Competition in shareholders protection
and portfolio diversification

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1 Motivation

1. Control benefits ↓ the amount of income that can be pledged to outsiders

   • control benefits = above mkt salaries, pet projects, transactions among affiliate companies at advantageous prices, etc.

   • limited pledgeability of income generates many pathologies

       – credit rationing (Williamson, Holmstrom-Tirole), loss of diversification (Holderness et al.)

       – demand for liquidity (Holmstrom–Tirole LAPM)

• want to study impact of limited pledgeability of income on public risk-return profiles

       – presence of control benefits affects public risk-return trade-off? diversification opportunities? how?
2. Can competition for funds eliminate control benefits by inducing entrepreneurs seeking funds to adopt more shareholder friendly governance?

- if the mkt penalizes share price of company for bad governance why not adopt measures that will make it more difficult to exploit minority shareholders?

- can contracting ability of parties be sufficient to eliminate control benefits?
2 Model

- Pure exchange economy

- 2 assets $j = 1, 2$, sunk investments

- 2 entrepreneurs = investors, $i = 1, 2$

- No risk free asset

- Each investor $i$ has a wealth $W_i$ ($W_1 = 1$), which is 100% ownership of asset $i$

- Budget constraint of Mr $i$

  $$\sum_{j=1}^{2} x_{i,j} = 1$$  \hspace{1cm} (1)

- Ownership structure of asset $j$

  $$\sum_{i=1}^{2} \alpha_{i,j} = 1$$  \hspace{1cm} (2)
• Denote $P_j$ the capitalization of asset $j$

$$\alpha_{i,j} P_j = x_{i,j} W_i$$  \hspace{1cm} (3)

$\Rightarrow$ allows us to express the problem in terms of ownership structure

• Since initially entrepreneur $i$ owns 100% of his asset $i \Rightarrow P_i = W_i \Rightarrow$ from (2), (3) we have

$$\alpha_{1,1} + \alpha_{1,2} P_2 = 1$$  \hspace{1cm} (4)

$$\alpha_{2,1} + \alpha_{2,2} P_2 = P_2$$  \hspace{1cm} (5)
• Cash flows; states of nature; probabilities

State 1; prob. = p  State 2; prob. = 1-p

<table>
<thead>
<tr>
<th>Asset 1</th>
<th>H</th>
<th>0</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset 2</td>
<td>0</td>
<td>H</td>
</tr>
</tbody>
</table>

• $p \neq 0, \neq 1, \neq 1/2$

• extreme assumption meant to capture diversification opportunities + simplify calculations

• $p \neq 1/2$ unique element of heterogeneity in this model; everything else is symmetric

• If I want to consume in both states of nature I need to buy a piece of the other asset =>

gives mkt power to the other entrepreneur
2.1 Limited pledgeability of income due to control benefits

- control benefits obtained only when cash flows are high
  - controlling shareholder (initial owner) can commit to divert fraction $0 \leq s_i \leq 1$ of cash flow of asset $i$ regardless of one’s ownership of asset
  - choosing $s_i$ means to choose a level of expropriation (negative of protection) of minority shareholders
  - alternative modelling assumptions with no commitment
    - no control change
    - no asymmetric information

- Public return $H(1 - s_i)$
• Only fraction $0 \leq \lambda \leq 1$ of diverted part can benefit owner

  – rule of law; same for all firms/entrepreneurs in a country

  – makes it less convenient to expropriate minority shareholders

  – its modelling role is to put limit to control benefits

• Mean-variance preferences
2.2 Timing

- $t=1$; each entrepreneur $i$ chooses and communicates his control benefits $s_i$ unilaterally, taking into account the impact that this will have on the demand of his asset via the price that other is willing to pay

- $t=2$; each entrepreneur $i$ chooses his portfolio unilaterally given the control benefits
2.3 Solving the problem from $t=2$

- Portfolio stage
  
  - Solve portfolio problem given control benefits $s_1, s_2$
  
  - find $\alpha_{2,2}^* (s_1, s_2), \alpha_{1,1}^* (s_1, s_2)$ via solution of a general equilibrium pure exchange economy

- Stage of control benefits
  
  - Cournot competition in control benefits - given the optimal portfolios, each entrepreneur chooses his control benefits to max his indirect utility function given the control benefits of the other entrepreneur
3 Portfolio stage

