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Blockholdings of Investment Professionals

Research Foundation Publications

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Investment Professionals

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Biographies of Authors

Sanjai Bhagat is a professor of finance at the University of Colorado at Boulder. He has published in the *Journal of Financial Economics*, the *Journal of Finance*, the *Journal of Accounting and Economics*, *Brookings Papers*, the *Journal of Financial and Quantitative Analysis*, and the *Journal of Law and Economics*. Mr. Bhagat has taught at Princeton University and the University of Chicago. He is considered an expert on corporate board structure and corporate finance, and his research has been cited extensively in the popular press.

Bernard S. Black is a professor of law at Columbia University. He is also a senior policy advisor to the Russian government. He is author of *Fundamentals of Negotiating and Drafting Acquisition Agreements* and has coauthored *A Guide to the Russian Law on Joint Stock Companies* (with Reinier and Anna Tarasova), *The Law and Finance of Corporate Acquisition* (with Ronald Gilson), and *Some of the Essentials of Finance and Investment* (with Ronald Gilson).

Margaret M. Blair is a senior fellow at the Brookings Institution. She has published *Wealth Creation and Wealth Sharing: A Colloquium on Corporate Governance and Investments in Human Capital*; *Ownership and Control: Rethinking Corporate Governance for the Twenty-first Century*; and *The Deal Decade: What Takeovers and Leveraged Buyouts Mean for Corporate Goverance*.

Foreword

Suppose you asked 100 practicing money managers the following question: What is the most important function you perform for your clients? Undoubtedly, many would quickly respond that selecting good stocks and bonds is the most fundamental decision they make on a day-to-day basis. Alternatively, some managers would argue that determining the proper asset and sector class allocations is (and should be) their primary focus. Still others might go so far as to say that educating investors about the nature of risk— and its relationship to promised return—is the true purpose of any investment counselor and that the actual investing is just a matter of details once the client's expectations have been properly managed.

Although reaching any sort of consensus on this seemingly simple query might be difficult, one response that you probably would not hear is that portfolio managers can best serve clients by cooperating with the companies in which they invest. If anything, the historical model of the financial services industry suggests that money managers should be advocates for investors to an extent that might require them also to be adversaries of corporations. The premise for this traditional view is that by centralizing control of capital among several investors, portfolio managers can serve as more-efficient monitors of corporate managers than if the individual investors performed this function separately. In this manner, the theory holds, many of the principal–agent costs that attend investing in the stock market—such as the payment of excessive perquisites—can best be controlled.

Notice that this view of money-manager-as-monitor carries with it the implied threat that a firm might be "disciplined" by having large blocks of stocks liquidated if it does not perform as expected. Indeed, the proliferation of hostile takeovers in the 1980s is often cited as compelling evidence of this trend toward investor activism. What if, however, institutional investors performed their monitoring role in a less threatening, more proactive manner? In particular, what if investors acquired large stock positions for long periods of time in an effort to work with firm management to increase organizational efficiency? In this monograph, Sanjai Bhagat, Bernard Black, and Margaret Blair examine whether this type of commitment—which has been called "relational" investing—actually does add value for the money management client by increasing firm value.

Specifically, the authors focus on the size and length of the stock positions investment advisors, investment companies, and broker/dealers take in various corporations and attempt to correlate these blockholdings with subsequent firm performance. At the end of this research, Bhagat, Black, and Blair summarize their findings as follows: "A conclusion that we can legitimately come to [is that] relationship investing is, at worst, neutral, and most probably adds value in many situations." If this seems a tepid judgment, the reader should bear in mind that the statistical methods the authors used are designed to be extremely conservative and protect against making strong statements prematurely. The problem in this case is not that the evidence supporting relationship investing is weak; rather, the significance of the myriad correlations reported varies greatly with the time period examined and how the investor is defined. In short, despite not being easily summarized, these findings do support the efficacy of investor–corporate partnerships.

Beyond their empirical work, the authors have done an excellent job of laying out the issues that define relationship investing. They have provided the reader with a brief but comprehensive literature review of research that further endorses the view that large block investments help to increase firm value. Bhagat, Black, and Blair are to be commended for the thoroughness of their effort and for extending the debate on institutional investor activism into these previously uncharted waters. Although the findings of their investigation might not have been as strong as they had hoped, the monograph nonetheless contains useful and thought-provoking information that enhances our understanding of this topic in a substantive way. The Research Foundation is proud to have supported this work, and we are pleased to bring it to your attention.

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Acknowledgments

Blockholdings of Investment Professionals

Corporate managers are the dominant power brokers in large U.S. corporations, but a substantial amount of financial research argues that U.S. corporate performance would be improved if corporations had monitors to oversee their managers (see Berle and Means 1932, and Jensen and Meckling 1976).

Roe (1991) noted that the particular political and economic history of the United States might be responsible for the dominance of corporate managers. After World War II, through the early 1970s, the United States was the dominant economic power in the world. This dominance is consistent with the argument that corporate governance and the power structure at that time was appropriate for the U.S. economy. Corporate America was delivering the goods, so the U.S. had no need to reconsider the corporate power structure. Others might argue that U.S. global economic dominance in this period was a direct result of the war, which had destroyed the physical and economic infrastructure of most other major economic players in the world.

Regardless of the reasons for the economic successes of the postwar period, by the late 1970s, even casual observers of the U.S. economy noted that U.S. corporations were losing their global competitive edge. The popular media argued that the decline in U.S. global competitiveness was the result of mismanagement of corporate resources. The argument was that corporate managers were more interested in expanding and promoting their empires than in serving shareholder interests. These observers noted that the reason managers were successful in engaging in such behavior was lack of meaningful oversight of their decisions and lack of an alternative power with disciplining authority.

In the 1980s, hostile bidders (raiders) perhaps played this monitoring/disciplining role with corporate takeovers, acquisitions, and mergers. The long-term effect of such raiders on corporations and the near-term effect on other stakeholders has been a matter of some concern (see Bhagat, Shleifer, and Vishny 1990). Sometime in the late 1980s, hostile takeovers became much rarer. Comment and Schwert (1995) and Bhagat and Jefferis (forthcoming 1998) discussed and provided potential explanations of this decline in takeovers.

Starting in the early 1990s, both the popular and academic media started emphasizing the benefits of "relational investing." Relational investors are those with large equity ownership who are patient but active monitors of managerial performance. The expectation is that those investors would help managements set corporate policy but not continuously threaten them with proxy fights or collaborate with outside bidders (raiders). Large institutional investors, which often have sizable and relatively illiquid stakes in their portfolio companies, are seen as well situated to play the role of relational investors, and the argument is that many more would play the role with the removal of certain legal impediments, such as the Glass–Steagall Act, which currently hinder institutional activism.[1] Such arguments, however, have largely been made only on theoretical grounds, because empirical evidence that active institutional investors positively affect corporate performance is scarce.

The concepts of relational investors and institutional investors are intertwined. Indeed, some commentators use the terms interchangeably. The evidence, however, suggests that not all types of institutional investors are alike in their ability (or have the incentive) to effectively monitor and constructively engage corporate managers. The Securities and Exchange Commission's (SEC's) 13-D form (required when an investor's block ownership exceeds 5 percent) notes at least 10 types of institutional investors: broker/dealer, bank, corporation, employee benefit or pension plan, holding company, investment advisor, insurance company, individual, investment company, and partnership. Although these types of institutional investors might not differ in any economic sense, evidence in Brickley, Lease, and Smith (1988) and in Bhagat and Jefferis (1991) suggests that at least some of them play quite different roles in corporate governance.

This monograph focuses on the role of investment companies, investment advisors, and broker/dealers as relational investors, analyzing their effects on corporate performance. Other researchers have looked for evidence of performance effects from certain actions that investors or investor groups take (e.g., filing shareholder resolutions, targeting a firm for takeover, or publicizing poor performers). Although such studies help in understanding the market's reaction to certain blockholder actions, they may entirely misunderstand how relationship investing works. Relational investors generally work constructively with management, usually without media glare or much, if any, public disclosure. Thus, the only way to determine the effect of relational

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[1]See, for example, Black (1990, 1992a, and 1992b); Roe; Coffee (1991); Jacobs (1991); Porter (1992); and Twentieth Century Fund (1992).

investors on firm performance is to consider performance over long horizons of several years.

We examined the relationship between ownership of large blocks of stock by investment companies, investment advisors, and broker/dealers and the financial performance of the 1,534 largest U.S. companies they own. The study period was 1983 to 1995 and included various subperiods.

We used 12 definitions of relational investors; these definitions represent different measures of the size of blockholdings and the number of years over which the blocks were held. Specifically, we considered 5 percent, 10 percent, 15 percent, and 20 percent blockholdings over two-, four-, and six-year periods. For investment companies and investment advisors, we noted a secular increase in the number of relational investors over our sample period, regardless of the definition of "relational investor." During this same period, we observed no particular pattern for broker/dealer relational investors.

As market-based measures of performance, we used cumulative market-adjusted returns over two-, four-, and six-year periods. We found evidence consistent with the notion that investment company blockholders in the latter half of the 1980s helped improve firm performance in the future. For the early 1990s, we found evidence consistent with the argument that broker/dealer relational investors improve concurrent performance of firms in which they have blockholdings. We documented evidence that suggests that broker/dealer relational investors increase their holdings in firms that have exhibited poor stock performance in the recent past.

