conclusion, the ways to foster long-term share-holding will be discussed.

¹ A more thorough discussion of several points raised in this article can be found in the reviews of academic literature by Gaspar (2009) and Garel (2016). The list of the studies mentioned herein is not intended to be exhaustive, more attention having been paid to recent studies.

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² In particular, such majority shareholders might approach strategy and policymaking differently; and this would limit the conclusions to be drawn about the impact of long-term shareholding on corporate decisions and performance. Akbas *et al.* (2020) have studied the investment horizon of insiders.

Who are long-term investors?

A long-term investor can be defined as an investor who plans to hold shares in a firm for a long time; in other words, he does not intend to sell his shares before several years. In contrast, a short-term investor imagines keeping shares for a short period; in other words, he intends to sell his shares very soon (within the year or quarter). How to know whether an investor intends to keep his shares for long? This is a major question.

Researchers have tried to infer investors' intentions from their past behaviors (BUSHEE 1998, CELLA *et al.* 2013, CREMERS & PAREEK 2016, DERRIEN *et al.* 2013, GASPAR *et al.* 2005). For instance, the average turnover rate in an investor's portfolio has been calculated to provide a historical average of the shareholding period. On the assumption that past behavior can serve to predict future behavior, metrics of this sort are then used to classify investors as a function of their expected investment horizon. A second hypothesis, by implication, is that an investor has more or less the same investment horizon for all firms in his portfolio. If this is not so, measuring his investment horizon on the basis of his portfolio will not be the best approach; instead, the measurement would have to be made in relation to each type of security in the portfolio.

What to expect from long-term investors in a firm's capital?

In a world without any agency problem, without market short-termism and without incorrect ratings of corporations, an investor's investment horizon should not affect corporate decisions. In contrast, in a firm where the CEO does not try to maximize the firm's intrinsic value, investors with a longer investment horizon might more closely oversee managerial decisions and intervene more often in management, whether when voting or through informal discussions (McCAHERY *et al.* 2016).

Everything else being the same, long-term investors, in contrast to short-term investors, have an interest in exercising more oversight, since the cost of their efforts to find and process information about the firms where they invest will be smoothed out over a longer period. They will thus benefit more from these efforts. In a cohort of long-term institutional investors represented by index funds, we might expect that, by advocating improvements in the quality of corporate governance (following the recommendations of proxy advisors), they help to increase a firm's value. Furthermore, such long-term investors might also loan their shares and help discipline executives through short-selling (MASSA *et al.* 2015); or they might support campaigns by activist investors for changes that would create value in the coming years (BRAV *et al.* 2015). As for passive institutional investors however, there is no consensus about their role. Bebchuk *et al.* (2017) have defended the idea that index funds have few incentives for trying to significantly improve a firm's governance or performance.

Another factor is often mentioned to argue for the positive role of long-term investors, namely the market's short-termism, which supposedly pushes firms to sacrifice long-term investment policies for better short-term results. This hypothesis implies that the market does not correctly evaluate long-term investments and/or that it overreacts to announcements of

earnings.³ In support of the idea that the securities market is conducive to short-termism, Asker *et al.* (2015) have found that listed companies invest much less than unlisted companies. Whereas several studies have questioned whether short-termism is endemic in the securities market as a whole (FRIED & WANG 2018, KAPLAN 2018, ROE 2018), others have shown that executives in listed firms might be occasionally incited to prefer short-term results to the detriment of investments for a longer term (EDMANS *et al.* 2017, GAREL 2017, KRAFT *et al.* 2018, LAUX 2012).

American directors of finance, in particular, feel forced to “meet or beat” the targets that analysts set for earnings per share (EPS) and, to do this, say they are ready to sacrifice long-term value (GRAHAM *et al.* 2005). Short-term investors might push executives to make exaggerated cuts in investments in order to surprise the market with a positive EPS. This supposes that short-term investors can benefit from a temporary inflation of the stock market price associated with this positive surprise and sell their shares, while the firm and long-term investors will have to put up with the consequences of a lack of investment (BOLTON *et al.* 2006). More long-term investors in a company’s capital might prevent this deviation. This theoretical argument is, it should be pointed out, based on the idea that short-term investors manage to resell their shares to other investors who do not perceive the eventual loss entailed by an inflated EPS.

This theoretical argument is usually grounded on the idea that, when the price of a firm’s securities in the stock market is temporarily not correlated with its intrinsic value, the investors who want to sell their shares soon will push executives to undertake certain actions, which might lead to decisions that destroy value. In general, long-term investors can form a shield against such actions. Since they do not want to sell their shares in the short run, they do not expect executives to blindly react to the price in the stock market when it is out of line with the firm’s intrinsic value. On the contrary, they presumably encourage executives to concentrate on management fundamentals, which condition the expectancy of gains in a longer run. This argument can be extended to crises when the share’s value falls below the intrinsic value. Whereas short-term investors tend to accelerate the drop in the stock market price by selling, long-term investors have no reason to sell and can wait till the storm is over. So, a large base of long-term investors should enable a firm to limit the impact of falling stock market prices during a crisis.

Another factor in line with this argument about short-termism is that the market has trouble correctly evaluating how intangibles should be reflected in a firm’s value. In modern corporations, intangibles (such as employee and customer satisfaction) are key means for creating value. Their contribution to the value of a firm has been established, but the market might lag in taking them into account. As Edmans (2011) has shown, intangibles have to have started producing tangible results (*e.g.*, more profit) before market expectations will be corrected.

