

Monitoring the Monitor:  
Evaluating CalPERS' Activism

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Many public pension funds engage in institutional activism. These funds use the power of their pooled ownership of publicly traded stocks to affect changes in the corporations they own. I review the theory and empirical evidence underlying the motivation for institutional activism. In theory, the merits of institutional activism hinge critically on two agency costs: (1) the conflicts of interest between corporate managers and shareholders, and (2) the conflicts of interest between portfolio managers and investors. This leads to two types of institutional activism: shareholder activism and social activism. While portfolio managers can use their position to monitor conflicts that might arise between managers and shareholders (shareholder activism), they can also abuse their position by pursuing actions that advance their own moral values or political interests at the expense of investors (social activism). Which of these effects dominates the actions of portfolio managers will determine the value of activism and is an empirical issue. Perhaps the most high profile activism has been pursued by CalPERS with their annual focus list. I document that CalPERS has pursued reforms at focus list firms that would increase shareholder rights and (imprecisely) estimate the total wealth creation from this shareholder activism to be \$3.1 billion between 1992 and 2005. Unrelated to the focus list program, CalPERS has also pursued social activism (e.g., the divestment of tobacco stocks). In general, I argue that institutional activism should be limited shareholder activism where there is strong theoretical and empirical evidence indicating the proposed reforms will increase shareholder value. At times, institutions will be forced to take engage in social activism and take positions on sensitive issues. In these situations, I argue portfolio managers should pursue the moral values or political interests of their investors rather than themselves.

Does institutional activism create value for shareholders? Proponents of activism argue that institutions are merely providing necessary monitoring of corporations with poor performance. In contrast, critics view activism as the actions of meddling portfolio managers spending investors' money to interfere in corporate policy. Who is right?

To answer this question, I begin from basic economic principles and analyze a simple framework where a portfolio manager has the unfettered objective of maximizing the value of an investment portfolio. I argue that the benefits of institutional activism – narrowly for the investors at the institution and broadly for society – hinge critically on the prevalence of two agency costs. The first agency cost is the well known conflicts of interest between shareholders and corporate managers; corporate managers may pursue projects that benefit themselves, but not shareholders. Effective monitoring by institutions can reduce these agency costs – benefiting not only their investors, but raising the value of stocks for all investors. I refer to this type of institutional activism as “shareholder activism.”

The second agency cost, less widely discussed than the first, is the conflicts of interest between portfolio managers and investors. Portfolio managers may pursue investment policies that benefit their own objectives, but not those of investors. The large block of voting rights under the control of institutional portfolio managers presents the most obvious potential source of agency costs. Just as this voting power can be used to benefit shareholders through effective monitoring of corporations, the voting power can be abused by advancing the interests of portfolio managers<sup>1</sup> that are different from those of their investors and reduce the value of the portfolio they manage. Generally, institutional activism in this arena centers around social issues, such as disclosure of greenhouse gas emissions, divestment in Sudan or tobacco firms. Thus, I refer to this type of institutional activism as “social activism.”

Social activism may lead to desirable or important social benefits. For example, institutional pressure may cause corporations to reduce pollution or be more vigilant in monitoring child labor practices. But pollution abatement technologies and the monitoring of labor practices is costly. Consequently, the social gains will often hurt the bottom line and potential returns earned by shareholders. Thus, a portfolio manager who is attempting to

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<sup>1</sup> I use the phrase portfolio manager for expositional convenience. In practice, the portfolio manager may not be the source of these agency costs. For example, boards that oversee portfolio managers may encourage investment practices to advance board interests rather than investor interests.

maximize the value of an investment portfolio would not pursue social activism when it forces corporations to incur avoidable costs. Many investors choose socially responsible mutual funds precisely because these funds invest in firms that are consistent with their personal values. However, most institutions (e.g., public pension funds) are not provided with such a clear moral mandate from their investors.

The two agency costs create a tension that renders the ultimate gains of institutional activism an empirical question. While admittedly imprecise, I argue that simple empirical methods – short-run event studies and the long-run returns of portfolios of targeted stocks – are the best methods available to estimate the net benefits of institutional activism.

While institutional activism is widespread, my empirical analyses focus on the efficacy and prudence of CalPERS activism – a long-time leader in the institutional activism. For almost two decades, CalPERS has been active in pursuing corporate reforms. In recent years, this activism has come under increased scrutiny as CalPERS took public stands on a wide range of issues including corporate governance, greenhouse gas emissions, auto fuel efficiency, labor negotiations, investments in tobacco firms, Sudan, South Africa, and the independence of audit committees.

Using simple empirical methods, I estimate the gains to the high profile activism of CalPERS focus list firms over the period 1992 to 2005. My short-run analysis indicates that CalPERS activism yields small, but positive, market reactions of 23 basis points (bps) on the date focus list firms are publicly announced. This translates into a total wealth creation of \$3.1 billion (\$224 million annually) over the 14 year period that I analyze.

My long-run analysis yields intriguing, but inconclusive results. Portfolios of focus list firms earn annualized abnormal returns ranging from 2.4 to 4.8 percentage points annually at holding periods ranging from 6 months to 5 years. If these abnormal returns are causally linked to the activism of CalPERS, the wealth creation is enormous -- as much as 20 times greater than the short-run benefits and as large as \$89.5 billion through December 2005. Unfortunately, while economically large and positive, the estimates of long-run abnormal returns are not reliably positive. Long-run returns are simply too volatile to conclude that the long-run performance of focus list firms is unusual. I argue that previous studies, which document reliably positive long-

run abnormal returns for focus list firms, either fail to account for the characteristics of focus list firms and/or rely on faulty statistics.

Having established a reasonable estimate of the value of CalPERS activities surrounding focus list firms, I review the nature of reforms that CalPERS publicly pursues at these firms through shareholder proposals sponsored by CalPERS at focus list firms. Without exception, the CalPERS proposals increase shareholder rights. Empirical research establishes a strong link between shareholder rights and firm value and provides strong support for prudence of CalPERS' initiatives designed to improve shareholder rights. Thus, these governance-related reforms at focus list firms are uniformly shareholder (rather than social) activism.

However, CalPERS has also pursued social activism unrelated to their annual focus list firms. I review some of the high profile decisions made by CalPERS. Many of these decisions lack clear evidence – empirical or theoretical – that CalPERS activism would improve shareholder value. CalPERS manages the assets of over a million public employees, retirees, and their families. When there is no clear link to improvements in shareholder value, whether CalPERS activism is in the best interests of those whose money they manage depends critically on the personal preferences of investors.