We also used four accounting-based performance measures and found that investment company relational investors invested in companies that experienced high rates of asset growth during the study period. Our evidence also suggests that in the early 1980s, investment company relational investors helped improve firm performance. We found evidence consistent with the argument that investment advisor relational investors in the early 1990s focused their holdings on companies that had experienced poor performance in the recent past. Broker/dealer blockholders in the mid-1980s appeared to increase their holdings of firms that had experienced good performance in the recent past.

Literature Review

Evidence suggests that active involvement by large-block shareholders, especially institutional investors, could improve corporate performance, although some of this evidence is anecdotal. Many people who believe strongly in the idea of relationship investing are drawing inferences from business historians' descriptions of the roles that large investors, such as

Pierre DuPont, J.P. Morgan, and in contemporary times, Warren Buffet, played in companies in which they invested (see, e.g., Lowenstein 1991 and De Long 1991). Additional anecdotal evidence is based on comparisons of U.S. companies, which operate in a regime of widely dispersed shareholdings with very little effective monitoring by institutional investors, with firms in Germany and Japan, where monitoring by institutional investors is believed to be much more intense (see Edwards and Eisenbies, forthcoming 1998).

Corporate Governance Rules and Performance. Indirect evidence shows that corporate governance rules (such as antitakeover charter amendments) and structures affect the value of firms and that efforts by investors to "reform" governance arrangements can generate positive market-adjusted returns (Blair 1994 provides a detailed review of this evidence).

Various types of antitakeover devices—supermajority amendments, poison pills, board entrenchment, antigreenmail, and issuance of blank check preferred stock—have been shown to reduce the value of the adopting company's shares (see Bhagat and Jefferis 1991). The negative effects of these antitakeover devices have been estimated to range from a high of about 3 percent of value (for supermajority amendments) to as little as 0.34 percent of value (for poison pills in companies that do not face takeover speculation). Although the value effects of these governance arrangements appear small, they are statistically significant. Gordon and Pound (1993) studied the performance of a sample of firms that, within a very short period of time in the 1980s, adopted a large number of antitakeover protections (which Gordon and Pound called "omnibus plans"). They found that such companies had unusually high cash flows during the two or three years surrounding the adoption of the protections, but other than that, they were unable to find any evidence of long-term performance differences between firms that had few takeover protections and firms that had a large number of takeover protections. Thus, the evidence is weak that antitakeover governance features strongly influence corporate value in the long run.

Many scholars and commentators have argued that one of the corporate governance benefits of having large-block shareholders is that they are more knowledgeable and active than small, dispersed shareholders in encouraging firms to repeal antitakeover arrangements in favor of arrangements that enhance the value of the firm. This point has found quite a bit of empirical support.

Bhagat and Jefferis (1991) found that the fraction of total votes the chief executive officer (CEO) controls, the fraction of votes officers and directors control, and the voting power of outside directors are negatively related to the likelihood that an antitakeover amendment will be proposed. The authors'

evidence suggests that officers who are blockholders tend to oppose amendments but are less vigorous in their opposition than officers who are not blockholders.

The positive influence of ownership by ESOPs (Employee Stock Ownership Plans) on the likelihood that antitakeover amendments will appear in the proxy is striking because of the magnitude of the effect and its contrast with the effect of increased ownership by corporate insiders. The ESOP block of votes has the special feature that although the shares are owned mostly by rank-and-file employees, management has the implicit right to cast the votes attached to these shares. Bhagat and Jefferis (1991) found that when managers control a block of votes and do not face the direct cost of value-decreasing charter amendments, they are more willing to propose such changes than when they do bear this cost.

Brickley, Lease, and Smith (1988, 1990) found that certain institutions (which they describe as "pressure-resistant") are more likely than other shareholders to vote at all, more likely to vote against manager proposals, and more likely to vote for proposals by other shareholders. Gordon and Pound (1990) and Van Nuys (1990) found that shareholder proposals receive more support at companies with poor long-term performance or strong proincumbent rules and that different types of shareholder and manager proposals receive different levels of institutional support. This pattern suggests that institutional investors exercise significant discretion and judgment, opposing management only when they have good reason to believe that management performance has been subpar. Agrawal and Mandelker (1990) documented that companies with high institutional ownership realize zero stock returns when the current managers propose antitakeover amendments and that companies with less institutional ownership realize negative returns. This fact suggests that if institutional ownership is high, managers are less likely to propose value-reducing antitakeover amendments.

Studies by Gordon and Pound (1992) for the California Public Employees' Retirement System (CalPERS) and by Gillan and Starks (1994) investigated whether large minority-block shareholders, especially institutional investors, can enhance corporate value by pressing for governance reforms. Nesbitt (1994) measured the total "excess return" (over the S&P 500 Index) earned by shareholders in 42 companies that CalPERS targeted for special governance attention during the 1987–92 period. From 1987 to 1989, CalPERS targeted 18 companies, largely in an attempt to reverse antitakeover amendments that these companies had previously passed. The companies in this group had experienced poor market performance in the years leading up to CalPERS' involvement, but Nesbitt found no evidence of superior market performance for these firms after CalPERS got involved. In contrast, Nesbitt

did find evidence that the performance of firms targeted in the 1990–92 period improved after CalPERS got involved, but these firms were, for the most part, targeted for their poor performance per se, not for corporate governance arrangements that were deemed to be antitakeover. Nesbitt's sample sizes are small, however, and he provided no information about the statistical significance of his findings.

Gordon and Pound (1992) examined a sample of 33 cases in which an investment partnership with a large minority blockholding in a company undertook a "proxy challenge to obtain partial board representation or to modify a specific corporate policy." They found that common shareholders earned market-adjusted abnormal returns of about 30 percent. The authors considered only proxy challenges in which the investor showed no intention of acquiring the company or controlling the board. The authors did not explain what kinds of corporate policy changes were included in their sample, so we cannot say whether they were related to changing the companies' corporate governance rules.

Gillan and Starks found that when institutional investors targeted firms for reform by "sponsoring shareholder proposals seeking the repeal of previously enacted antitakeover amendments," shareholders realized a positive and statistically significant market-adjusted return in a 30-day window around the date when the institutions mailed out the proxies. Over the longer term (measured as a series of 21-day trading months stretching out two years), however, the cumulative returns were not statistically different from zero.

In sum, the evidence shows that large minority-block shareholders, especially outside shareholders, resist some antitakeover amendments and that the market generally bids down the shares of companies that adopt them. There is little or no evidence, however, that antitakeover amendments, even those that result in stock-price declines, actually cause any reduction in the underlying performance of the companies that adopt them. There is also little or no evidence that large investors' actions to change certain antitakeover corporate governance policies can increase stock prices in the long run.

Who Is a Relational Investor? Neither the academic literature nor the popular press has provided an unambiguous definition of relational investor, although most commentators refer to relational investors as individual organizations, or groups that own a block of stock in a company over a period of time. These commentators also suggest that such blockholders engage in "constructive dialogue" with the company's management. The size of the block of stock or the length of the holding time is seldom, if ever, carefully defined, motivated, or specified. The nature and substance of constructive dialogue is discussed with even less specificity or consistency.

We used four definitions of a block of stock based on percentage held and three definitions of the holding period. These definitions are neither mutually exclusive nor exhaustive. In our opinion, however, based on our understanding of the empirical research on this topic, these definitions provide a useful and structured starting point for defining relational investors. We considered blockholders that own (a minimum of) 5 percent, 10 percent, 15 percent, or 20 percent of a company's stock. (Thus, a company that has one 15 percent blockholder for a certain period will also have at least one 10 percent and one 5 percent blockholder for the same period.) Our three minimum holding periods were two years, four years, and six years. Hence, the 1983–93 period has 10 overlapping two-year holding periods (1983–84, 1984–85, . . . , 1992–93), 8 overlapping four-year holding periods (1983–86, 1984–87, . . . , 1990–93), and 6 overlapping six-year holding periods (1983–88, 1984–89, . . . , 1988–93).

A prerequisite to constructive dialogue is an understanding—indeed, a sophisticated understanding—of the firm's financial environment. Investment companies, investment advisors, and broker/dealers, given the nature of their businesses, are required to have a thorough and current understanding of financial markets in general and, in particular, of specific industries in which they specialize. Their significant equity stake in the companies under study provides these blockholders with appropriate economic incentive to engage in constructive dialogue with corporate managers.

The Role of Relational Investors. McEachern (1975) found weak evidence that firms with a controlling shareholder were somewhat more profitable than firms that were manager controlled. Salancik and Pfeffer (1980) found that for firms with a controlling shareholder, CEO tenure correlated with firm profitability but that this relationship was not true for other companies. Holderness and Sheehan (1985) found that the purchase of a majority block by an outsider, without announced plans for a complete takeover, produced a 9.4 percent stock-price gain over a 30-day window. They found no evidence, however, that Tobin's q or any other accounting measure of profitability differs between majority-owned and diffusely owned firms.[2]

Early studies suggested that share ownership by insiders correlates positively with measures of Tobin's q up to about 5 percent of shares but found no consistent evidence of a relationship between performance and insider ownership beyond that point. (Morck, Shleifer, and Vishny 1988; Wruck

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[2]Tobin's q is the market value of the firm divided by replacement cost of the firm's assets. Tobin's q greater than 1 can be attributed to superior firm performance—that is, the market value of the firm is greater than its replacement cost. Conversely, inferior firm performance is reflected in Tobin's q of less than 1.

1989). McConnell and Servaes (1990) found a statistically significant positive relationship between the degree of insider ownership and Tobin's q up to about 40 to 50 percent. Himmelberg and Palia (1994), however, suggested that the empirical relationship between Tobin's q and managerial ownership is firm specific (i.e., some firms do better with high managerial ownership, and some do not; the relationship is idiosyncratic) and little or no evidence shows that changes in managerial ownership in a given firm lead to changes in Tobin's q.

