Firm Policies and Active Ownership Investors

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Firm policies and active ownership investors

- How do institutional investors affect firm policies?

- Two polar forms of influence:
    - Activist investors – Activist campaigns – Buy, enact change, sell
    - Passive investors – Index funds – Can affect firms through voice (not-exit)

- How about active ownership investors?
    - Pension funds, mutual funds, sovereign wealth funds…
    - Diversified, long-term oriented portfolios
    - Away from the benchmark, active
    - Infrequent re-balancing, no churning

- Can active ownership investors affect firm policies?

A Specific Class of Active Investors - Sovereign Wealth Funds

- Particular type of Active Investors: Sovereign Wealth Funds (SWFs)
    - Collectively, 94 SWFs manage $7.5 trillion (9% of all listed shares globally)

- They often have specific preferences about issues beyond returns:
    - New Zealand (Green Investments)
    - Qatar (Country Branding)
    - Norwegian Fund (Good Corporate Governance)

Focus on firm's reaction to changes in fund preferences

This paper:

Use an unexpected change in the governance preferences of Norwegian Bank Investment Management's (NBIM) to see its impact on firm's governance.

- November 2012: NBIM announces emphasis on <u>effective corporate governance.</u>
  - Board accountability and composition
  - Equal shareholder voting

  Unexpected announcement earlier that year, slowly filtered during 2012.

- **Research questions:**
  - Did NBIM really target its investment to its newly stated specific preferences?
  - Did firms react to the change preferences?

Norges Bank Investment Management

- Norges Bank Investment Management World's largest sovereign wealth fund.
  Assets $1,010 billion. $642 billion in stocks of more than 9,000 firms.

- Governance strategy
  - Actively engage with firms
  - Exclude firms that fail to engage with NBIM (part of investment strategy too)
  - Participate in (but not initiate) activist campaigns

- Investment strategy:
  - Benchmark FTSE Global Cap x country corrections reflect economic exposure.
  - Over-Under weight firms according to expected performance and governance.
  - Exclude firms that do not fulfill the Ethics committee principles

Norges Bank Investment Management

- Investment intensity
  - For firm i, in country c at time t

  $$\text{Investment}_{it} = I(\text{ethics}=1) \times I(\text{engage}=1) \times (\text{FTSE Global}_{it} \times \text{Country}_c + \text{Stance}_{it})$$

Norges Bank Investment Management

- Investment intensity
  - For firm i, in country c at time t

    $\text{Investment}_{it} = I(\text{ethics}=1) \times I(\text{engage}=1) \times (\text{FTSE Global}_{it} \times \text{Country}_c + \text{Stance}_{it})$

 - Exogenous to the Fund.

  - Discretionary elements

    $\text{Weight}_{it} = \text{Investment}_{it} / \sum_{i=1}^{I} (\text{Investment}_{it})$

Empirical approach

- NBIM specific measure of governance reflecting NBIMs (new) preferences
    - Eikon ESG Management score at a firm-year level.
        - Equally weighted sum of the firm rank over 32 indicators
        (CEO-Chairman separation, board background and skills, independent board members, board cultural diversity, etc)

- Difference in differences approach using the change in preferences
    Period 2009-2015 - 2,956 (1,273) firms inside (outside) NBIM in Dec 2015

- Decompose effects into
    - Changes in the investment strategy of NBIM
    - Changes of the governance strategy of firms
    - Marginal effects