The remainder of this paper is organized as follows. In section 1, I provide an overview of the theory underlying institutional activism. In section 2, I provide empirical evidence regarding the short-run and long-run performance of CalPERS focus list firms. In section 3, I review the nature of reforms pursued at focus list firms and provide anecdotes regarding other activism pursued by CalPERS outside of their focus list initiative.

## **1 Institutional Activism: Theory**

In this section, I formally lay out a simple framework to analyze the expected effects of institutional activism.

### **1.1 Shareholders v. Managers**

It is well known that conflicts of interest may arise between shareholders, who seek to maximize firm value, and firm managers, who may have interests other than value maximization (e.g., empire building or maximizing compensation packages). These conflicts create a cost for shareholders that lead to lower firm valuations. Absent these agency costs, the market would reach some maximum agency-cost-free valuation, call it  $V^*$ .

Absent any monitoring by investors, agency costs (A) take a (relatively) large percentage of this maximum valuation. Investors can reduce the agency cost bite taken out of the valuation pie by monitoring corporations, but monitoring is costly, varies in effectiveness, and, no doubt, has diminishing marginal returns. In the top graph, figure 1, I represent agency costs as a decreasing, convex function of monitoring resources (M).

Large institutional investors invest tens of billions of dollars in stocks – generally in an index fund or at least an equity portfolio that tracks the market reasonably well. Nonetheless, even the largest institutional investors own only a small percentage of the total market. For example, CalPERS, with U.S. equity investments of \$79 billion in mid-2005, owns approximately 0.5 percent of the total market, which is valued at approximately \$16 trillion in July 2005. For CalPERS to justify investment in the monitoring of corporate managers as a value enhancing proposition, a dollar spent on monitoring must increase the value of monitored firms by *at least*  $\$200 = \$1 / 0.5\%$ , since CalPERS only owns a small slice of the monitored firms. If CalPERS prudently spends \$1,000,000 on monitoring each year, the expenditure would lead to a minimum increase in firm value of \$200,000,000.

This analysis presumes the benefits of activism are limited to the firms that are directly pursued by an institution. But widespread monitoring by institutions can also deter corporate malfeasance. If corporations know that institutions stand ready to publicly excoriate firms that engage in practices that reduce shareholder value, corporations will be less likely to engage in these practices in the first place. The deterrence benefits of activism are exceedingly difficult to measure, but nonetheless provide additional justification for institutional activism.

In general, a savvy portfolio manager will choose a monitoring cost ( $M^*$ ) that maximizes the value of his portfolio ( $P^*$ ). In the bottom graph of figure 1, I depict the manager's portfolio value as a function of the monitoring costs that he incurs. In principle, the optimal level of monitoring ( $M^*$ ) will be achieved when the marginal cost of monitoring equals the marginal benefit (i.e., reduction in agency costs realized in the manager's portfolio). Unfortunately, in practice, it is nearly impossible to estimate precisely the marginal benefit of monitoring. Thus, it is difficult to determine ex-ante whether institutions are investing in an optimal amount of monitoring. Even with the benefit of over a decade of hindsight, it is difficult to *precisely*

estimate the total value of the gains resulting from CalPERS activism. I discuss this issue at length in the empirical section of this paper.

## **1.2 Free Riders**

As the above analysis makes clear, while large investors incur monitoring costs, all investors enjoy the benefits of monitoring. On one hand, this is a positive externality created by the monitoring of the large investor. On the other hand, that others benefit from the actions of the large investor creates a free rider problem (Admati, Pfleiderer, and Zechner, 1994). To see this immediately, assume all investors choose a market index, but only the large investor incurs monitoring costs. It is immediately obvious that small investors, who incur no monitoring costs but enjoy the benefits of monitoring by large investors, will outperform the large investor. An investor who delegates the management of his money to the large investor would flee the large investor and choose to manage his own money. And, of course, as the portfolio of the large investor shrinks, the incentive to monitor corporate actions is reduced.

To solve the free rider problem such that monitoring occurs in equilibrium, there must be either economies of scale to investment management or an institutional framework that encourages pooled investments.<sup>2</sup> Certainly, both conditions are true in today's financial markets. With economies of scale to investment management (e.g., reduced transaction costs or improved diversification), the equilibrium size of a portfolio will be determined such that the transaction costs savings are exactly offset by the cost of monitoring (Admati et al., p. 1118). Furthermore, current investment practices encourage pooled investments. Corporations (or municipalities) provide employees with (generally) limited investment options for their retirement portfolios or manage a large investment portfolio that is intended to cover the beneficiaries of a corporate (or municipal) defined-benefit retirement plan.

## **1.3 Portfolio Manager v. Investor**

Conflicts of interest can arise between investors and those who manage their money (e.g., portfolio managers). While investors seek to maximize the value of their invested wealth, portfolio managers may have incentives that are not fully aligned with this objective. In the context of shareholder activism, it is possible that a portfolio manager might have an interest in pursuing a political agenda (Romano, 1993a, 1993b, 1995). Some argue that aspects of CalPERS activism are politically motivated. Perhaps the greatest controversy was raised when CalPERS

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<sup>2</sup> Thaler (1992) summarizes evidence that the strong free rider hypothesis is violated in many contexts (e.g., we contribute to public radio, we tip servers at places we will never visit again, we vote in elections when the chance that a single vote will sway an election is exceedingly small).

voted to oust Safeway's CEO, Steven Burd, from Safeway's board of directors in May 2004 for his harsh dealing with employee unions. I discuss this and related issues in detail later when I examine the nature of CalPERS activism.

It is important to note that the conflicts of interest that arise between investors and portfolio managers hinge critically on the objectives of investors in the portfolio. Consider a simple example: A CEO pursues a policy of manufacturing the firm's products in the US rather than overseas despite the fact that overseas manufacturing would be less costly. As a portfolio manager, you have a sizable stake in the company. You could attempt to rally support for ousting the CEO and replacing him with a CEO that would move the firm's manufacturing operations overseas; if successful, this would undoubtedly increase the value of the firm's stock. However, the investors in your portfolio uniformly oppose the wealth-maximizing initiative for moral reasons (e.g., perhaps the foreign manufacturers have lax labor or environmental standards and American jobs would be lost). If the portfolio manager were to pursue wealth maximization, he would not be serving the interests of his investors.