Utility functions

\[
\begin{align*}
  u_1 &= \alpha_{1,1} p H (1-s_1) + p H s_1 \lambda + \alpha_{1,2} (1-p) H (1-s_2) \\
  &\quad - \frac{\gamma}{2} p (1-p) H^2 \left\{ (\alpha_{1,1} (1-s_1) + s_1 \lambda)^2 - 2 [\alpha_{1,1} (1-s_1) + s_1 \lambda] \alpha_{1,2} (1-s_2) + \alpha_{1,2}^2 (1-s_2)^2 \right\} \\
  u_2 &= \alpha_{2,1} p H (1-s_1) + \alpha_{2,2} (1-p) H (1-s_2) + (1-p) H s_2 \lambda \\
  &\quad - \frac{\gamma}{2} p (1-p) H^2 \left\{ \alpha_{2,1}^2 (1-s_1)^2 - 2 \alpha_{2,1} (1-s_1) [\alpha_{2,2} (1-s_2) + s_2 \lambda] + [\alpha_{2,2} (1-s_2) + s_2 \lambda]^2 \right\}
\end{align*}
\]
3.1 Looking for optimal $\alpha$’s as a function of $P_2$

- From (4) $\alpha_{1,2} = \frac{1-\alpha_{1,1}}{P_2}$ replacing $\alpha_{1,2}$ in $u_1$, we can re-write it in terms of $\alpha_{1,1}$

\[
\begin{align*}
  u_1 &= \alpha_{1,1}pH(1 - s_1) + pHs_1\lambda + \frac{1-\alpha_{1,1}}{P_2}(1-p)H(1 - s_2) \\
  \gamma p(1-p)H^2 &\left\{ [\alpha_{1,1}(1 - s_1) + s_1\lambda)]^2 - 2[\alpha_{1,1}(1 - s_1) + s_1\lambda] \frac{1-\alpha_{1,1}}{P_2}(1 - s_2) \\
  &+ \left(\frac{1-\alpha_{1,1}}{P_2}\right)^2 (1 - s_2)^2 \right\}
\end{align*}
\]
• Derivating \( u_1 \) w.r.t \( \alpha_{1,1} \) the F.O.C. leads to the following optimal share

\[
\alpha_{1,1}^* \left( s_1, s_2, P_2, \lambda, p, H, \gamma \right) = \frac{\gamma p(p - 1)H[-1 + s_2 + P_2(s_1 - 1)][s_1 \lambda P_2 - 1 + s_2] + P_2[p P_2(s_1 - 1) + (p - 1)(s_2 - 1)]}{\gamma p(p - 1)H[P_2(s_1 - 1) - 1 + s_2]^2}
\]

(6)

• In the same way, by replacing \( \alpha_{2,1} = P_2(1 - \alpha_{22}) \) (5) in \( u_2 \) and by derivating it w.r.t \( \alpha_{2,2} \), the F.O.C. leads to the following optimal share:

\[
\alpha_{2,2}^* \left( s_1, s_2, P_2, \lambda, p, H, \gamma \right) = \frac{\gamma p(p - 1)H[s_2 - 1 + P_2(s_1 - 1)][P_2(s_1 - 1) + s_2 \lambda] + (1 - p)(s_2 - 1) + p P_2(1 - s_1)}{\gamma p(p - 1)H[(s_2 - 1 + P_2(s_1 - 1)^2)]}
\]

(7)
• Looking for price $P_2$ that clears assets mkt

• from (4), (5) (2) =

\[ \alpha_{1,1} + P_2(1 - \alpha_{2,2}) = 1 \]  \hspace{1cm} (8)

• Solving (8) using the optimals $\alpha$’s in (6) and (7), we have equilibrium price as a function of control benefits

\[ P_2 \left( s_1, s_2, \lambda, p, H, \gamma \right) = \frac{(p - 1)(s_2 - 1)\gamma pH(s_1 - s_2)(\lambda - 1) + 2}{p(s_1 - 1)\gamma H(s_1 - s_2)(p - 1)(\lambda - 1) + 2} \]  \hspace{1cm} (9)
• Finding the optimal ownership structure: replace $P_2$ in (6) and (7)

$$\alpha_{1,1}^* \left( s_1, s_2, \lambda, p, H, \gamma \right) = \frac{\gamma p(1 - p) H (s_1 - s_2) (\lambda - 1) [ (\lambda - 1) (s_1 + s_2) + 2 ] + 2 (\lambda - 1) (1 - p) (s_1 + s_2) + 4 (s_1 - p)}{4 (s_1 - 1)} \tag{10}$$

$$\alpha_{2,2}^* \left( s_1, s_2, \lambda, p, H, \gamma \right) = \frac{\gamma p (p - 1) (\lambda - 1) (s_1 - s_2) H [ (\lambda - 1) (s_1 + s_2) + 2 ] + 2 p (s_1 + s_2) (\lambda - 1) + 4 (p - 1 + s_2)}{4 (s_2 - 1)} \tag{11}$$
4 Control benefits stage