Black (1992b) reported that "companies with high inside ownership are more likely than manager-controlled companies . . . to agree to a friendly acquisition and less likely to expand sales at the expense of profits. Bidders with high inside ownership make fewer conglomerate acquisitions, make better acquisitions generally, and pay lower takeover premiums." Black's comments summarize the findings reported in about a dozen other studies (see Black 1992b, p. 919, for more citations).

On large minority blockholdings by outsiders, Mikkelson and Ruback (1985) and others have found increases in the stock value of target firms upon the announcement that an investor has taken a large block position, but most of the positive returns are explained by eventual takeover of the firm. The gains are subsequently reversed for firms that are not taken over. Barclay and Holderness (1992), however, found a sustained, market-adjusted increase in the price of the remaining publicly traded shares in the wake of a transaction in which a large block of shares is acquired at a premium. This finding is true for firms that were not subsequently acquired (at least within the first year), as well as for firms that were subsequently acquired, although the increase is smaller for the nonacquired group.

Bhagat and Jefferis (1994) investigated targeted share repurchases, or "greenmail" transactions, in which managers agree to repurchase a block of shares at a premium from a single shareholder or group of shareholders. The motivation for the repurchase is presumably the deterrence of a takeover on terms that would be unfavorable to incumbent management. Bhagat and Jefferis studied the joint distribution of ownership, performance, managerial turnover, and takeover activity at repurchasing firms during a five-year period centered on the repurchase. They compared this distribution with that of a control sample selected on the basis of size and industry and with the distribution that describes the experience of firms filing 13-D forms. The authors' evidence suggests that a blanket characterization of managers who pay greenmail as poor performers seeking shelter from market discipline at the expense of shareholders is unwarranted. They found that firms that pay greenmail are just as likely to receive a subsequent tender offer, merger proposal, or buyout proposal as firms with an outstanding 13-D filing. Moreover, the performance

of firms that pay greenmail cannot be distinguished from that of firms in the control group—prior to or subsequent to the repurchase. Among firms that experience neither a change in ownership nor managerial turnover—a group that seems to represent entrenched management—they found no evidence of inferior performance in the greenmail sample.

Gordon and Pound (1992) studied a small sample (18) of "patient capital investments," which they define as transactions "in which an investment partnership purchases a new block of equity and is granted at least one seat on the board." Together, Warren Buffet and Corporate Partners Fund accounted for about half of their sample, the authors report. They found that "on average, 'patient capital' investing activity has not produced returns that are statistically different from the S&P 500." They also found that certain investors in their sample, including Warren Buffet, have consistently enhanced corporate value through such investment arrangements, although others have consistently been associated with reductions in the value of common equity.

Fleming (1993) found that investors who, between 1985 and 1989, acquired a large equity stake in a firm that was not subsequently taken over did little to enhance the firm's performance. He showed positive and significant market-adjusted returns to the stock of the target company during the first two months after the announcement of the investor's new position in the company but significant declines in returns over the subsequent two years. Much of Fleming's sample consists of hostile, large-block acquisitions by corporate raiders and arbitrageurs, such as Victor Posner and Ivan Boesky.

Bethel, Liebeskind, and Opler (1996) examined activist investors' purchases of large blocks of stock in large companies during the 1980s. They found that activist block purchases were followed by abnormal share price appreciation, an increase in asset divestitures, an increase in operating profitability, and a decrease in merger and acquisition activity.

Jones, Lehn, and Mulherin (1990) found that companies having a high proportion of stock held by institutional investors experienced greater increases in the liquidity of their stock in the 1980s relative to companies with a low proportion of stock held by institutional investors. This finding suggests that firms with high institutional investor involvement may have a lower cost of capital than others. Also, greater liquidity in the secondary equity market, presumably measured by smaller bid–ask spreads, leads to a lower cost of capital in the primary equity market. The authors also found that these firms had higher levels of spending on research and development and capital investments than firms with low levels of institutional ownership but that they had greater declines in these categories of long-term spending during the 1980s. This study considered only aggregate holdings by institutional

investors and did not look at the influence of specific investors.

Nesbitt provided evidence on the effect of actions by CalPERS, during the 1990–92 period, to target 24 firms for special attention (based on the firms' poor performance rather than on any special concern for whether the companies had antitakeover arrangements in place). These companies had underperformed the market by an average of 86 percent during the five years leading up to CalPERS' involvement, but in the first two years following CalPERS' involvement, they outperformed the market by an average of 28 percent. It is not clear from Nesbitt's study, however, exactly what kind of involvement CalPERS had with these companies, only that they made CalPERS' list of poor performers and that CalPERS wrote letters to and sought meetings with executives of the companies.

Similarly, Opler and Sokobin (1995) found evidence that corporations targeted by the Council of Institutional Investors on its annual "hit list" have poor stock-price performance in the year prior to being targeted and experience average share-price increases of 11.6 percent (above the S&P 500) in the year after being listed. The authors interpreted this finding as evidence that coordinated institutional activism can create shareholder wealth. The magnitude of the effect they found, however, easily translates to an increase of several hundred million dollars per firm, which appears to be implausible. More likely, the authors' estimate of the value improvement is misspecified, because they consider long-horizon periods in estimating the value improvement (see Kothari and Warner 1997 and Barber and Lyon 1997). Daily, Johnson, Ellstrand, and Dalton (1996), using a sample of 200 large firms during the four-year period 1990 to 1993, found no systematic relationship between the level of institutional investor holdings and firm financial performance.

Summary. The extant literature provides some modest evidence that large block investments either by insiders (management) or by outsiders can help increase a company's value. This finding is subject to considerable variance, however, and in these studies, the role large investors play is unclear. Which activities and governance arrangements contribute to value creation and which may destroy value creation is unknown. Moreover, all of the studies discussed here are based on relatively small samples, considered over relatively short time periods. None of the existing studies gave any special consideration to the role of investment companies, investment advisors, and broker/dealers as relational investors.

Sample Selection and Data Collection

Our analysis of the relationship between ownership of large blocks of stock

by investment professionals and the financial performance of companies in which such blocks are owned proceeded in four steps. First, we selected a sample of the 1,500 largest U.S. companies. Next, we obtained data on large blockholders in those companies. Third, we constructed market-based and accounting-based measures of performance for the sample firms. Lastly, we correlated block ownership in the firms with their performance.

The data for this study were assembled from the universe of firms in the Compustat database that, for 1983 and 1992, were the 1,000 nonfinancial and 100 financial firms with the largest total capitalization, based on market value of equity and book value of debt. We eliminated foreign-owned companies and subsidiary companies with a parent already represented in our data.

This study, like any study of long-term performance, faces the potential problem of survivorship bias—entry into and exit from the sample over time. To construct stock price performance measures, we used return data on about 1,000 firms for each year in the period from 1983 to 1995; however, those 1,000 firms are different for each of the 13 years. We attempted to address this problem in the way we constructed our initial sample. We included the 1,000 largest nonfinancial companies and 100 largest financial companies in 1983 and again in 1992. Although some companies that were in our sample in 1983 were also in our 1992 sample, other companies that entered our sample in 1983 either were no longer separate companies or were no longer among the largest financial or nonfinancial companies in 1992, which is why the final sample consists of 1,534 companies and not 2,200 (or 1,100) companies. For any performance period that includes 1983 or 1992, survivorship bias, in the traditional sense, would not be relevant. Each of the final 1,534 publicly traded companies had data in Compustat for at least 1 year during the 1983–93 period, and many had data for all 11 years.

Information on ownership positions in these companies came from CDA/Spectrum, a commercial data company that compiles information from SEC filings, which provided access to data on all 13-D, 13-G, and 14-D (1) SEC filings made by individual and institutional investors from 1983 to 1993. These data were matched to the list of 1,534 companies in our sample to identify all investors who had reported that they held significant positions in any of these companies. If a single owner reported positions in more than one class of stock for a given company, those positions were aggregated to measure the investor's share of the total equity capitalization. We eliminated any investors that did not hold at least 5 percent of the firm's aggregate equity value. We added information from the LEXIS-NEXIS ABIUS (American Business Information U.S.) file, which identifies investors by whether they are investment advisors, investment companies, or broker/dealers. These data were then linked to data on stock-price performance and accounting measures

of performance for each year in our sample period.

The number of 5 percent investment company blockholders increased from 105 to 321 in the 11-year period from 1983 to 1993; the number of 5 percent investment advisor blockholders increased more substantially, from 49 to 296; and the number of 5 percent broker/dealer blockholders experienced a modest increase, from 50 to 65. Figure 1 depicts the number of 5 percent blockholders of each of the three types within our sample of 1,534 firms.