Heterogeneity in the moral or political views of investors in the institutional portfolio further complicates matters. Given the different objectives of investors within the portfolio, the portfolio manager cannot hope to satisfy everyone. These moral issues are invariably sensitive, but the point is simple: Once considerations other than wealth maximization are relevant for investors, aligning the interests of portfolio managers and investors becomes extremely difficult. Given the delicate nature of many of these ethical considerations, portfolio managers generally pursue policies that attempt to maximize shareholder value and avoid taking stands on sensitive moral issues. As the above example illustrates, whether this maximizes the utility, rather than wealth, of investors depends on their shared objectives.

#### **1.4 Oversight of the Portfolio Manager**

Strong oversight of the portfolio manager could prevent him from pursuing a political agenda that destroys the wealth of investors in his portfolio. In public pension funds, like those run by CalPERS and CalSTRS, this oversight comes in the form of a board. Presumably, an effective board would remove a portfolio manager who pursues his own interests at the expense of investors.

But boards are often political in nature. Indeed, CalPERS' board members started many of CalPERS' controversial initiatives. If the portfolio manager and board share political



objectives, the board's oversight may be ineffective. Equally pernicious, a board may have a political interest in squelching prudent activism by a portfolio manager.

Consider the following example: A portfolio manager regularly pursues shareholder initiatives with strong and demonstrably positive effects on shareholder wealth. However, these initiatives tend to weaken the position and influence of top CEOs, who are strong supporters of members of the board that are assigned to oversee the portfolio manager. The corporate CEOs might use their influence with the board to put an end to the portfolio manager's shareholder activism.

Not surprisingly, politics are a double-edged sword. Infusing politics into shareholder activism can lead to suboptimal outcomes in two ways. On one hand, politically-motivated boards could thwart valuable shareholder activism by a portfolio manager. On the other hand, lax oversight might enable a politically-motivated portfolio manager to pursue his social activism that reduces shareholder value and is not aligned with the values of his investors.

### **1.5 *Evaluating the Portfolio Manager***

Traditionally, portfolio managers are evaluated relative to an appropriate benchmark (e.g., the S&P 500 or Russell 2000). Fancier evaluation tools might calculate alphas or abnormal returns relative to multiple benchmarks (or factors). Unfortunately, all of these methods miss the benefits of shareholder activism. Consider an index fund manager who invests in the S&P 500 and, by construction, is unable to earn a positive alpha. However, the fund manager pursues numerous shareholder initiatives that have demonstrably positive effects on share prices. This manager has improved the returns of his investors. However, since all investors in the marketplace benefit (the free rider issue discussed above), this performance boost does not show up in the form of a positive alpha.

A simple and effective method for evaluating the activities of the portfolio manager is to measure the abnormal returns around the announcement of events related to shareholder activism. In an efficient market, the expected benefits of shareholder activism would be reflected in stock prices. Thus, the announcement of a shareholder initiative by an institutional investor should lead to share price changes if the announcement is unanticipated and leads to material changes in shareholder value. If prices do not react immediately to the announcement of a shareholder activism initiative, price effects may continue for some time after the announcement date. Given

the controversy surrounding the degree of market efficiency in financial markets, it seems reasonable to analyze both the short- and long-run evidence.

## **2 The CalPERS Evidence**

### **2.1 CalPERS Activism**

CalPERS formally began its corporate governance activities in 1987 under the leadership of then-CEO Dale Hanson. Between 1987 and 1992, CalPERS' staff would select companies to target. Many of the early reforms were targeted at the repeal of poison pills and staggered boards (Crutchley, Hudson, and Jensen, 1998). Subject to CalPERS Board approval, letters were sent to the targeted company's CEO (Nesbitt, 1994).

In these early years, there was no formal announcement of the targeted companies. CalPERS activism would only become public when CalPERS formally sponsored a shareholder resolution. However, in 1992 CalPERS began publicly announcing its focus list in an effort to apply public pressure to targeted companies.

My empirical analyses concentrate on these focus list firms. It is important to note that CalPERS activism is not limited to these firms. As I discuss in detail at the close of this section, CalPERS has taken public stands on a wide range of issues.

### **2.2 Short-Run Returns**

I begin with an analysis of the short-run returns around the public announcement of focus list for the 115 firms targeted by CalPERS over the period 1992 to 2005. Some firms appear on the focus list in multiple years.

Before summarizing the short-run evidence, it is useful to consider the conditions under which the short-run analysis would provide a reasonable approximation of the valuation impact of CalPERS activism. First, financial markets must be efficient; the information contained in the CalPERS announcement must be fully and immediately reflected in price.

Second, the announcement must be, to some extent, unanticipated. If market participants are fully aware that CalPERS plans to target the identified firms prior to the announcement, the press release would contain no new information. Similarly, if the announcement is partially anticipated, the short-run analysis around the press release date will underestimate the total

valuation impact. Since CalPERS carefully guards the identity of focus list firms prior to the press release, this assumption seems reasonable.

Third, the information contained in the CalPERS announcement must be the revelation that CalPERS plans to work for change in the focus list firms. If CalPERS has information about target companies that is unavailable to market participants, the announcement might reveal this private information. For example, CalPERS might have attempted to effect change with target companies prior to the press release. If these attempts are successful, the firm might be removed from the focus list prior to the press release. Thus, to some extent, firms that remain on the focus list might have management that is unusually reticent to change corporate practices. Thus, the announcement of the focus list would have two bits of information: (1) CalPERS intentions to reform the focus list firms, and (2) management's reluctance to reform prior to the press release date. Assuming CalPERS pursues prudent corporate reforms, the former is likely positive news, while the latter is negative news. The mixture of positive and negative news in the public announcement would cause the researcher to underestimate the benefits of CalPERS activism.

Finally, the value of CalPERS activism must be limited to those firms that they publicly pursue. If CalPERS is able to successfully negotiate behind-the-scenes changes in corporate policy that redound to the benefit of shareholders, an analysis of only publicly announced intervention will underestimate the total value of activism. Similarly, monitoring may deter corporate malfeasance. It is impossible to precisely estimate the benefits of behind-the-scenes negotiations or deterrence, though both of these effects can contribute to the value of activism.<sup>3</sup>

In summary, the short-run analysis leans on the assumption of market efficiency and might underestimate the total benefit of CalPERS activism if the announcement is either partially anticipated or conveys some information about managerial entrenchment. In addition, the analysis misses auxiliary benefits of activism that might accrue from private negotiations or the potential deterrence of corporate malfeasance. For these reasons, short-run event time analysis yields a conservative estimate of the total benefits of CalPERS activism.