- We know optimal $\alpha_{1,1}^1$ and $\alpha_{2,2}^2$ in terms of $s_1$ and $s_2$, and parameters

- Insert $\alpha_{1,1}^1$ and $\alpha_{2,2}^2$ from (10) and (11) in $u_i$

- Each entrepreneur $i$

\[ \max_{x_i \geq 0} u_i(s_i, \bar{s}_j), \ i \neq j \]
• Yields the optimal \( s_1^*(\gamma, p, H, \lambda, s_2) \); \( s_2^*(\gamma, p, H, \lambda, s_1) \)

• Best response functions

\[
s_1^* = \frac{\gamma(1-p)H(2 + s_2(1-\lambda)) - 4}{3\gamma(1-p)H(1-\lambda)} \tag{12}
\]
\[
s_2^* = \frac{\gamma p H(2 + s_1(1-\lambda)) - 4}{3\gamma p H(1-\lambda)} \tag{13}
\]
\[
\frac{ds_1^*}{ds_2} > 0; \frac{ds_2^*}{ds_1} > 0 \tag{14}
\]
Figure 1:

strategic complementarities of control benefits
Solving

\[ s_1^* = \frac{2\gamma p(1 - p)H - (2p - 1) - 2}{2\gamma p(1 - p)H(1 - \lambda)} \]  
\[ s_2^* = \frac{2\gamma p(1 - p)H + (2p - 1) - 2}{2\gamma p(1 - p)H(1 - \lambda)} \]  

We restrict \( s_1^*, s_2^* \geq 0 \iff 2\gamma p(1 - p)H - (2p - 1) - 2 \geq 0 \)
• Remark: competition for funds may fail to eliminate control benefits

• Intuition:

  – return complementarity of the two assets give mkt power to each controlling shareholder

  – you will invest in my company even if my minority shareholder protection is lousy

    because I offer you valuable **diversification opportunities**

  – even if I can commit not consume control benefits it may be not in my best interest to

    consume zero benefits
5 Empirical strategy

5.1 What the model tells us

Public cash flows, state of nature, probabilities

State 1; prob. = $p$  State 2; prob. = $1 - p$

<table>
<thead>
<tr>
<th>Asset 1</th>
<th>$H(1 - s^*_1)$</th>
<th>0</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset 2</td>
<td>0</td>
<td>$H(1 - s^*_2)$</td>
</tr>
</tbody>
</table>

1. Levels

- $p < 1/2 \Rightarrow s^*_1 > s^*_2$ and $\beta_1 < \beta_2$

- Companies with low $\beta$ have a bad governance ($s^*_i$).

- If you offer a security whose return differs from the other you can extract more control benefits; mkt power effect
Figure 2:

Mapping of equilibrium points
2. variable changes

- you obtain control benefits only in the successful state of nature; the higher the control benefits the more the 2 assets return similar cash flows in a given state => assets are more "similar" to the mkt => their returns are better explained by the mkt return in the CAPM regression

\[ r_i - r_f = x_i + \beta_i (r_m - r_f) + \epsilon_i \]

\[ => \epsilon_i \downarrow \Rightarrow \sigma_{\epsilon_i}^2 \downarrow = \text{i.e. idiosyncratic volatility} \downarrow \]

- higher control benefits have different impact on good/bad governance companies

good: ↑ eq. control benefits ⇔ ↑ β

bad: ↑ eq. control benefits ⇔ ↓↓ β
5.2 Data description

- The empirical counterparty of equilibrium control benefits $s^*_t$ is Gompers, Ishii, and Metrick (QJE 2003) index (GIM Index)

- Measure of anti-takeover provisions; measure of governance

  - 24 provisions: staggered board, poison pill, supermajority voting requirement, limits to amend bylaws, limits to amend charters, golden parachute, etc.