Figure 1. Number of 5 Percent Investment Company, Investment Advisor, and Broker/Dealer Blockholders in Sample Firms, 1983–93
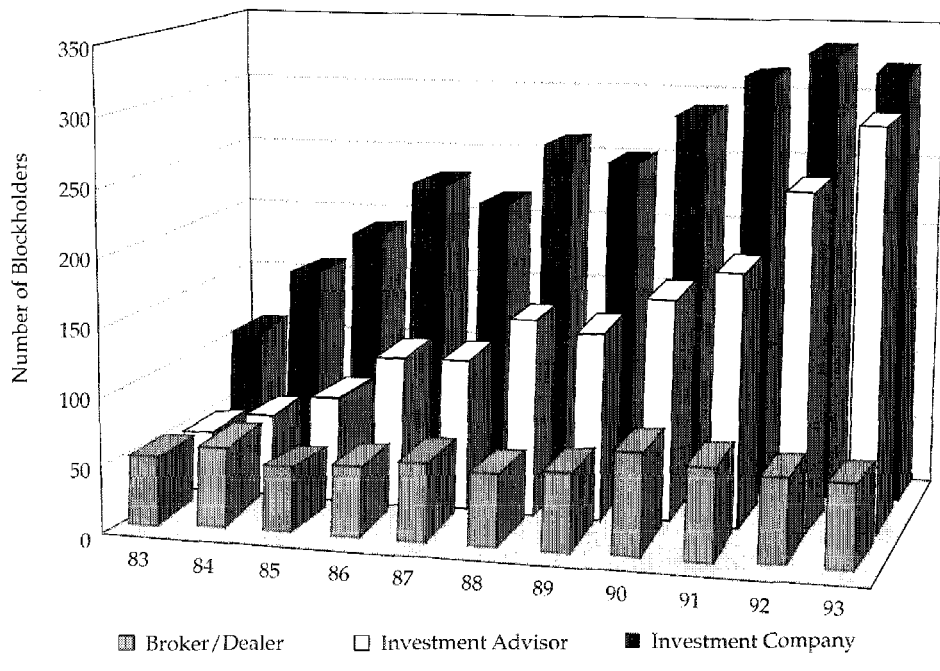
Investment Company Blockholders

Figure 2 shows the number of firms in our sample that had 5, 10, 15, and 20 percent investment company blockholders for two (Panel A), four (Panel B), and six (Panel C) years over various periods during the 1983–93 period. The number of firms that have a 5 percent blockholder exhibits a secular increase from 37 in the two-year period from 1983 through 1984 to 103 from 1992 through 1993. The mean (median) ownership share of such blockholders increases from 7.4 percent (6.5 percent) in 1983 and 1984 to 12.0 percent (8.7 percent) in 1992 and 1993.

Figure 2. Number of Firms in Sample: Investment Company Blockholders

A. Two-Year Periods

B. Four-Year Periods

C. Six-Year Periods

Block Size
▨ 20%   ☐ 15%   ▦ 10%   ■ 5%
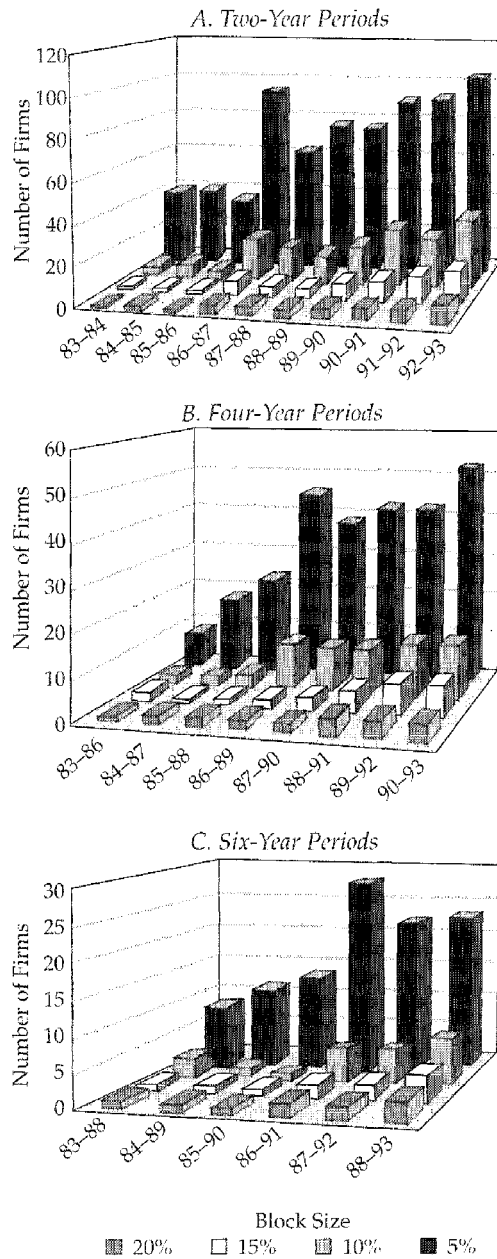
When we constrained the sample to 5 percent blockholders holding their blocks for at least four years, the secular increase in number of firms with such blockholders persisted, rising from 9 in 1983 through 1986 to 52 in 1990 through 1993 (Panel B). The mean (median) ownership share of such block-holders is 10.9 percent (8.5 percent) in 1983 through 1986 and 11.1 percent (8.8 percent) in 1990 through 1993. Blockholders in 8 firms had a six-year ownership period from 1983 through 1988, and those in 23 firms had six-year ownership from 1988 through 1993 (Panel C). The mean (median) ownership share among such blockholders was 10.8 percent (8.4 percent) in the 1983–88 period and 14.1 percent (10.4 percent) from 1988 through 1993.

In summary, regardless of the number of years for which we consider the ownership by investment company blockholders, we observed a secular increase in their number during the study period. The percentage ownership of four- and six-year blockholders, however, does not appear to have increased as much as that of two-year blockholders over the same period, although the increase in the number of blockholders for the two-, four-, and six-year periods is of the same order of magnitude. The number for the two-year period goes from 37 to 103, a 250 percent increase; the number for the four-year period rises from 9 to 52, more than a 500 percent increase; and the number for a six-year period goes from 8 to 23, more than a 250 percent increase.

For purposes of investigating the prevalence of relationship investing among investment company blockholders, the way one defines a relational investor in terms of the size of block and/or the period is important. For example, for the 1983–84 period, when the ownership requirement went from 5 percent to 10, 15, and finally 20 percent, the number of firms that have such a blockholder decreases dramatically from 37 to 4, 2, and 1, respectively. For the four-year period from 1983 through 1986, as the ownership requirement rose from 5 percent to 10, 15, and then to 20 percent, the number of firms that have such a blockholder decreases, again rather dramatically, from nine to two, two, and one. For the six-year period 1983 through 1988, when the ownership requirement rises from 5 to 10, 15, and finally 20 percent, the number of firms that have such a blockholder decreases from eight to two, one, and one.

Figure 2 also suggests that if we define investment company relational investors rather restrictively—for example, as a blockholder that owns a 20 percent block for at least six years—few investors fit the description. This finding has economic and statistical implications. Economically, if relationship investing requires holding large blocks over long periods, then most investment companies have not played that role for large U.S. firms in our sample. One consequence is that the small sample prevents us from making statistical inferences with confidence. Technically, the very small samples for large blockholders (more than 10 percent) over long time periods (more than

six-year periods) reduces the power of our test to a point at which strong updates on our prior beliefs are not likely.

The time-series pattern of investment company blockholders exhibits strong autocorrelation, regardless of how the numbers of investment company blockholders are defined. For example, a high number of blockholders in the 1990–91 period is likely to be followed by a high number of such blockholders in the 1991–92 period. We also found that the type of blockholder rarely changes over time. For example, if a company has a 10 percent investment company blockholder in 1988 and 1989, it will probably have a 10 percent investment company blockholder in 1989 and 1990, suggesting that the blockholder variables in adjacent time periods are also highly correlated. For example, a 5 percent investment company blockholder variable from 1988 to 1989 would be highly correlated with the 5 percent investment company blockholder variable in the 1989–90 period. This correlation implies that our regression estimates of the impact of blockholders on firm performance are less than precise.

Performance Measures. We used a number of different variables to measure market-based and accounting-based performance. Many results are statistically significant at conventional levels but are not robust to a change in the performance measure. The sensitivity of our results to the choice of performance measure underscores the value of using a broad range of performance measures.

Market Measures. Our sample includes firms for which stock price data were available on the 1996 Center for Research in Security Prices (CRSP) tapes. The CRSP tapes contain daily returns of all NYSE (New York Stock Exchange), Amex (American Stock Exchange), and Nasdaq (National Association of Securities Dealers Automated Quotation) firms going back to 1962. We used different stock price performance measures to test the robustness of our results. We report performance in three ways (for an explanation of these measures, see Brown and Warner 1985):

- *Market-adjusted return* (MAR) is cumulated over the measurement period of daily market-adjusted returns (MAR_t) for the entire sample: MAR_t equals the sample return on day t, R_t, minus the return on the S&P 500 Index, RM_t.
- *Cumulative abnormal return* (CAR) also treats the entire sample as a single portfolio but with an adjustment for firm risk, b. We estimated daily abnormal returns over the measurement period, AR_t, for the entire sample based on the market model: $AR_t = R_t - a - b(RM_t)$. The market model parameters, a and b, and the standard deviation of the portfolio abnormal returns, s, are estimated during the year preceding the measurement

period, using the S&P 500 as the market index. Under the null hypothesis of no abnormal performance and stationarity of the returns-generating process over time, the CAR for the sample should be zero.

- *Standardized abnormal return* (SAR) is accumulated over the measurement period of daily standardized abnormal returns, $SAR_{i,t}$, for each firm (as in Dodd and Warner 1983). The market model parameters, a_i and b_i, and the standard deviations of the sample firms' abnormal returns, s_i, are estimated during the year preceding the measurement period, using the S&P 500 as the market index. This technique controls for heteroscedasticity in the abnormal returns across firms. Under the null hypothesis of no abnormal performance and stationarity of the returns-generating process over time, the firm SARs should be distributed unit normal (mean = 0, standard deviation = 1). The portfolio should have an SAR of zero and, assuming independence across the n sample firms, a standard deviation of $1/n^{0.5}$.

Because the market return is the same for all firms in our sample for a given measurement period, the regression results (because of entry and exit of firms over time) would differ only slightly if we studied raw (nonadjusted) returns instead of MARs.