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<sup>3</sup> For example, Qiu (2003) documents public pension fund ownership decreases the probability that a firm will become an acquirer. Several studies argue many acquisitions are motivated by managerial, rather than shareholder, interests. Thus, the decreased acquisitiveness of firms owned by public pension funds arguably redounds to shareholders' benefit.

Several prior studies analyze the short-run returns around the public release of CalPERS focus list firms or CalPERS proxy initiatives. Wahal (1996), Smith (1996), and Del Guercio and Hawkins (1999) all analyze a small number of firms targeted by CalPERS in the 1987 to 1993 period and document short-run returns that are not reliably different from zero. Unfortunately, identifying a clean announcement date during this period is problematic, since CalPERS did not formally announce the focus list. Thus, the small sample size and the ambiguous announcement dates yield unreliable estimates of short-run abnormal returns.

English et al. (2004) and Anson et al. (2003) solve the announcement date problem by analyzing the period beginning in 1992, when CalPERS began announcing the constituents of their focus list firms in a formal press release. English et al. document reliably positive and economically large short-run returns of 0.98% for 63 focus list firms targeted between 1992 to 1997, while Anson et al. (2003) find positive, but statistically insignificant, returns of 0.26% for the 96 focus list firms targeted between 1992 and 2001.

I update the short-run results for the 115 firms targeted between 1992 and 2005 and document reliably positive market-adjusted returns of 0.23%. For the short-run analysis, I calculate market-adjusted returns for each firm on the announcement day using a CRSP value-weighted market index. For each year, I calculate an average market-adjusted return weighting each firm equally or by market cap. All data are from the Center for Research in Security Prices (CRSP) dataset. Table 1 presents the results of the short-run analysis by year. These results provide solid evidence that CalPERS shareholder activism, on average, improves shareholder value. In the typical year, targeted firms experience a small, but reliably positive, market reaction of 23 basis points (equally-weighted) or 35 basis points (value-weighted).<sup>4</sup>

A reasonable estimate of the total shareholder wealth created by the CalPERS activism can be calculated by multiplying the market-adjusted return for each firm by its market cap. In each year, the market cap of all firms targeted and the total shareholder wealth created by CalPERS activism are presented in the last two columns of table 1. Over the last fourteen years, CalPERS activism improved shareholder wealth by nearly \$3.1 billion. This translates into an average annual wealth creation of \$224 million.

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<sup>4</sup> Each year is considered an independent observation since the event day is common for all firms within a year. Thus, the reader can calculate the *t*-statistics by taking the ratio of the mean abnormal return across years and dividing by the standard deviation of the mean annual return.

Even this estimate of the wealth creation, though reasonable, is sensitive to the method used. I test whether the results are sensitive to the exclusion of firms with earnings announcements within two, five, or ten days of the focus list announcement. The results for firms without earnings announcements, though not reliably positive, are qualitatively similar to the full sample results. Calculating abnormal returns using market model parameters estimated *after* the announcement date yields generally larger and reliably positive abnormal returns, while including returns on the day before and after the announcement date reduces the estimated abnormal returns and renders them indistinguishable from zero. Ultimately, I prefer the simple method of using market-adjusted returns on the announcement day for two reasons. First, market-adjusted returns do not require the estimation of parameters (e.g., betas) which are often sensitive to the estimation window selected. Second, there is no uncertainty regarding the focus list announcement date to warrant the extension of the event window.

While the short-run analysis provides solid evidence that CalPERS activism creates shareholder value, does this activism benefit CalPERS investors? In other words, do the benefits that accrue to CalPERS investors justify CalPERS expenditures on activism? Using the \$3.1 billion estimate provided above, the annual increase in CalPERS portfolio is \$1.12 million.<sup>5</sup> Given a staff of three full-time professionals devoted to issues related to the corporate focus list, it is likely that the expenditures on this staff are justified by the record to date. One might argue that the benefit that accrues to CalPERS investors is small relative to an investment portfolio of \$170 billion (i.e., less than 7 bps annually = \$1.12 million / \$170 billion). This is an overly simplistic view for two reasons. First, the CalPERS benefit is only the tip of the iceberg – all market participants benefit from CalPERS activism. Second, as discussed throughout the paper, the short-run reaction to focus list announcements underestimates the total benefits to CalPERS activism.

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<sup>5</sup> In July 2005, CalPERS held US equity investments with a market value of \$79 billion (out of \$194.6 billion in assets under management). In July 2005, the total market value of stocks trading on the New York, American, and Nasdaq exchanges was \$16.4 trillion. Thus, CalPERS owns approximately 0.5% of all outstanding US equity, and CalPERS investors would accrue average annual benefits of roughly \$1.12 million dollars (mean market-wide annual benefits of \$224 million \* 0.5% CalPERS ownership). Of course, these back-of-the-envelope calculations assume CalPERS investment in focus list firms are roughly in line with their weighting in the overall market portfolio; if focus list firms are overweighted in the CalPERS portfolio, the benefits for CalPERS investors would exceed \$1.12 million.

### 2.3 Long-Run Returns

Of course, the analysis of short-term returns discussed above leans heavily on the assumption that markets respond immediately to the release of the CalPERS focus list. If markets are slow to respond to full implications of CalPERS activism, more information might be revealed in the analysis of long-run returns.

Several studies attempt to analyze long-run returns following the announcement of CalPERS focus list. Unfortunately, all of these studies focus on event-time returns, which are well-known to yield biased test statistics, and/or employ benchmarks that do not fully account for the characteristics of firms appearing on CalPERS focus list.<sup>6</sup> I elaborate on both of these issues below.<sup>7</sup>

To get an initial sense for the long-run performance of the focus list firms, consider a simple event-time analysis, where day 0 is defined as the date of the CalPERS announcement of the focus list firms. Figure 2, presents the mean cumulative market-adjusted returns (firm return less a value-weighted market index) for focus list firms for the three years leading up to the announcement date and for the five years following the announcement date. The focus list firms lag the market by a substantial margin in the years leading up to the announcement date. This is not surprising, since CalPERS explicitly uses poor stock performance to identify corporations that might require more careful monitoring.