Given their distant investment horizon, long-term investors are the natural beneficiaries of policies for developing intangibles, including those related to corporate social responsibility (CSR). Long-term investor would tend to encourage the firms in their portfolios with regard to intangibles, since, in the long run, when the market reprices shares, these intangibles will add

³ In the absence of such biases, it might be optimal for a firm to distribute cash to shareholders. When there is a lack of investment opportunities, this would not be evidence of market short-termism.

to the share value (thus benefitting these investors). This is not so for short-term investors (BÉNABOU & TIROLE 2010). A prediction consistent with this theoretical argument is that long-term investors should favor intangible investments, which create value in the long run, including investments in CSR (such as employee satisfaction).

What are the actual effects of long-term investors?

One set of studies reports findings in support of the argument that long-term investors contribute positively to a firm's value because of a disciplinary effect on corporate executives: improved performance in cases of mergers and acquisitions (GASPAR *et al.* 2005, CHEN *et al.* 2007) and better governance (HARFORD *et al.* 2018). In particular, American mutual funds that are passive investors influence the governance of firms “*resulting in more independent directors, removal of takeover defenses, and more equal voting rights*” (APPEL *et al.* 2016).

Another set of empirical studies supports the idea that long-term investors attenuate the short-termism of corporate executives. Accordingly, a larger presence of long-term investors in the capital is associated with: on the one hand, fewer manipulations to meet or beat earnings targets (KOH *et al.* 2007) and less financial fraud (HARFORD *et al.* 2018), and, on the other hand, more investment (BUSHEE 1998) and more innovation (HARFORD *et al.* 2018).⁴

A third set of empirical studies lends support to the idea that the presence of long-term investors protects firms from a temporary mispricing of their securities by the market. When a firm's stock is undervalued, a larger base of long-term investors is associated with “*more investment, more equity financing, and less payouts to shareholders*” (DERRIEN *et al.* 2013). During market turmoil, investors with a short term horizon are more inclined to sell their securities than investors with a long horizon (CELLA *et al.* 2013), thus causing the prices of these securities to drop even farther. As a consequence, the securities in short-term investors' portfolios undergo a severe price swing, including an eventually bigger rebound, whereas the price swing of the shares of firms where majority shareholders are long-term investors are more limited. Garel and Petit-Romec (2017) have reported similar findings about banks during the subprime crisis. Specific to the theoretical argument about how the market misprices intangibles, Garel and Petit-Romec (2018) have empirically examined the relation between long-term investors and employee satisfaction. Their findings are consistent with the idea that CSR, when supported by long-term investors, maximizes long-term value.

Finally, Gaspar *et al.* (2012) have shown that firms with a large number of investors with short investment horizons tend to more often repurchase shares (plausibly to sell them in better circumstances). This underscores the actual effect of investment horizons on a firm's payout policies.

⁴ From another viewpoint unrelated to institutional investors, in a study of the contractual horizon of venture capital funds, Barrot (2016) has found that those funds with a long horizon select firms at an earlier stage of growth with a significantly growing stock of patents (compared with venture capital funds with a short horizon).

Conclusion

The academic literature has provided a theoretical basis for examining the impact of investors' investment horizons on listed firms; and empirical studies have confirmed the actual effects of the presence of long-term investors on: investments in tangible and intangible assets; the stock market during crises; the propensity of corporate executives to yield to the market's short-termist demands; a firm's payout policy; and its performance in cases of mergers or acquisitions.

So, how to bring more long-term institutional investors into the capital of listed firms? This question is two-pronged. First of all, what means (one share/two votes, bonus dividends, etc.) can be used to attract long-term investors or to stretch out the investment horizons of current shareholders? Secondly, how to implement these means — through regulation or market forces?

Bourveau *et al.* (2019) have analyzed the effects of tenure-based voting rights, specifically of the two votes per share introduced by the Florange Act in France. However this measure was intended to increase the power not so much of long-term institutional investors as of majority shareholders (families, the state). It is, therefore, unlikely that it has led to the benefits associated with the presence of more long-term institutional investors. What is worse: there is a risk that minority shareholders might end up expropriated. According to Bourveau *et al.* (2019), the introduction of a "double vote" has had a negative effect on foreign institutional shareholding, including by long-term investors, and is associated with higher capital costs. Apparently, this measure has tended to transfer power from certain long-term shareholders (institutional, foreign) toward other long-term shareholders (families, the state) without any significant positive effects on the firm's value.⁵ This is no surprise since, as Becht *et al.* (2018) have explained, the Florange Act forced some firms to adopt a system of governance that upset the previous equilibrium. The fact that most of the firms that had introduced tenure-based voting decided, by a wide majority, to return to a one-share/one-vote system is proof that they thought the prior situation was better. This provides food for thought about the limitations of shaping corporate governance through regulatory interventions.

Bolton and Samama (2013) have proposed another approach that leaves it up to each firm to decide. They have advocated rewarding with "loyalty shares" the investors who are willing to keep their shares in the firm for several years. The reward is a warrant "*giving the right to purchase a pre-determined number of new shares at a pre-specified price and granted to loyal investors at the expiration of the loyalty period*". This reward is worthless if, once the contractual horizon is reached, the firm's value has not increased much. The offering of "loyalty shares" should attract long-term investors who want to profit from the reward while helping to increase the firm's value.

In the coming years, more analyses will be made of the consequences of the many incentive arrangements now being set up either to attract new long-term investors or to make the investment horizon of a firm's current shareholders longer. These analyses will help us better understand the effects of long-term shareholding on firms and the best ways to form or consolidate a base of long-term shareholders.

⁵ According to Bena *et al.* (2017), a larger presence of foreign institutional investors is correlated with more long-term investments in tangible and intangible assets and in human resources.

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