As Table 1 shows, many of the single-year MARs are surprisingly large. Most are statistically significant under the conventional assumption of independence of each firm's net-of-market return, so that portfolio standard deviation equals single-firm standard deviation divided by the square root of the sample size. These returns, however, have no apparent sign pattern, which suggests that either the net-of-market returns to the firms in our sample are not independent of each other or (consistent with Kothari and Warner and with Barber and Lyon) long-horizon stock performance measures are misspecified.

Using the market model (the CAR and SAR series, which are not shown in Table 1) reduces the quality of the data. Standard deviation is uniformly higher for CAR than for MAR, which is consistent with evidence in Kothari and Warner that long-horizon MAR tests are better specified than CAR or SAR tests. Accordingly, we relied principally on the MAR measure of stock performance for our regression analysis.

The large single-year portfolio returns are not an artifact of our choice of market index. We also computed MAR, CAR, and SAR series using the CRSP equally weighted index instead of the S&P 500 as the market index. The entries in individual years were different, sometimes markedly so, but the combination of no clear overall trend with large single-year and multiyear returns persisted. The sensitivity of our portfolio returns to the choice of market index is further evidence that long-horizon tests for stock price returns are badly specified.

Table 1. Regressions of Firm Performance against Measures of 5 Percent Investment Company Blockholders, Various Holding Periods

(*t*-statistics in parentheses)

Market-Adjusted Return Period	Coefficients of Independent Variables			Adjusted R^2	F
	Lag Relational Investors	Contemporary Relational Investors	Lead Relational Investors		
1983–84	—	0.083	0.066	0.0005	1.25
		(1.09)	(0.82)		
1985–86	−0.135	−0.053	0.027	0.0001	1.02
	(−1.49)	(−0.52)	(0.35)		
1987–88	0.063	−0.99	0.051	−0.0020	0.36
	(0.46)	(−0.98)	(0.57)		
1989–90	−0.171	0.031	−0.029	0.0004	1.13
	(−1.70)	(0.34)	(−0.34)		
1991–92	0.135	0.034	−0.051	0.0010	1.32
	(1.77)	(0.41)	(−0.66)		
1993–95	−0.102	0.154	—	0.0023	2.12
	(−1.24)	(2.06)			
1983–86	—	0.069	0.294	0.0035	2.66
		(0.27)	(2.12)		
1987–90	−0.187	−0.300	0.069	0.0007	1.21
	(−0.52)	(−1.63)	(0.41)		
1991–95	0.277	−0.146	—	0.0026	2.19
	(2.01)	(−1.26)			
1983–88	—	0.0998	0.24	−0.0008	0.67
		(0.29)	(0.96)		
1989–95	−0.028	−0.197	—	−0.0010	0.58
	(−0.09)	(−1.02)			

Barber and Lyon found that the misspecification of long-horizon returns can be corrected by matching sample firms to control firms that are similar in size and book-to-market ratio. This correction was not practical for our study because our sample is essentially the universe of large U.S. public firms; a control sample does not exist. We report results using the S&P 500 Index, which is the best match for our large-firm sample. Apart from the large cross-sectional dependence among firms in our sample, little about the data is remarkable. There is no consistent evidence that our sample either underperforms or outperforms the market during the period of our study.

We began our analysis of the impact of investment company blockholders with a simple test: Does the presence of a large-block investment company shareholder that holds the block for some period of time affect stock price

performance for the sample firms?

If investors could perfectly anticipate the firm-value effect of relational investing, the tests discussed in this section would be of limited value. Stock returns measure only the departure of actual results from the *expected* results that are already impounded in stock prices. Other studies of long-term stock price performance—including long-term performance of acquirers of other firms (Agrawal, Jaffe, and Mandelker 1992) and long-term performance of initial public offerings (Ritter 1991)—provide grounds for skepticism about whether investors have perfect foresight. To the extent that investors have imperfect foresight, stock price tests can provide a valuable source of information about the perceived value of relational investing. In any event, the accounting-based performance measures discussed later are not subject to this criticism.

Table 1 summarizes the results.[3] We used cumulative market-adjusted returns over two-, four-, and six-year periods as the dependent variable in our regressions, consistent with the time for which we considered block ownership.[4] Our discussion focuses mostly on the two-year returns. As we go from two- to four- and six-year blockholders, the number of such investment company blockholders drops off quickly, with a corresponding decrease in the precision of the regression coefficients as reflected in the *t*-statistics.

We considered three independent variables, data permitting, for each regression: contemporary relational investors, lag relational investors, and lead relational investors.[5] The regression specification for the 1991–92 period, for example, is

Market-adjusted returns, 1991–92 = Constant
$$+ b_1 \text{ (lag relational investor, 1989–90)}$$
$$+ b_2 \text{ (contemporary relational investor, 1991–92)}$$
$$+ b_3 \text{ (lead relational investor, 1992–93)}$$
$$+ \text{an error term.}$$

The contemporary relational investor variable is a dummy variable that takes a value of 1 if the investment company has been a 5 percent blockholder in the sample firm for two years (1991 and 1992) and zero otherwise. A

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[3]All regressions reported in this monograph also include a constant term, which we omit in our discussions because the constant term has no special meaning in this study.

[4]To include the return data for 1995 in our analysis, we also considered one three-year period, 1993 to 1995; return data for 1996 were not available in 1996 CRSP tapes.

[5]The following discussion refers only to 5 percent blockholders. Although we have data on 10 percent, 15 percent, and 20 percent blockholders, the number of such blockholders is so small that it leads to imprecise regression coefficient estimates.

significant positive correlation between the contemporary relational investor variable and market-adjusted return would be consistent with a positive concurrent effect of relational investing on firm performance; of course, this inference would be based on the joint hypothesis of the effect of relational investing and our measure of relational investor and firm performance.

The lead relational investor variable is a dummy variable that takes a value of 1 if the investment company has been a 5 percent company blockholder for two lead years (1992 and 1993) and zero otherwise. A significant negative correlation between lead relational investor and market-adjusted return would be consistent with relational investors being attracted to underperforming firms—subject to the joint-hypothesis caveat noted above. The lag relational investor variable is a dummy variable that denotes the existence of a 5 percent investment company blockholder for two lag years (1989 and 1990). A significant positive correlation between lag relational investor and market-adjusted return would be consistent with relational investing improving future firm performance.

Besides the joint-hypothesis caveat, semistrong efficient market considerations suggest that market-based measures of firm performance are not related to lead relational investors; however, our skepticism regarding perfect market oversight is appropriate here. For the 1991–92 performance measure, we found an insignificant negative correlation with the lead relational investor variable. The sign of the regression coefficient is consistent with relational investors focusing their investments in underperforming firms in 1992. The lack of statistical significance, however, raises serious concerns about the statistical validity of this inference.

For the 1991–92 performance period, we found no significant relation between contemporary relational investors and firm performance and a positive relation between lag relational investors and firm performance. The latter result is consistent with relational investors improving future firm performance, but it is not robust for the choice of the performance period. In both the 1985–86 period and the 1989–90 period, we found a statistically significant negative relationship between lag relational investors and firm performance.

The inconsistency of the relation between lag relational investors and performance measures over various periods has at least two possible explanations. First, the relationship may change over time; it may have been there from 1991 to 1992 and not the other years. Second, lag relational investors may be unrelated to firm performance; significant results are being obtained by pure chance, as might be expected given the large number of regressions involving the same basic specification.

The finding noted above from 1991 to 1992 is also not robust to the holding period we used to define relationship investors. When we considered regressions with investment company relationship investors defined as 5 percent blockholders who held for at least four years, we found a negative and statistically significant relationship between contemporary relational investors and firm performance from 1987 to 1990 and a negative and statistically somewhat less significant relationship between contemporary relationship investors and firm performance from 1991 to 1995. This negative relationship is inconsistent with the notion that investment company relational investors improve firm performance. We also found a positive and statistically significant relation between lag investment company relational investors and firm performance for the 1991–95 period. This last finding is consistent with the notion that investment company relational investors during the 1987–90 period helped to improve future firm performance.

Our data do not allow us to specify a regression with all three relational investor variables for the six-year holding period. We included incomplete specifications of our earlier regression for completeness, but we found no consistent relationships for the six-year holding periods.

Accounting Measures of Performance. We turned next to the relationship between the presence of large-block shareholders and three accounting measures of performance and one mixed stock-price and accounting measure: Tobin's q. All accounting data are from Compustat, which has data for at least some variables and some years for 1,044 sample firms.

The raw accounting variables used in our study were assets (AST), net income (INC), and operating income (OPI, which is equal to INC plus interest expense plus income taxes). From these raw variables, we derived fractional growth in assets ($GrAST$) and fractional growth in net income ($GrINC$).[6]

Tobin's q is measured as the sum of market value of common stock, book value of preferred stock, and book value of long-term debt, divided by the book value of total assets. Other measures of Tobin's q are possible, but Chung and Pruitt (1994) reported very high correlation between relatively complex and relatively simple measures of Tobin's q. Also, Perfect and Wiles (1994) found that a Tobin's q estimator of the type we used produces robust empirical results. We defined return on assets (ROA) as the ratio of operating income to assets.

Using this set of variables, we tested various ways in which ownership structure and, particularly, the presence or absence of an investment company

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[6]We discarded negative income and cash flow values when computing percentage growth variables. This practice is standard for income variables in the accounting literature because percentage changes from negative to positive income are difficult to interpret.

relational investor might affect a firm's profitability. Roughly speaking, the growth variables, *GrAST* and *GrINC*, are useful in determining whether relational investors affect how rapidly firms grow, and the ratio variables, *ROA* and Tobin's *q*, provide measures of a firm's profitability and effective use of resources. Of course, such an extensive data set will provide some statistically significant results merely by chance.