What is more intriguing is the strong performance of these stocks following the announcement date. After five years, the average focus list firm has outperformed the market by almost 32%. This is an impressive track record, but there are two problems with ascribing this strong performance to CalPERS activism. First, there is a benchmark problem. Clearly, the market index is not the appropriate benchmark for focus list firms. CalPERS targets firms with

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<sup>6</sup> These studies include Nesbitt (1994), Del Guercio and Hawkins (1999), Crutchley et al. (1998), Prevost et al. (2000), English et al. (2004), and Anson et al. (2004). All but Del Guercio (1999) conclude the returns of focus list firms at long horizons are reliably positive. Of these studies, only Anson et al. (2004) explicitly control for the cross-sectional dependence. Del Guercio and Hawkins (1999) and English et al. (2004) control for size and value characteristics of focus list firms, which tend to be large value firms with poor recent returns. Crutchley et al. (1998) and Anson et al. (2003, 2004) rely on a market model, where parameters are estimated in the period *before* the focus list announcement. Using parameter estimates from the pre-announcement period will yield expected returns that are biased downward, since focus list firms perform poorly prior to the announcement. Downwardly biased expected returns will yield upwardly biased estimates of abnormal returns (see Nelson (2006)).

<sup>7</sup> See also Barber and Lyon (1997), Kothari and Warner (1997), Lyon et al. (1999), Fama (1998), and Mitchell and Stafford (2000) for a discussion of these issues.

poor performance, which – as we will see in subsequent analyses – tend to be value rather than growth stocks. It is well known that value stocks tend to outperform growth stocks over long horizons, so clearly this firm characteristic must be carefully accounted for when assessing the long-run performance of the focus list firms.

Second, how do we assess whether the admittedly large long-run returns earned by focus list firms are a result of CalPERS activism or a mere chance outcome. To do so, we formally test the null hypothesis that the long-run returns are zero and lean heavily on statistical analyses. Unfortunately, statistics based on event-time returns such as those depicted in figure 1 are notoriously unreliable (i.e., they tend to reject the null hypothesis more than they should). Though there are numerous issues, perhaps the most obvious is the explicit assumption that the returns earned by each focus list firm are independent. Security returns tend to be positively correlated. Thus, unless one can identify *all* factors that influence the cross-section of returns – a Herculean task – this assumption is almost certainly false.

Fortunately, there is a simple way to overcome the shortcomings of event-time analyses. The solution is simple: construct a calendar-time portfolio that invests in focus list firms. Firms are placed into the focus list portfolio at the close of trading on the date of the CalPERS press release. On any day, the return on the portfolio is merely a weighted average of returns on the focus list firms, where weights are proportional to each firm’s market capitalization. This value-weighted portfolio can be thought of as a “slice” of the market portfolio (or the CalPERS portfolio), which assumes varying investment holding periods in each focus list firm. In the analysis that follows, I vary the holding period from two weeks to five years.

The focus of the empirical analysis is the time series of daily returns on the focus list portfolio. Note that this analysis garners power from a longer time series (i.e., more daily returns) rather than more focus list firms. Thus, the analysis implicitly relies on the reasonable assumption that returns are independent over time. In contrast, the typical event time analysis, used in all prior analyses of the long-run returns of focus list firms, assume each firm generates an independent observation and relies on the dubious assumption that returns are independent across firms.

The abnormal returns on this portfolio can be calculated using standard asset pricing techniques. It is now common practice in financial economics to estimate abnormal returns using the following four-factor model:

$$(R_{pt} - R_{ft}) = \alpha + \beta(R_{mt} - R_{ft}) + sSMB_t + hHML_t + uUMD_t + \varepsilon_t$$

Where  $R_{pt}$  is the return on the focus list portfolio,  $R_{ft}$  is the return on one-month T-Bills,  $R_{mt}$  is the return on a value-weighted market portfolio,  $SMB_t$  is the spread in returns between small and big firms,  $HML_t$  is the spread in returns between high and low book-to-market firms, and  $UMD_t$  is the spread in returns between stocks recently up and stocks recently down (a momentum factor).<sup>8</sup> The daily excess returns on the focus list portfolio is regressed on the daily realizations of the four factors. Positive coefficients on the size (SMB), book-to-market (HML), and momentum (UMD) factors represent tilts toward small firms, high book-to-market firms, and stocks recently up (respectively), while negative coefficients represent tilts toward big firms, low book-to-market firms, and stocks recently down. The parameter of interest in this regression is the intercept, which represents the daily portfolio “alpha” or abnormal return after controlling for the style tilts of the portfolio.

The factor model regressions also address the second issue that plagues many of the prior studies of the long-run returns on focus list firms: the use of benchmarks that do not adequately control for the characteristics of focus list firms. The independent variables provide explicit controls for the size, value, and momentum characteristics of the focus list portfolio.

Factor regression results for the period 1992 to 2005 are presented in table 2. Focus list firms are added to the portfolio at the close of trading on the date of the CalPERS press release.<sup>9</sup> Coefficient estimates from the four-factor model are presented in Panel A, while  $t$ -statistics are presented in Panel B. Each row of numbers represented the returns for a different holding period – ranging from two weeks to five years. The results of the daily regressions yield a daily alpha. To simplify the discussion, the daily alpha is annualized by multiplying the daily alpha by 252 (the number of trading days in a year).

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<sup>8</sup> The factor data and the details of their construction are available on Ken French’s web site: <http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/>.

<sup>9</sup> Several firms are included on the CalPERS focus list in multiple years. Each firm is represented in the focus list portfolio only once. For example, in 1992 the focus list portfolio begins with a position in Chrysler. In 1993, Chrysler is again included on the CalPERS focus list. The focus list portfolio that assumes a holding period of two years would contain only one position in Chrysler, which would be divested two years after Chrysler’s last inclusion on the CalPERS focus list.



The style tilts of the focus list portfolio are not surprising. Relative to the market portfolio, focus list firms have slightly greater than average market risk (i.e., betas greater than one), and are small ( $s > 0$ ),<sup>10</sup> value firms ( $h > 0$ ) with poor recent returns ( $u < 0$ ). The value and momentum tilts of the portfolio are consistent with CalPERS targeting poorly performing firms. During the period of analysis, the mean daily return on the market, size, value, and momentum portfolios were 3.0, 0.5, 2.2, and 4.4 bps (respectively). It is immediately obvious that the style tilts are important considerations when analyzing the long-run returns of focus list firms. For example, the coefficient estimate on the value (HML) factor of 0.51 at a one year holding period indicates that  $0.51 \times 2.2 = 1.1$  bps of the daily return on the focus list portfolio can be ascribed to the value tilt of the portfolio.