Effect of the Announcement on the Overall Governance Levels of NBIM

Overall effect

Governance Index differences between NBIM and non-NBIM firms
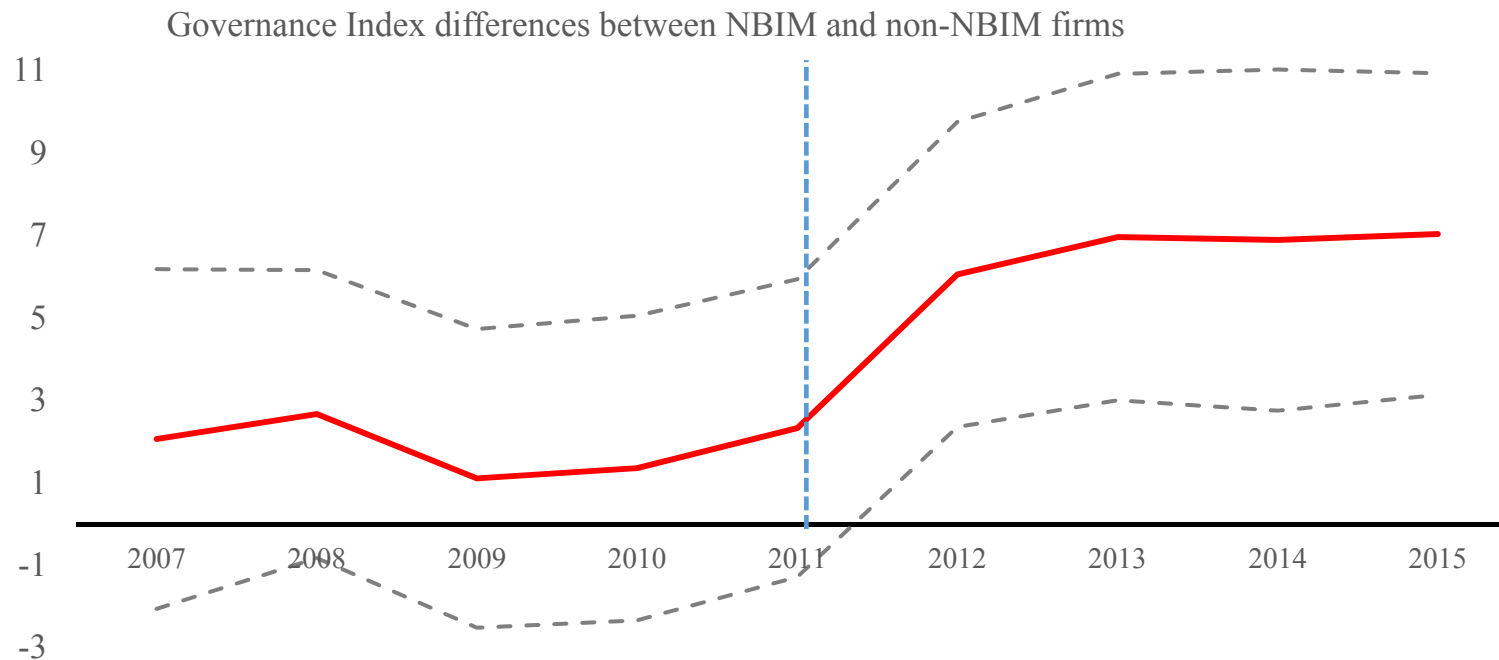
$$Governance_{it} = \alpha_t + \sigma_t \, \text{NBIM}_{it} + \varepsilon_i$$

σ estimates from yearly cross-sectional regressions (90% confidence intervals).

Decomposition of the Overall Effect

Change in the governance index of the NBIM portfolio (firm i, period t)

- $\Delta G_t = \sum_{i=0}^{I} w_{it+1} g_{it+1} - \sum_{i=0}^{I} w_{it} g_{it}$

Decompose weights and individual indices into levels and changes

- $\Delta G_t = \sum_{i=0}^{I} (w_{it} + \Delta w_{it})(g_{it} + \Delta g_{it}) - \sum_{i=0}^{I} w_{it} g_{it}$

Re - arrange

- $\Delta G_t = \sum_{i=0}^{I} \Delta w_{it} g_{it} + \sum_{i=0}^{I} w_{it} \Delta g_{it} + \sum_{i=0}^{I} \Delta w_{it} \Delta g_{it}$

| Overall Change | Re-weighting | Change in governance | Cross product |

Decomposition of the Overall Effect

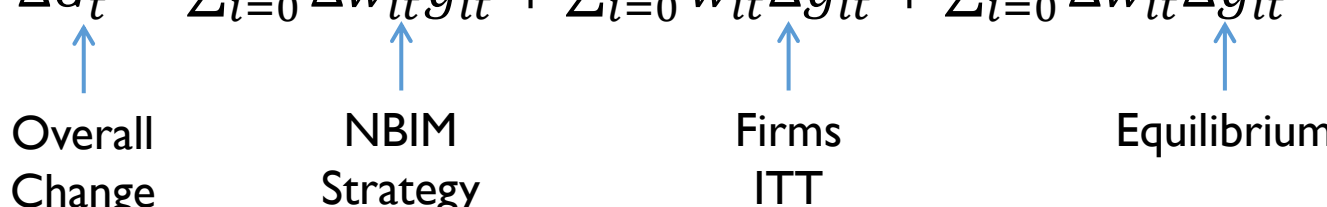Change in the governance index of the NBIM portfolio (firm i, period t)