  - From 1 to 19. Re-scaled: 0,1,2,3,4,5

  - 0 = best governance, 5 = worse

Figure 3:

companies by governance measure
5.3 Beta and Idiosyncratic Volatility

- Using CAPM for each stock \( i \) and each year, we regress stock’s daily returns. Stocks data from Center for Research in Stock Prices (CRSP) and S&P Compustat

\[
r_i - r_f = x_i + \beta_i (r_m - r_f) + \epsilon_i
\]

where

- \( r_i \) daily total returns of stock \( i \) in USD
- \( r_m \) daily returns of value weighted index of stocks in our dataset
- \( r_f \) 3-month T-Bills
We obtain

- $\beta_i$ yearly beta of asset $i$

- $VR_i = \frac{\sigma_{\epsilon,i}^2}{\sigma_{Mkt}^2}$ yearly normalized idiosyncratic volatility of asset $i = \text{intrinsic risk of asset } i$, used as proxy for information flow, i.e. transparency
  
  - $\sigma_{\epsilon,i}^2$ volatility of the residuals in CAPM regression
  
  - $\sigma_{Mkt}^2$ market volatility

- $x_i$ yearly excess return of asset $i$
<table>
<thead>
<tr>
<th></th>
<th>Obs</th>
<th>Beta</th>
<th>$\sqrt{VR}$</th>
</tr>
</thead>
<tbody>
<tr>
<td>All companies</td>
<td>24940</td>
<td>0.994 (0.570)</td>
<td>2.685 (2.213)</td>
</tr>
<tr>
<td>g=0,1,2 Good governance</td>
<td>10673</td>
<td>1.034 (0.588)</td>
<td>2.910 (2.332)</td>
</tr>
<tr>
<td>g=3,4,5 Bad governance</td>
<td>14267</td>
<td>0.964 (0.555)</td>
<td>2.516 (2.105)</td>
</tr>
<tr>
<td>g=0</td>
<td>64</td>
<td>1.024 (0.561)</td>
<td>2.575 (1.384)</td>
</tr>
<tr>
<td>g=1</td>
<td>2485</td>
<td>1.003 (0.641)</td>
<td>3.020 (2.456)</td>
</tr>
<tr>
<td>g=2</td>
<td>8124</td>
<td>1.044 (0.570)</td>
<td>2.879 (2.298)</td>
</tr>
<tr>
<td>g=3</td>
<td>9497</td>
<td>0.975 (0.542)</td>
<td>2.586 (2.041)</td>
</tr>
<tr>
<td>g=4</td>
<td>4240</td>
<td>0.953 (0.594)</td>
<td>2.373 (2.209)</td>
</tr>
<tr>
<td>g=5</td>
<td>530</td>
<td>0.856 (0.448)</td>
<td>2.414 (2.301)</td>
</tr>
<tr>
<td>two-means t-test</td>
<td>9,520</td>
<td></td>
<td>13,736</td>
</tr>
</tbody>
</table>

Companies with better governance have higher beta than companies with poor governance and a higher idiosynchratic volatility than companies with poor governance.
5.4 Literature

- Jin and Myers, JFE 2006

  - Lack of transparency drives $R^2$ of stock returns higher in a cross-country study

    * Stocks are affected by one market factor (observable to everyone) and 2 idiosyncratic factors, only one of which is observable also to outsiders

    * The fact that the other factor is observable only to insiders (lack of transparency) allows them to steal from the cash flows when they are high

  - This implies that less idiosyncratic risk is impounded in the stock price and thus that the stock has higher comovement with the market
• Ferreira and Laux, JF 2007
  
  - Using GIM index Generalize Jin and Myers, JFE 2006 at U.S. company level
  
  - Worsening in governance drives a decrease in transparency; i.e. a lower idiosyncratic volatility
• Informational interpretation of idiosyncratic volatility

  – high levels of idiosyncratic volatility
    * more efficient capital allocation (Durnev, Morck, and Yeung 2004)
    * stock prices more informative about future earnings (Durnev et al. 2003)

  – low levels of idiosyncratic volatility
    * in emerging markets w.r.t developed markets (Morck, Yeung, and Yu 2000)
    * poor country-level governance and opaque accounting (Jin and Myers JFE 2006)
Ordered probit.