The abnormal returns (alphas) of the focus list portfolio are generally positive, but not reliably different from zero. At short horizons of two weeks and one month, the focus list portfolio earns impressive daily alphas of 18.4 and 9.3 bps per day (46.4 and 9.3 percentage points annually). At longer horizons of six months to five years, the daily alphas are consistently positive, though smaller – ranging from 2.4 percentage points annually to 4.8 percentage points annually. Note that these portfolio returns exclude the announcement return analyzed in table 1 and thus would represent additional benefit to shareholder activism if we can conclude these returns are *caused* by the CalPERS intervention.

It is straightforward to estimate the cumulative abnormal gains on the focus list portfolio by summing the product of the size of the portfolio ( $V_t$ ) and sum of the estimated intercept and residual from equation (1):  $\sum_t V_t (\alpha + \varepsilon_t)$ . In figure 3, we present the result of this estimation over holding periods ranging from 2 weeks to 5 years based on the returns of the focus list portfolio from 1992 through December 2005. For comparison purposes, the one-day valuation effects of \$3.1 billion estimated in table 1 are presented on the far left side of the graph. The estimates of long horizon gains on the focus list firms are uniformly positive. In addition, the long horizon gains often are orders of magnitude larger than the one-day valuation effects. For example, the estimated gain at a two week holding period is \$10.5 billion, but grows to \$89.5 billion dollars assuming benefits accrue over five years following the CalPERS intervention.

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<sup>10</sup> At the two week horizon, the size factor is negative but not reliably different from zero.

While long-run returns on the focus list firms are economically large, they are not reliably positive. None of the *t*-statistics for the alphas presented in Table 2, Panel B are close to conventional levels of statistical significance. This underscores the Achilles heel of the analysis of long-run returns – volatility. While the alphas that we estimate are uniformly positive and economically large, we cannot conclude that they are unusual based on the available evidence.

### **3 The Nature of CalPERS Activism**

Instead of leaning on return analyses to evaluate the activism of CalPERS, one can also analyze the nature of the reforms pursued by CalPERS. I identify 17 shareholder proposals sponsored by CalPERS that appear on the proxy statements of focus list firms in the five years after the year a firm is placed on the focus list. All shareholder proposals sponsored by CalPERS attempted to expand shareholder rights, most often by declassifying boards (seven proposals) or requiring independent board committees or directors (five proposals).

There is solid empirical evidence that firms with strong shareholder rights have higher valuations. Gompers, Ishii, and Metrick (2003) analyze the valuation of firms with varying levels of shareholder rights by constructing a shareholder rights score based on a number of firm practices including, for example, the presence of classified boards, unequal shareholder voting rights, and the presence of poison pills. They document that firms with strong shareholder rights (democratic firms) have mean valuations that are 33 percent greater than valuations of firms with few shareholder rights (dictatorial firms). La Porta et al. (2002) document higher valuations for firms in countries with better protection of investor rights. This evidence provides strong support that the nature of reforms pursued by CalPERS, which are clearly designed to expand shareholder rights, should improve shareholder value.

While CalPERS activism connected with focus list firms can be broadly justified from the scientific evidence cited above, CalPERS activism is not limited to focus list firms. Two examples are salient.<sup>11</sup>

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<sup>11</sup> There are other examples of activism unrelated to shareholder rights. CACI international has also been criticized by a CalPERS board member for having three civilian interrogators who are under Army investigation for their roles at Abu Graib prison. CalPERS was also widely criticized for voting against the appointment of Warren Buffett to Coca-Cola's board of directors. The vote against Buffett was a result of a policy of voting against audit committee members who approved significant non-audit contracts for the companies auditors. This policy has been subsequently changed. CalPERS has also criticized auto companies for filing suit over California's clean car regulations.

In 2000, CalPERS board voted 7 to 5 to divest all of its holdings in tobacco firms. CalPERS staff did not support the divestiture. Press accounts indicated that Philip Angelides, CalPERS board member and the California State Treasurer, was a strong advocate for this divestiture. Though this decision took place at a time when tobacco stocks were performing poorly, the decision was almost certainly motivated by moral, rather than investment, considerations. There is no evidence – theoretical or empirical – that tobacco firms should or do earn subpar rates of return. And, past performance is not a reliable indicator of future performance. In fact, recent evidence suggests sin stocks, like tobacco, earn superior returns precisely because they are spurned by large segments of the investment community (Hong and Kacperczyk, 2005). According to press accounts of this decision, the CalPERS board did not consider the political or moral values of CalPERS investors when arriving at their decision. The decision has proven costly for CalPERS investors. From October 2000 to June 2006, a dollar invested in tobacco stocks has grown to \$2.77 while a dollar invested in the S&P 500 has decreased to 98 cents. Given CalPERS divested of \$365 million of tobacco stocks, it's reasonable to assume the CalPERS portfolio has taken a performance hit of over \$650 million.<sup>12</sup>

In 2004, Sean Harrigan, then-president of CalPERS board, was a key player in CalPERS involvement in a Safeway labor dispute. In 2003, United Food and Commercial Workers (UFCW) union organized a strike against Safeway over cuts in employees' health care benefits. In December 2003, acting at Harrigan's direction, CalPERS wrote Safeway CEO Steven Burd and urged Mr. Burd to wrap up union negotiations "fairly and expeditiously" adding that "fair treatment of employees is a critical element in creating long-term value for shareholders."<sup>13</sup> Besides being CalPERS president, Mr. Harrigan also served as the executive director of the UFCW's Southern California council.<sup>14</sup> If CalPERS intervened in the Safeway case to maximize shareholder value, there is little theory or empirical evidence to support their position. In stark contrast, there is a strong body of economic research supporting a link between shareholder rights and firm value – the main focus of many of CalPERS corporate reform efforts. To be sure, deft

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<sup>12</sup> This estimate assumes: (1) CalPERS tobacco holdings earned returns similar to the industry returns, (2) divested tobacco stocks were invested in the S&P 500, and (3) divestment occurred month-end October, 2000. Tobacco industry returns are from Ken French's data library of industry returns using 30 industry portfolios.

<sup>13</sup> See "Gadfly activism at CalPERS leads to possible ouster of president," Wall Street Journal, December 1, 2004, p. A1, and "Moving the Market," Wall Street Journal, December 2, 2004, p. C3.

<sup>14</sup> Public pension funds for Illinois, Connecticut, California, and the city and state of New York withheld support for Burd. Some published reports indicate the reason for their lack of support was Safeway's poor corporate performance, Burd's joint position as CEO and board Chairman, and the lack of independence of Safeway's board.

handling of labor relations clearly has implications for shareholder value. Unfortunately, there is no scientific evidence that provides an objective measure of good labor relations. This lack of scientific evidence and Harrigan's UFCW connections present obvious concerns about this particular intervention. Ultimately, only 17% of shareholders voted against appointing Burd to Safeway's board. The CalPERS board voted to remove Harrigan as a board member in December 2004.