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| Overall Change | NBIM Strategy | Firms ITT | Equilibrium |

Effect of the Announcement on the Investment Strategy of NBIM

Governance Levels

Change in NBIMs investment strategy after the announcement

Did the fund re-balance its portfolio according to new governance guidelines?

First step: fix firm governance types.

• Set firm-level governance levels to the pre-period (2011) - $Governance_{i2011}$

Second step: Investment strategy.

Relate entry (and exit) to firm types in a difference-in-differences specification.

$$Governance_{i2011} = \sigma POST_{(t \geq 2012)} * \text{NBIM entry}_{it} + \text{NBIM entry}_{it} + YEAR_t + \varepsilon_{it}$$

Do firms that enter (exit) NBIM have better (worse) governance post-announcement?

Does NBIM <u>enter</u> good governance firms after the announcement?

Control group →	Non-NBIM	NBIM	ALL
NBIM enter * Post		:	
Observations			
R-squared			

NBIM entry =1 if firm enters and remains in NBIM for at least 2 years

$$\text{Governance}_{i2011} = \sigma \text{POST}_{(t \geq 2012)} * \text{NBIM entry}_{it} + \text{NBIM entry}_{it} + \text{YEAR}_t + \varepsilon_{it}$$

Does NBIM <u>enter</u> good governance firms after the announcement?

Control group →	Non-NBIM	NBIM	ALL	Non-NBIM	NBIM	ALL
NBIM enter * Post	4.426*	5.889***	5.486**	6.406**	7.916***	7.451**
	(2.501)	(2.196)	(2.196)	(3.241)	(2.990)	(2.993)
Observations	2,906	14,892	17,026	2,572	14,558	16,692
R-squared	0.003	0.004	0.002	0.004	0.002	0.001

NBIM entry =1 if firm enters and remains in NBIM for at least 2 years

Discretionary Investments Only

$$\text{Governance}_{i2011} = \sigma \text{POST}_{(t \geq 2012)} * \text{NBIM entry}_{it} + \text{NBIM entry}_{it} + \text{YEAR}_t + \varepsilon_{it}$$

Does NBIM <u>exit</u> poor governance firms after the announcement?

Control group →	Non-NBIM	NBIM	ALL
NBIM exit * Post			
Observations			
R-squared			

NBIM exit =1 if firm leaves the portfolio for at least 2 years

$$\text{Governance}_{i2011} = \sigma \text{POST}_{(t \geq 2012)} * \text{NBIM exit}_{it} + \text{NBIM exit}_{it} + \text{YEAR}_t + \varepsilon_{it}$$

Does NBIM exit poor governance firms after the announcement?

Control group →	Non-NBIM	NBIM	ALL	Non-NBIM	NBIM	ALL
NBIM exit * Post	-5.807*	-5.058*	-5.311*	-7.661**	-6.954**	-7.184**
	(3.268)	(2.954)	(2.956)	(3.442)	(3.120)	(3.123)
Observations	2,651	14,637	16,771	2,596	14,582	16,716
R-squared	0.003	0.001	0.001	0.004	0.002	0.001

NBIM exit =1 if firm leaves the portfolio for at least 2 years

Discretionary Divestitures Only

$$\text{Governance}_{i2011} = \sigma \text{POST}_{(t \geq 2012)} * \text{NBIM exit}_{it} + \text{NBIM exit}_{it} + \text{YEAR}_t + \varepsilon_{it}$$

Does NBIM change strategy after the announcement?