Accounting measures of performance pose a particular econometric problem. Given that stock prices are forward looking, one- or two-year stock returns are informative about the long-run effect of blockholders on performance. By construction, however, accounting growth measures relate only to performance over the period from which the accounting variable is drawn. For example, growth in assets over the 1983–86 period will not speak to growth or performance in 1987 and beyond. For this reason, we considered only four- and six-year periods for performance measures.

The use of four- or six-year periods, however, reduces the number of investment company blockholders rather dramatically from the two-year number, which would lead to imprecise estimates of regression coefficients. To address this problem, we considered blockholders over two-year periods. For example, for the regression that has income growth from 1987 to 1990 as the dependent variable, we considered investment company blockholders from 1988 to 1989 to be contemporary relational investors and investment company blockholders from 1985 to 1986 and 1991 to 1992 to be lag and lead relational investors, respectively. For the contemporary relational investor variable, we could have chosen the 1987–88 or 1989–90 periods, but we chose 1988 to 1989 because it is in the middle of the four-year period under consideration. More importantly, this time period allows us to minimize the multicollinearity problem among the independent variables in the regression. Blockholders from 1988 to 1989 are less correlated with blockholders from 1991 to 1992 than blockholders from 1989 to 1990 are correlated with those from 1991 to 1992. Minimizing multicollinearity among the independent variables produces more-precise estimates of the regression coefficients.

As Table 2 shows, we found a marginally positive relationship between contemporary investment company relational investors and growth in assets from 1989 to 1995. This finding is consistent with relational investors improving the growth of firms in which they have holdings. We also found a marginally positive relationship level between lead relational investors and growth in income from 1987 to 1990. This result suggests that these relational investors increased their holdings in firms that had experienced high levels of growth in income in this period. We found a marginally positive relationship between lag relational investors and Tobin's *q* in 1985, suggesting that relational

Table 2. Regressions of Firm Performance against Measures of 5 Percent Investment Company Blockholders, Various Holding Periods

(*t*-statistics in parentheses)

Market-Adjusted Return Period	Coefficients of Independent Variables				Adjusted R^2	F
	Lag Relational Investors	Contemporary Relational Investors	Lead Relational Investors	Firm Size		
Percentage growth in assets						
1983–86	—	–27.29	5.96	–29.56	0.1261	38.10
		(–1.16)	(0.32)	(–10.68)		
1987–90	–3.25	–17.89	24.89	–23.88	0.0639	13.78
	(–0.10)	(–0.89)	(1.25)	(–7.27)		
1991–95	20.19	12.64	—	–23.99	0.0685	18.09
	(1.05)	(0.77)		(–7.31)		
1983–88	—	–127.17	83.33	–84.90	0.0809	21.88
		(–1.34)	(1.25)	(–8.02)		
1989–95	–41.23	136.47	—	–85.36	0.0649	16.56
	(–0.47)	(1.83)		(–6.77)		
Percentage growth in net income						
1983–86	—	–111.17	–87.68	–1.27	–0.0039	0.02
		(–0.15)	(–0.16)	(–0.02)		
1987–90	–8.57	10.24	143.11	–3.11	0.0003	1.06
	(–0.07)	(0.14)	(1.92)	(–0.25)		
1991–95	402.17	449.19	—	478.48	–0.0013	0.70
	(0.20)	(0.26)		(1.38)		
1983–88	—	68.93	–497.78	566.18	–0.0028	0.34
		(0.01)	(–0.14)	(1.00)		
1989–95	8.39	96.23	—	–70.94	0.0101	3.26
	(0.05)	(0.70)		(–3.03)		
Tobin's q						
1983	—	0.202	–0.048	–0.289	0.1912	65.94
		(1.16)	(–0.25)	(–13.88)		
1985	0.303	0.058	–0.134	–2.60	0.1681	40.29
	(1.78)	(0.29)	(–1.92)	(–12.28)		
1987	0.234	–0.239	0.061	–0.193	0.0844	18.61
	(1.08)	(–1.40)	(0.39)	(–08.32)		
1989	–0.128	–0.041	–0.175	–0.214	0.0898	19.00
	(–0.70)	(–0.24)	(–1.19)	(–8.46)		
1991	–0.292	0.179	–0.269	–0.358	0.1002	21.40
	(–1.22)	(0.68)	(–1.13)	(–8.99)		
1993	–0.144	–0.037	—	–0.263	0.0810	22.96
	(–0.71)	(–0.21)		(–8.20)		
1995	–0.049	—	—	–0.133	0.232	16.40
	(–0.34)			(–4.20)		

Table 2. (Continued)

Market-Adjusted Return Period	Lag Relational Investors	Contemporary Relational Investors	Lead Relational Investors	Firm Size	Adjusted R^2	F
Return on assets						
1983	—	0.053	–0.023	–0.001	0.0033	1.75
		(2.19)	(–0.96)	(–0.51)		
1985	0.045	–0.043	–0.011	0.003	0.0036	1.58
	(1.78)	(–1.50)	(–0.51)	(0.81)		
1987	–0.018	–0.027	–0.018	0.001	0.0033	1.55
	(–0.68)	(–1.36)	(–1.00)	(0.07)		
1989	–0.026	–0.031	0.011	0.001	0.0037	1.61
	(–1.26)	(–1.68)	(0.67)	(0.17)		
1991	–0.33	–0.006	–0.002	–0.005	0.0050	1.81
	(–1.89)	(–0.30)	(–0.11)	(–1.74)		
1993	0.001	–0.017	—	0.001	–0.0025	0.46
	(0.08)	(–0.98)		(0.41)		
1995	0.002	—	—	0.006	0.0042	2.21
	(0.13)			(2.09)		

investors in the 1983–84 period helped improve future firm performance. We also found a marginally positive relationship between contemporary relational investors and *ROA* in 1983 and between lag relational investors and *ROA* in 1985, which suggests that investment company blockholders from 1983 to 1984 helped improve concurrent and future firm performance.

Investment Advisor Blockholders

Regardless of the number of years over which we consider the ownership of the investment advisor blockholder, the number of such relational investors undergoes a secular increase. The percentage holdings of these blockholders have no obvious patterns during the study period. Figure 3 shows the number of firms that had a 5 percent investment advisor blockholder for two, four, and six years over various periods from 1983 to 1993. The number of firms that have a 5 percent blockholder increases from 10 for the two-year period 1983 and 1984 to 73 for 1992 and 1993 (Panel A). The mean (median) ownership of such blockholders increases from 6.5 percent (5.9 percent) for 1983 and 1984 to 9.0 percent (8.3 percent) for 1992 and 1993.

When 5 percent blockholders hold their blocks for at least four years (Panel B), the number still increases secularly—from 2 for 1983 through 1986 to 24 for 1990 to 1993. The mean (median) ownership of such blockholders is 17.8 percent (17.8 percent) from 1983 through 1986 and 9.0 percent (8.2 percent) from 1990 through 1993.

Figure 3. Number of Firms in Sample: Investment Advisor Blockholders

A. Two-Year Periods

B. Four-Year Periods

C. Six-Year Periods

Block Size
20%   15%   10%   5%
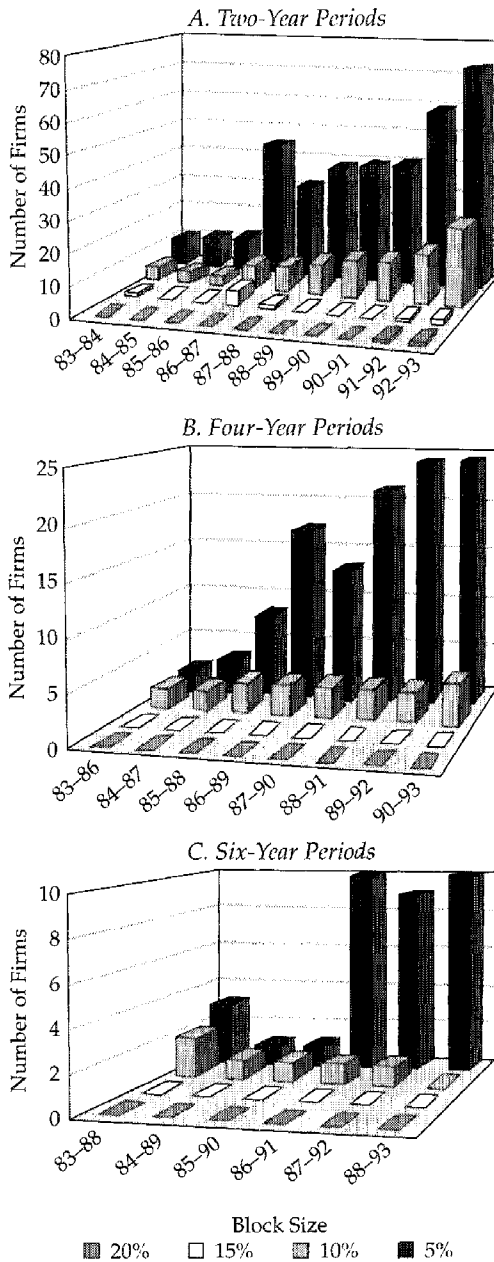
Only 3 blockholders had at least a six-year ownership period (Panel C) from 1983 through 1988, and 10 did from 1988 through 1993. The mean (median) ownership share of such blockholders is 12.6 percent (14.5 percent) from 1983 to 1988 and 10.7 percent (12.3 percent) from 1988 through 1993.