When activism cannot be justified as a mechanism to improve shareholder value, the moral or political objectives of investors, not fund managers, should be considered paramount. It seems reasonable to ask whether the millions of people whose assets are managed by CalPERS would choose to hold tobacco stocks or intervene in labor negotiations.

#### **4 Conclusion**

Institutional activism is a double-edged sword. When prudently applied, shareholder activism can provide effective monitoring of publicly traded corporations. When abused, portfolio managers can pursue social activism to advance their personal agendas at the expense of those whose money they manage.

Social activism involves taking public stands on sensitive issues. Most institutions simply ignore these considerations when investing. Unfortunately, ignoring these considerations is not necessarily in the best interests of investors. It is possible that the vast majority of investors would approve of the divestment of tobacco firms. An institution who ignores these considerations would not be serving investors. It would seem reasonable to require a high level of investor support for an institution to engage in social activism. When institutions engage in social activism that cannot reasonably be expected to maximize shareholder value, the preferences of investors should be given top priority. Institutions must open lines of communication with investors; they must understand how investors stand on moral issues that might affect investment policy.

Moral issues are challenging and nettlesome. But do not throw the baby out with the bath water. Shareholder activism can provide important and effective monitoring of publicly traded firms *and* benefit shareholders. My analysis of announcement reaction of CalPERS focus list firms indicates these targeted and well-reasoned interventions have created \$3.1 billion dollars of shareholder value. This is surely an underestimate of the total value of CalPERS activism for

several reasons. For example, CalPERS' public announcements may be partially anticipated and convey negative information about managerial entrenchment. I am also unable to measure the value of CalPERS' private negotiations with firms or the extent to which CalPERS activism serves as a deterrent to corporate malfeasance. Finally, though unreliably positive, the long-run returns of focus list firms are economically large and represent potential long-run gains as high as \$89.5 billion.

With rare exceptions, CalPERS interventions in focus list firms are designed to improve shareholder rights. All shareholder proposals at focus list firms sponsored by CalPERS were designed to improve shareholder rights. There is strong empirical evidence that improving shareholder rights improves shareholder value.

Institutional activism designed to improve shareholder value should be well grounded in scientific evidence – either theoretical or empirical (preferably both). When moral considerations affect investment policy, investor preferences should be paramount. We need to carefully monitor institutions to ensure they live up to these standards.

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Table 1: Announcement Day Market-Adjusted Returns and Valuation Impact for CalPERS Focus List Firms by Year

The CRSP value-weighted NYSE/ASE/Nasdaq market index is the benchmark. The announcement day is the date of the CalPERS press release for focus list firms.

Year	No. of Firms	Mean Market-Adjusted Return (%)		Valuation Impact (\$ Mil)	Market Cap (\$ Mil)
		Equally-Weight	Value-Weighted		
1992	12	0.32	0.01	13.9	93,763.2
1993	12	0.47	2.12	1,699.0	80,245.1
1994	10	-0.19	-1.14	-694.2	60,919.1
1995	9	0.20	0.13	20.2	15,341.6
1996	10	0.98	0.34	25.6	7,474.0
1997	10	0.15	-0.05	-6.9	12,950.0
1998	9	0.45	0.08	26.8	35,390.4
1999	9	0.53	0.12	18.6	16,040.5
2000	10	0.25	1.57	739.1	46,930.1
2001	5	0.36	-0.03	-1.0	3,707.6
2002	4	-0.10	1.35	480.6	35,640.6
2003	6	-0.66	-0.34	-45.6	13,323.6
2004	4	0.42	0.53	551.1	103,407.5
2005	5	-0.02	0.19	313.9	169,485.2
<b>MEAN</b>		0.23	0.35	<b>SUM</b> 3,141.4	694,618.4
<b>Std. Dev.</b>		0.39	0.83		
<b>t-statistic</b>		2.09	1.51		



Table 2: Daily Abnormal Returns (Alpha) to Value-Weighted Portfolios of CalPERS Focus List Firms at Different Holding Periods (through December 2005)

Focus list portfolios are constructed assuming an investment in proportion to each firm's market cap at the close of trading on the date of the CalPERS press release. The holding period for each investment is varied. Abnormal returns (alphas) are calculated by regressing the portfolio return less the riskfree rate on market, size, value, and momentum factors.

<b>Coefficient Estimate on:</b>							
<b>Holding Period</b>	<b>Annualized Alpha (%)</b>	<b>Daily Alpha (%)</b>	<b>MRP</b>	<b>SMB</b>	<b>HML</b>	<b>UMD</b>	<b>Obs</b>
<b>2 weeks</b>	46.4	0.184	1.06	-0.11	0.78	-0.38	140
<b>1 month</b>	9.3	0.037	1.18	0.12	0.64	-0.47	294
<b>6 mths</b>	3.6	0.014	1.30	0.37	0.59	-0.47	1764
<b>1 year</b>	2.4	0.010	1.31	0.37	0.51	-0.39	3319
<b>2 years</b>	2.9	0.011	1.26	0.30	0.40	-0.25	3474
<b>3 years</b>	4.8	0.019	1.21	0.16	0.26	-0.12	3474
<b>4 years</b>	2.7	0.011	1.15	0.07	0.12	-0.04	3474
<b>5 years</b>	4.1	0.016	1.12	0.02	0.16	-0.08	3474
<b><i>t</i>-Statistics</b>							
<b>2 weeks</b>		1.43	5.88	-0.43	2.77	-2.69	
<b>1 month</b>		0.45	10.40	0.79	3.45	-5.25	
<b>6 mths</b>		0.36	25.25	5.02	6.43	-9.24	
<b>1 year</b>		0.34	33.58	6.87	7.51	-10.34	
<b>2 years</b>		0.55	44.80	7.71	8.30	-9.18	
<b>3 years</b>		1.21	56.56	5.25	7.28	-5.72	
<b>4 years</b>		0.78	61.66	2.77	3.91	-2.45	
<b>5 years</b>		1.28	64.83	0.88	5.30	-4.85	

Table 3: Figure 1: Relation between Agency Costs, Monitoring Expenditures, and Portfolio Value