- NBIM investment strategy aligns with the announced preferences
  - After the announcement <u>entrants</u> have <u>better</u> inherent governance
  - After the announcement, <u>exits</u> have <u>worse</u> inherent governance

- Effects stronger for discretionary investment changes

- Entry/exit provides incentives for firms to improve governance

Effect of the Announcement on the Firm Governance of NBIM Holdings

The effect on governance of NBIM portfolio firms

Relationship of interest:

$$\text{Governance}_{it} = \sigma\text{POST}_{(t \geq 2012)}*\text{NBIM}_{it} + \text{NBIM}_{it} + \text{YEAR}_t + \text{Firm}_i + \varepsilon_{it}$$

NBIM_{it} takes value one if the firm <u>belongs</u> to the NBIM and zero <u>otherwise</u>

- Problem: NBIM_{it} may be correlated with ε_{it} :

(e.g. firms with better/improved governance more likely to be added to the fund)

- Solution: Instrument NBIM_{it} with NBIM_{i2011}

Reduced-form regression is:

$$\text{Governance}_{it} = \sigma\text{POST}_{(t \geq 2012)}*\text{NBIM}_{i2011} + \text{YEAR}_t + \text{Firm}_i + \varepsilon_{it}$$

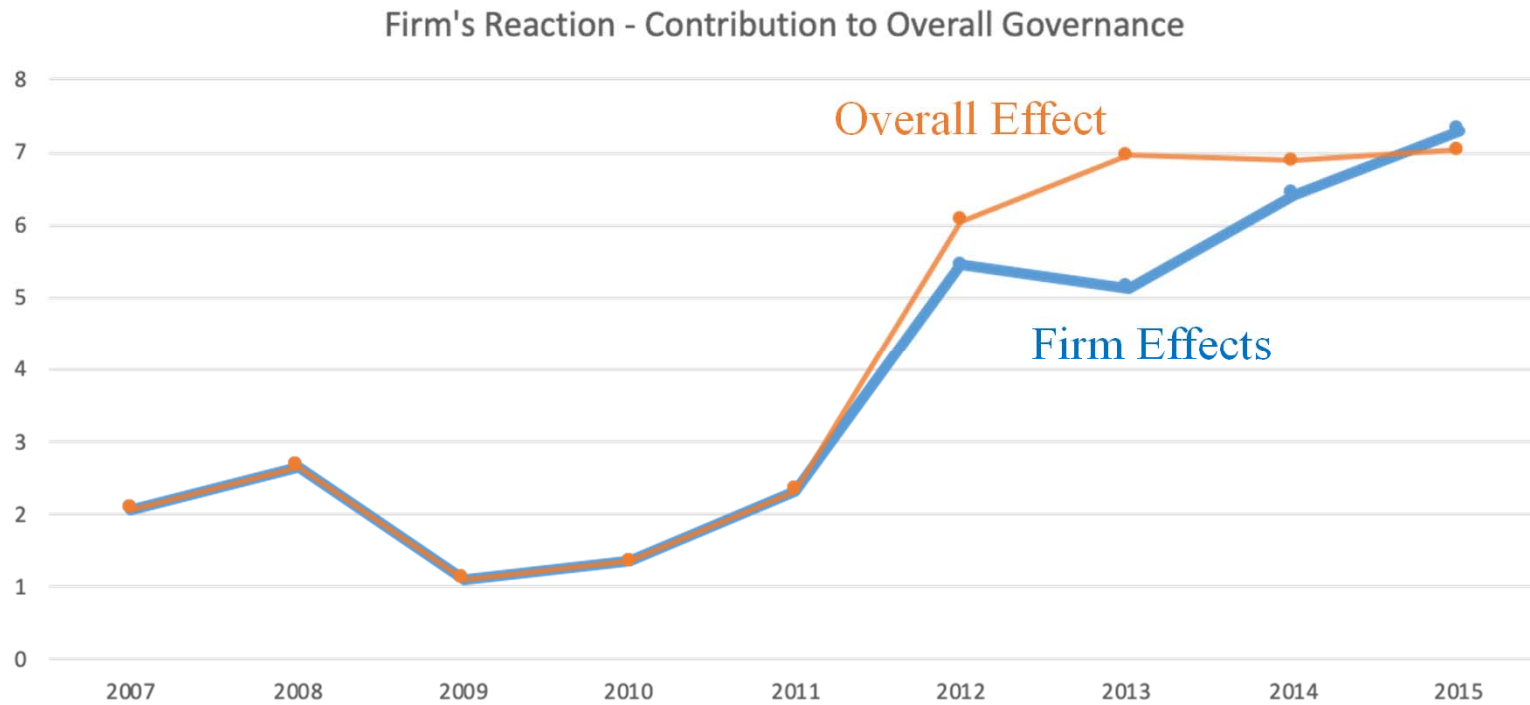# The effect on governance of NBIM portfolio firms (ITT)