Large blockholders may be more takeover or control oriented than investment advisors, possibly explaining why so few (or no) investment advisors are in the 10, 15, and 20 percent categories. Investment advisors may not have significant amounts of capital to purchase or own such large blocks. They may also prefer greater diversification (holding four 5 percent blocks rather than one 20 percent block) to more-concentrated investments.

Figure 3 also shows the number of 10 percent, 15 percent, and 20 percent investment advisor blockholders in our sample. For the two-year period, 1983 and 1984, as we constrain the ownership requirement from 5 percent to 10 percent, 15 percent, and finally 20 percent, the number of firms that have such a blockholder decreases rather dramatically from 10 to 4, 1, and 0, respectively. For the four-year period from 1983 to 1986, as we constrain the ownership requirement from 5 percent to 10 percent, 15 percent, and finally 20 percent, the number of firms with such a blockholder decreases from 2 to 2, 0, and 0, respectively. For the six-year period 1983 to 1988, as we constrain the ownership requirement from 5 percent to 10 percent, 15 percent, and finally 20 percent, the number of firms that have such a blockholder decreases from 3 to 2, 0, and 0.

Clearly, the way one defines a relational investor in terms of the size of block and/or the period of time for which the block is held matters for purposes of investigating the prevalence of relationship investing among investment advisor blockholders. Indeed, no investment advisor blockholders in our sample have held 15 or 20 percent blockholdings for four or more years.

Should investment advisor blockholders have a similar or different effect on firm performance compared with their investment company counterparts? To the extent that investment advisors and investment companies share similar investment objectives, we would expect a similar impact.

Table 3 shows a negative relation between lead investment advisor relational investors and growth in income from 1987 to 1990. This finding is consistent with investment advisor relational investors from 1991 to 1992 increasing their holdings in firms that have experienced unusually poor income growth in the recent past. We found a similar, but only marginally significant, negative relationship between lead relational investors and ROA in 1989, which is consistent with investment advisor relational investors from 1991 to 1992 increasing their holdings in firms that have experienced unusually poor ROA in the recent past.

Table 3. Regressions of Firm Performance against Measures of 5 Percent Investment Advisor Blockholders, Various Holding Periods

(*t*-statistics in parentheses)

Market-Adjusted Return Period	Coefficients of Independent Variables				Adjusted R^2	F
	Lag Relational Investors	Contemporary Relational Investors	Lead Relational Investors	Firm Size		
Percentage growth in assets						
1983–86	—	–33.13	–12.95	–29.42	0.1254	37.86
		(–0.71)	(–0.51)	(–10.64)		
1987–90	–26.84	–16.56	–11.84	–24.08	0.0628	13.54
	(–0.44)	(–0.62)	(–0.48)	(–7.32)		
1991–95	–10.22	1.56	—	–23.70	0.0660	17.41
	(–0.41)	(0.08)		(–7.22)		
1983–88	—	–83.34	63.20	–83.61	0.0783	21.16
		(–0.43)	(–0.77)	(–7.94)		
1989–95	–53.27	–11.57	—	–86.07	0.0606	15.46
	(–0.48)	(–0.13)		(–6.78)		
Percentage growth in net income						
1983–86	—	–139.48	–76.50	–0.76	–0.0039	0.01
		(–0.10)	(–0.10)	(–0.01)		
1987–90	61.20	112.79	–254.45	–5.82	0.0054	2.00
	(0.27)	(1.11)	(–2.74)	(–0.47)		
1991–95	572.9	580.8	—	491.3	–0.0013	0.70
	(0.22)	(0.28)		(1.42)		
1983–88	—	–198.9	–448.01	563.76	–0.0028	0.34
		(–0.02)	(–0.10)	(1.00)		
1989–95	–96.71	61.07	—	–70.47	0.0098	3.18
	(–0.46)	(0.36)		(–2.99)		
Tobin's q						
1983	—	–0.145	–0.587	–0.291	0.1923	66.37
		(–0.41)	(–1.50)	(–14.06)		
1985	–0.165	–0.472	0.023	–0.264	0.1654	39.55
	(–0.48)	(–1.23)	(0.13)	(–12.53)		
1987	–0.444	0.068	–0.069	–0.197	0.0830	18.28
	(–1.02)	(0.32)	(–0.39)	(–8.52)		
1989	0.014	–0.137	0.045	–0.215	0.0862	18.21
	(0.06)	(–0.70)	(0.25)	(–8.48)		
1991	–0.373	0.266	–0.040	–0.360	0.0987	21.07
	(–1.23)	(0.78)	(–0.14)	(–9.02)		
1993	0.002	–0.104	—	–0.264	0.0801	22.67
	(0.01)	(–0.48)		(–8.20)		
1995	0.026	—	—	–0.134	0.230	8.93
	(0.15)			(–4.22)		

Table 3. (Continued)

Market-Adjusted Return Period	Coefficients of Independent Variables				Adjusted R^2	F
	Lag Relational Investors	Contemporary Relational Investors	Lead Relational Investors	Firm Size		
Return on assets						
1983	—	0.060	0.029	–0.002	–0.0002	0.95
		(1.48)	(0.58)	(–0.57)		
1985	0.012	0.023	–0.004	0.003	–0.0044	0.29
	(0.27)	(0.41)	(–0.15)	(0.96)		
1987	0.011	0.022	–0.023	0.001	–0.0035	0.41
	(0.22)	(0.89)	(–1.04)	(0.13)		
1989	0.019	0.031	–0.038	0.001	0.0015	1.25
	(0.80)	(1.42)	(–1.85)	(0.07)		
1991	–0.003	–0.013	0.011	–0.005	0.0009	0.85
	(–0.16)	(–0.56)	(0.54)	(–1.74)		
1993	–0.015	–0.001	—	0.001	–0.0034	0.27
	(–0.68)	(–0.02)		(0.36)		
1995	0.008	—	—	0.006	0.0045	2.30
	(0.43)			(2.11)		

Broker/Dealer Blockholders

The number of firms in our sample that had a 5 percent broker/dealer blockholder for two, four, and six years over various periods from 1983 to 1993 is shown in Figure 4. The number of firms that have a 5 percent blockholder (Panel A) fluctuated from 19 in the two-year period 1983 and 1984, to 5 in 1985 and 1986, and to 14 in 1992 and 1993. The mean (median) ownership of such blockholders increased from 7.2 percent (6.1 percent) for 1983 and 1984 to 10.6 percent (7.4 percent) for 1992 and 1993. When 5 percent blockholders hold their blocks for at least four years (Panel B), the number increases from one in 1983 through 1986 to eight in 1990 through 1993. If we consider a six-year ownership period (Panel C), the comparable figures are one for 1983 through 1988 to two for 1988 through 1993. In summary, regardless of holding period, the number of broker/dealer relational investors had no particular intertemporal pattern during the 1983–93 period.

Figure 4 also illustrates the number of 10 percent, 15 percent, and 20 percent broker/dealer blockholders in our sample. For the two-year period, 1983 and 1984, as we constrain the ownership requirement from 5 percent to 10 percent, 15 percent, and finally 20 percent, the number of firms that have such a blockholder decreases rather dramatically from 19 to 6, 0, and 0. For the four-year period, 1983 through 1986, as the ownership requirement changes from 5 percent to 10 percent, 15 percent, and finally 20 percent, the number of firms

Figure 4. Number of Firms in Sample: Broker/Dealer Blockholders

A. Two-Year Periods

B. Four-Year Periods

C. Six-Year Periods

Block Size

20%   15%   10%   5%
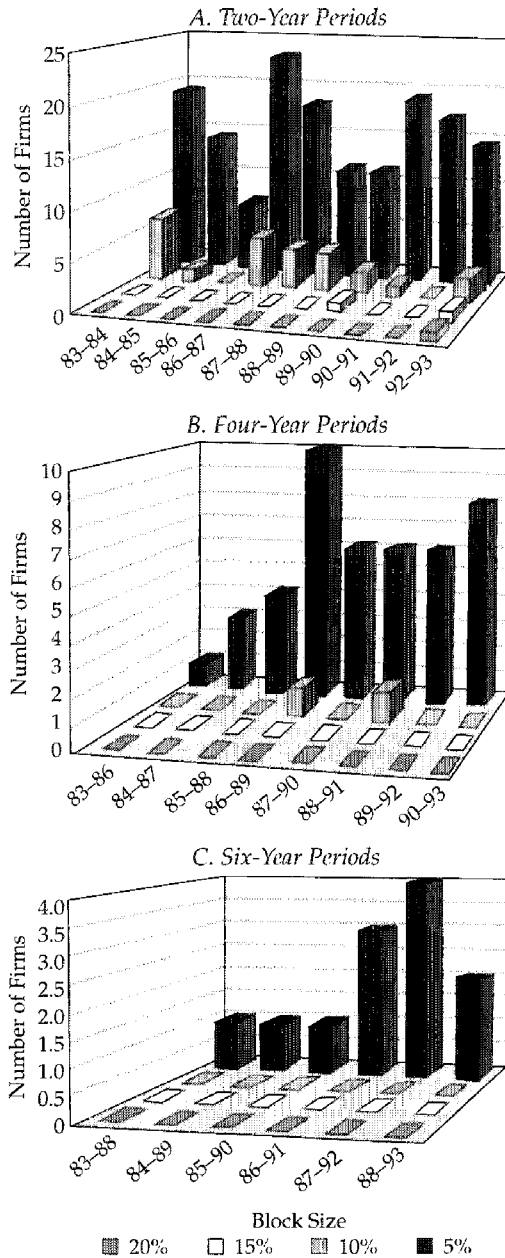
that have such a blockholder decreases from one to zero, zero, and zero. For the six-year period, 1983 through 1988, as the ownership requirement goes from 5 percent to 10 percent, 15 percent, and 20 percent, the number of firms with such a blockholder decreases from one to zero, zero, and zero. Clearly, few (and often no) broker/dealer blockholders hold blocks of 10 percent or more longer than four years. This finding suggests that if broker/dealers are engaging in relational investing, it is most likely to be in 5 percent holdings over two years.