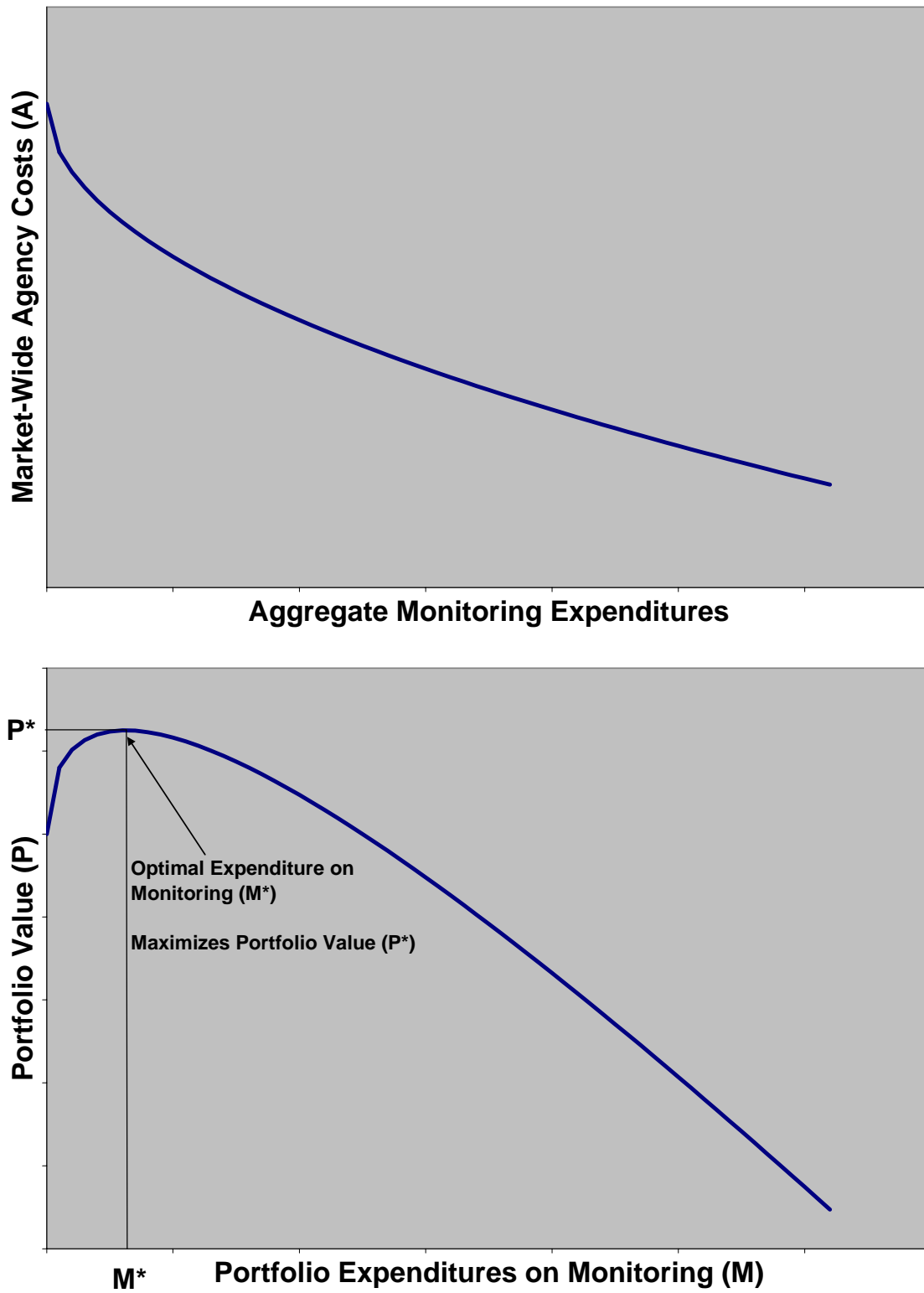


Figure 2: Cumulative Market-Adjusted Returns for CalPERS Focus List firms through December 2005

Event day 0 is the date of the CalPERS press release. Market-adjusted returns are calculated as a firm's return less the market return. On each event day, mean market-adjusted returns are calculated. The graph presents cumulative mean market-adjusted returns separately for (1) the period prior to the CalPERS announcement (left area) and (2) the period after the CalPERS announcement (right area).

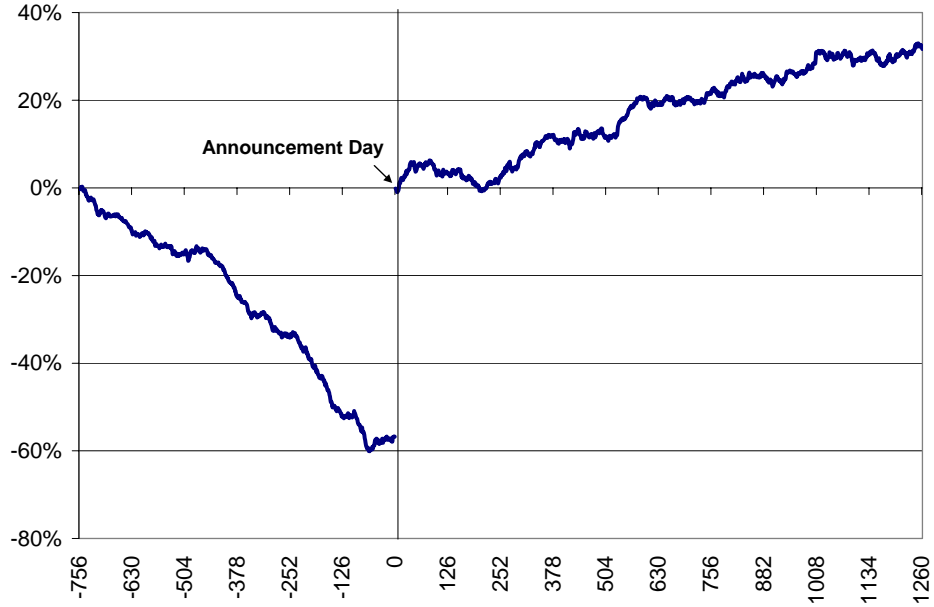


Figure 3: Cumulative Gains from CalPERS Shareholder Activism for Different Horizons

Gains at one day are from table 1 and include firms targeted from 1992 to 2005. Gains for horizons from 2 weeks to 5 years are based on four-factor abnormal returns in table 2 and market capitalization of the focus list portfolio over the period 1992 to December 2005. See text for a complete description of the gain estimation.