	(1)	(2)	(3)
NBIM*Post	5.912***	4.913***	
	(1.785)	(1.299)	
NBIM*year2010			0.639
			(1.422)
NBIM*year2011			2.349
			(1.569)
NBIM*year2012			5.293***
			(1.746)
NBIM*year2013			4.984***
			(1.836)
NBIM*year2014			6.246***
			(2.060)
NBIM*year2015			7.072***
			(1.994)
Year & Post*Country dummies	Yes	Yes	Yes
Firm F.E.	No	Yes	Yes
Observations	14,966	14,966	14,966
R-squared	0.035	0.024	0.025

- Dependent variable: Governance$_{it}$

- NBIM =1 if firm is part of NBIM in 2011.

- Large governance improvement for firms in the NBIM portfolio
  - Reduced form effect 4.9

- Important effect at announcement.
- Effect is increasing over time

The effect on governance of NBIM portfolio firms (ToT)
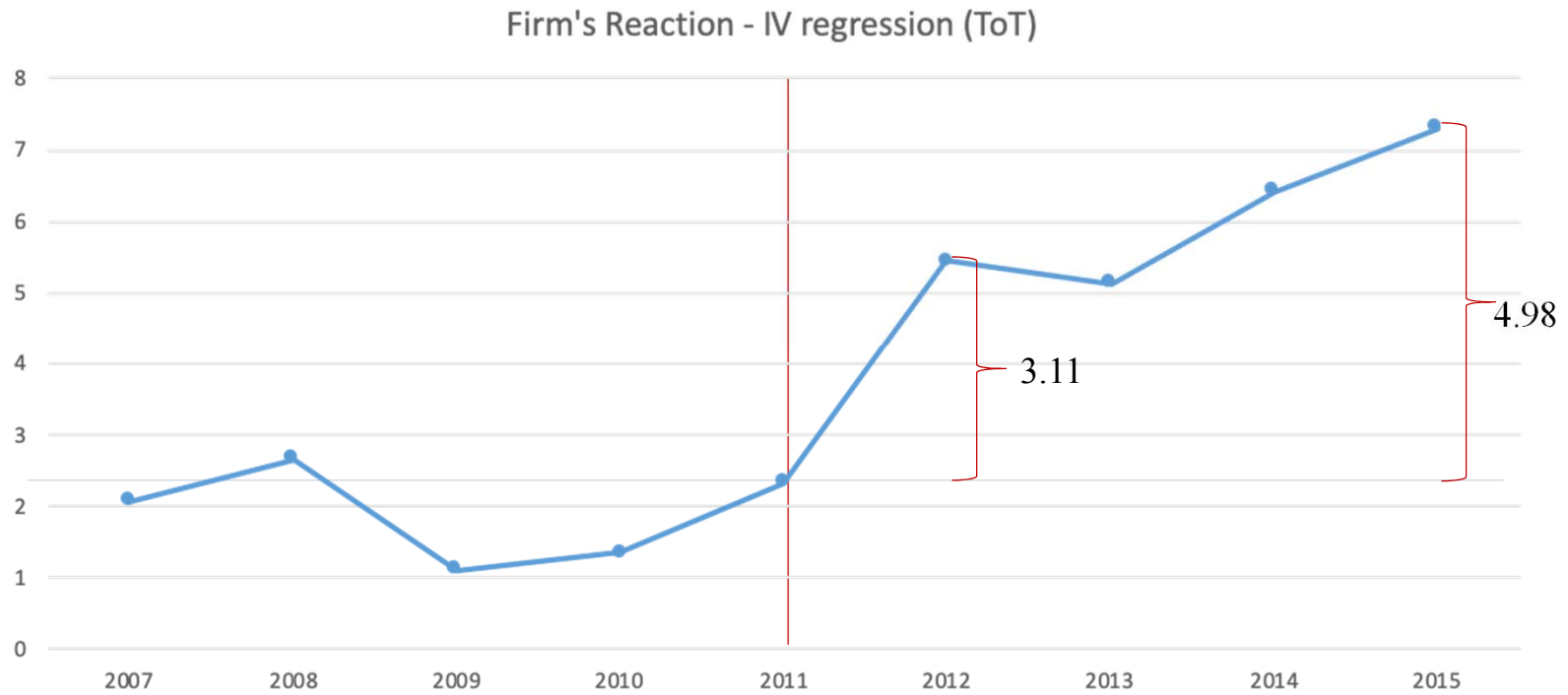
Firm's Reaction - IV regression (ToT)