Broker/dealers are more likely than investment companies to hold a stock for inventory purposes; hence, we do not expect the two groups to have a similar effect on firm performance. Among the statistically significant results for the effect of broker/dealer blockholders on performance, we found a positive relation between contemporary broker/dealer relational investors and market-adjusted returns from 1991 to 1992 and 1993 to 1995 (see Table 4). This result is consistent with these relational investorsimproving the stock market performance of firms in which they have holdings. We also found a negative relationship between lead relational investors and market-adjusted returns over three different subperiods: 1985 to 1986, 1989 to 1990, and 1991 to 1992, which suggests that broker/dealer relational investors tend to increase their holdings in firms that have exhibited poor stock performance in the recent past. We found a negative relationship between contemporary broker/dealer relational investors and market-adjusted returns from 1989 to 1995 and, as Table 5 shows, a positive relationship between lead relational investors and Tobin's q in 1983. This finding suggests that broker/dealer blockholders from 1985 to 1986 increased their holdings of firms that have experienced good performance in the recent past. These findings also suggest that the relation between broker/dealer blockholdings and performance is sensitive to the analysis period and the way performance is measured.

Implications for Practicing Financial Analysts

In this study, we examined whether ownership of large blocks of stock by investment companies, investment advisors, and broker/dealers is related to financial performance of 1,534 of the largest U.S. companies in which such blocks are owned. The study period for performance was from 1983 to 1995 and various subperiods within it. In estimating stock market and accounting performance measures of these sample firms, we obtained data on ownership of large blocks of stock by investment companies, investment advisors, and broker/dealers for each of the years in the 1983–93 period.

We differentiated within each category of investment professional by size of blockholding and the number of years over which these blocks were held. Specifically, each of the three types of investor was broken down into

Table 4. Regressions of Firm Performance against Measures of 5 Percent Broker/Dealer Blockholders, Various Holding Periods

(*t*-statistics in parentheses)

Market-Adjusted Return Period	Coefficients of Independent Variables			Adjusted R^2	F
	Lag Relational Investors	Contemporary Relational Investors	Lead Relational Investors		
1983–84	—	–0.123	–0.191	0.0011	1.55
		(–1.13)	(–1.13)		
1985–86	–0.011	0.031	–0.322	0.0035	2.15
	(–0.08)	(0.15)	(–2.48)		
1987–88	0.036	–0.027	0.46	–0.0030	0.03
	(0.13)	(–0.16)	(0.22)		
1989–90	–0.202	–0.048	–3.87	0.0041	2.32
	(–1.14)	(–0.23)	(–2.24)		
1991–92	–0.083	0.34	–0.318	0.0023	1.74
	(–0.42)	(2.09)	(–1.75)		
1993–95	–0.375	0.340	—	0.0042	3.07
	(–2.31)	(1.89)			
1983–86	—	0.707	–0.116	–0.0013	0.39
		(0.88)	(–0.36)		
1987–90	0.671	0.068	–1.71	–0.0024	0.27
	(0.63)	(0.16)	(–0.46)		
1991–95	0.203	–0.393	—	–0.0002	1.10
	(0.67)	(–1.41)			
1983–88	—	1.25	0.26	0.0001	1.01
		(1.36)	(0.41)		
1989–95	–0.111	–1.38	—	0.0042	2.83
	(–0.14)	(–2.37)			

5 percent, 10 percent, 15 percent, and 20 percent blockholdings over two-, four-, and six-year periods—12 categories in all. Investment companies and investment advisors showed a secular increase in the number of relational investors over our sample period (1983 to 1993), regardless of the definition of "relational investor." Over this same period, broker/dealer relational investors showed no particular pattern.

Our results are sensitive to the definition of relational investor and the measure of performance. Market-adjusted returns cumulated over two-, four-, and six-year periods were used as market-based measures of performance. We also used four accounting-based performance measures: growth in assets, growth in income, return on assets, and Tobin's *q*.

We found evidence consistent with the notion that investment company blockholders in the latter half of the 1980s helped improve future firm

Table 5. Regressions of Firm Performance against Measures of 5 Percent Broker/Dealer Blockholders, Various Holding Periods
(*t*-statistics in parentheses)

| | Coefficients of Independent Variables | | | | | |
Market-Adjusted Return Period	Lag Relational Investors	Contemporary Relational Investors	Lead Relational Investors	Firm Size	Adjusted R^2	F
Percentage growth in assets						
1983–86	—	–47.16	–6.34	–29.36	0.1261	38.07
		(–1.07)	(–0.22)	(–10.63)		
1987–90	–35.04	–7.67	–46.21	–23.80	0.0632	13.63
	(–0.37)	(–0.17)	(–1.06)	(–7.25)		
1991–95	–16.34	66.02	—	–23.89	0.0682	18.02
	(–0.33)	(–1.33)		(–7.27)		
1983–88	—	–44.03	–16.03	–83.36	0.0773	20.87
		(–0.18)	(–0.09)	(–7.90)		
1989–95	–59.62	–93.53	—	–85.71	0.0611	15.57
	(–0.43)	(–0.58)		(–6.78)		
Percentage growth in net income						
1983–86	—	–51.45	–134.84	–0.068	–0.0039	0.01
		(–0.04)	(–0.15)	(–0.001)		
1987–90	–74.23	13.46	–60.32	–2.92	–0.0050	0.06
	(–0.21)	(0.08)	(–0.37)	(–0.24)		
1991–95	259.59	1,654.90	—	491.69	–0.0020	0.69
	(0.05)	(0.32)		(1.42)		
1983–88	—	126.82	–1,022.80	568.70	–0.0020	0.34
		(0.01)	(–0.11)	(1.00)		
1989–95	–108.9	–7.91	—	–70.66	0.0100	3.13
	(–0.43)	(–0.03)		(–3.62)		
Tobin's q						
1983	—	–0.123	0.823	–0.287	0.1933	66.82
		(–0.44)	(1.86)	(–13.91)		
1985	–0.274	–0.392	–0.014	–0.264	0.1660	39.70
	(–1.00)	(–0.85)	(–0.06)	(–12.54)		
1987	–0.355	–0.208	–0.361	–0.195	0.0850	18.75
	(–0.69)	(–0.80)	(–0.100)	(–8.42)		
1989	–0.157	–0.326	–0.272	–0.214	0.0883	18.67
	(–0.55)	(–0.87)	(–0.86)	(–8.43)		
1991	–0.546	–0.328	–0.555	–0.360	0.1003	21.43
	(–0.94)	(–0.65)	(–0.79)	(–9.04)		
1993	–0.274	–0.455	—	–0.266	0.0827	23.44
	(–0.73)	(–0.93)		(–8.28)		
1995	–0.324	—	—	–0.136	0.2370	9.18
	(–0.72)			(–4.27)		

Table 5. (Continued)

Market-Adjusted Return Period	Coefficients of Independent Variables				Adjusted R^2	F
	Lag Relational Investors	Contemporary Relational Investors	Lead Relational Investors	Firm Size		
Return on assets						
1983	—	−0.018	−0.330	−0.002	−0.0020	0.36
		(−0.53)	(−0.56)	(−0.62)		
1985	−0.065	0.081	−0.002	0.003	−0.0010	0.82
	(−1.53)	(0.64)	(−0.05)	(0.96)		
1987	0.005	−0.029	−0.057	0.001	−0.0017	0.72
	(0.09)	(−0.82)	(−1.34)	(0.27)		
1989	−0.030	−0.053	0.010	0.001	−0.0018	0.70
	(−0.84)	(−1.33)	(0.25)	(0.27)		
1991	−0.023	0.026	−0.270	−0.004	−0.0076	0.87
	(−0.51)	(0.64)	(−0.54)	(−1.70)		
1993	0.024	−0.040	—	0.001	−0.0033	0.27
	(0.59)	(−0.72)		(0.38)		
1995	−0.015	—	—	0.006	0.0044	2.27
	(−0.36)			(2.06)		

performance. Additionally, for the early 1990s, we found weak evidence consistent with the argument that broker/dealer relational investors improve concurrent performance of firms in which they have blockholdings. Other evidence suggests that broker/dealer relational investors increase their holdings in firms that have exhibited poor stock performance in the recent past.

Investment company relational investors invested in companies that had experienced high rates of asset growth from 1989 to 1995. Evidence based on Tobin's q and ROA suggests that investment company relational investors in the early 1980s helped improve firm performance. Investment advisor relational investors in the early 1990s appeared to focus their holdings on firms that had experienced poor performance (based on income growth and ROA) in the recent past. Broker/dealer blockholders in the mid-1980s increased their holdings of firms that experienced good performance (measured by Tobin's q) in the recent past.

Our findings suggest that investment companies, advisors, and broker/ dealers have engaged in relationship investing to varying degrees. Such investing appears to have some value; however, the context and period of the investment must be considered carefully. A conclusion that we can legitimately reach on the basis of this research is that relationship investing is at worst neutral and most probably adds value in many situations.

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