The effect on governance of NBIM portfolio firms (ToT)

Firm's Reaction - Contribution to Overall Governance

The effect on governance of NBIM portfolio firms (ITT)

	(1)	(2)	(3)	(4)
NBIM*Post	4.913***		4.119***	
	(1.299)		(1.462)	
FTSE*Post		3.089***	1.444	
		(1.085)	(1.216)	
OnlyNBIM*Post				3.863**
				(1.953)
NBIMFTSE*Post				5.171***
				(1.551)
OnlyFTSE*Post				1.105
				(2.851)
Excluded-ethics*Post				-1.949
				(4.134)
Firm F.E.	Yes	Yes	Yes	Yes
Year & Post*Country dummies	Yes	Yes	Yes	Yes
Observations	14,966	14,966	14,966	14,966
R-squared	0.024	0.023	0.025	0.025

- Improvements in governance of FTSE-global firms are only present for NBIM firms.

- NBIM only firms also experience governance improvements.

- Effect is not present for excluded firms

Skin in the firm vs. Strong voice

	(1) Fund %	(2) Firm %
Post* I(% quartile1)	4.26***	1.52
	(1.51)	(2.12)
Post* I(% quartile2)	4.71***	3.75**
	(1.48)	(1.62)
Post* I(% quartile3)	4.82***	4.86***
	(1.46)	(1.63)
Post* I(% quartile4)	5.76***	8.50***
	(1.45)	(1.70)
Year dummies and firm F.E.	Yes	Yes
Post*Country dummies	Yes	Yes
Observations	14,966	14,910
R-squared	0.02	0.02

Relative importance of
- Fund holding as % of the firm
- Firm as % of the fund holdings

- The fund % has mostly an impact on the extensive margin.

- Small effect of fund % on the intensive margin.

- The firm % impacts governance both on the extensive and intensive margin.

Do firms change strategy after the announcement?

- After the announcement <u>included</u> firms increase their governance index

- Both the weight of the firm in the fund and the weight of the fund in the firm matter. Both the intensive and the extensive weight matter

- Heterogeneous effects - Stronger results for:
    - Smaller firms
    - Worse performance
    - Medium-governance
    - Illiquid stocks
    - In better governed countries

Effect of the Announcement on the Investment Strategy of NBIM
Governance Deltas

Are changes in investment linked to governance changes?

Does the fund react to further changes in governance?

Do firms react to incremental changes in fund weights?

	Fund (1)	Firm (2)
Post*ΔNBIM_Weight(t+2,t)	24.51**	0.58
	(10.42)	(0.59)
ΔNBIM_Weight(t+2,t)	0.54	0.13
	(6.28)	(0.36)
Year & Post*Country dummies	Yes	Yes
Observations	10,690	10,649
R-squared	0.014	0.013

- Contemporaneous changes in governance more correlated with changes in fund weights after the announcement.

- Hard to establish causality for marginal changes. We can extrapolate from the previous two parts

Conclusions

- SWFs preferences provide evidence on how active investors affect firm policies
  - Fund specific change in preferences across all firms

- New governance stance of NBIM followed by changes in investment policies

- <u>Firms</u> reacted to this change by targeting NBIM preferences

    - Most of the overall effect comes from the firms' reaction
    - Both % of firm in the fund and % of fund in the firm matter
    - Both intensive and extensive margins matter
    - Heterogeneous effects informative about channels

Thanks!