Dependent variable: entrenchment index GIM; $g = 0, 1, 2, 3, 4, 5$

Ferreira-Laux proxy for opacity (comovement): $-e^\psi = -\frac{1-R^2}{R^2} = -\frac{VR}{\sigma_r^2}$

$\sqrt{VR} = \sqrt{\frac{\sigma_r^2}{\sigma_{m}^2}}$ = idiosyncratic volatility = negative of opacity

Good Gov = 0,1,2; $\beta > \beta_{AVG} = 1$; Bad Gov. = 2,3,4; $\beta < \beta_{AVG} = 1$

<table>
<thead>
<tr>
<th></th>
<th>Good</th>
<th>Bad</th>
<th>All</th>
<th>Good</th>
<th>Bad</th>
<th>All</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Ferreira-Laux</td>
<td>Our results</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$-\psi = -\ln \frac{VR}{\beta}$ opacity</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$-\sqrt{VR}$ opacity</td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
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<tr>
<td>$\beta$</td>
<td></td>
<td>+</td>
<td>-</td>
<td>-</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Market value</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td></td>
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<tr>
<td>Price/Book Value</td>
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<td></td>
<td></td>
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<tr>
<td>Dividend yield</td>
<td>-</td>
<td>+</td>
<td></td>
<td>-</td>
<td>+</td>
<td></td>
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<tr>
<td>N. Observations</td>
<td>10670</td>
<td>14264</td>
<td>24934</td>
<td>10670</td>
<td>14264</td>
<td>24934</td>
</tr>
<tr>
<td>Pseudo $R^2$</td>
<td>0.005</td>
<td>0.0019</td>
<td>0.0022</td>
<td>0.0037</td>
<td>0.003</td>
<td>0.0041</td>
</tr>
</tbody>
</table>

Further controls: sectorial dummies, year dummies.

Only statistically significant coefficients are reported.
- 10 sectorial dummies: oil&gas, basic materials, non-cyclical, cyclical, health care, financial services, technology, telecom, utilities

Table 2: Ordered Probit

<table>
<thead>
<tr>
<th>Factors</th>
<th>Estimates (t-stat)</th>
<th>F.&amp;L.</th>
<th></th>
<th></th>
<th>Good</th>
<th>Bad</th>
<th>All</th>
</tr>
</thead>
<tbody>
<tr>
<td>$\delta$</td>
<td>0.047 (5.64)</td>
<td>0.026 (3.38)</td>
<td>0.049 (10.40)</td>
<td>F.&amp;L.</td>
<td>Good</td>
<td>Bad</td>
<td>All</td>
</tr>
<tr>
<td>$\sqrt{\tau R}$</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>lnmv</td>
<td>-0.009 (-1.11)</td>
<td>0.016 (2.54)</td>
<td>0.006 (1.39)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>pthv</td>
<td>0.000 (1.25)</td>
<td>0.000 (0.25)</td>
<td>0.000 (0.67)</td>
<td></td>
<td></td>
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<tr>
<td>dy</td>
<td>0.406 (0.97)</td>
<td>-0.562 (-1.99)</td>
<td>0.046 (2.09)</td>
<td></td>
<td></td>
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<tr>
<td>eps</td>
<td>0.004 (1.15)</td>
<td>0.000 (0.12)</td>
<td>0.002 (1.19)</td>
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<td></td>
</tr>
<tr>
<td>Nb. Obs.</td>
<td>10670</td>
<td>14264</td>
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<td>10670</td>
<td>14264</td>
<td>24934</td>
<td></td>
</tr>
<tr>
<td>Pseudo-$R^2$</td>
<td>0.005</td>
<td>0.002</td>
<td>0.002</td>
<td>0.004</td>
<td>0.003</td>
<td>0.004</td>
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</tr>
</tbody>
</table>
5.5 Comments on our results

- we find general effect that ↑ control benefits is associated with ↑ comovement (as in literature)
  - ↓ idiosyncratic volatility (↑ opacity)
  - ↑ β

- we also find that for companies with bad governance there is a mitigating effect going in the opposite direction:
  - lower beta is associated with a higher control benefits
    * interpretation: mkt power effect; if you have a security that offers valuable diversification opportunities you can afford to extract more control benefits
    * visible for companies with bad governance because they have a low beta to start with
• How did we reach this conclusion?

• We disentangled Ferreira and Laux measure of idiosyncratic volatility $\psi = \ln \left( \frac{V R}{\sigma^2} \right)$

$$VR = \frac{\sigma^2_{\mu}}{\sigma^2_m} = \text{volatility ratio}$$

- $VR$: remains our measure of idiosyncratic volatility, provides the same results as literature

- $\beta$: provides a new effect: market power for bad governance companies
6 Conclusions

- Competition in protection of minority shareholders generally fails to eliminate expropriation, even if not all expropriated cash flow can be enjoyed.

- Mkt power effect from offering diversification opportunities.

- Limited amount of cash flow that can be paid to outsiders affects public risk-return profiles.

- ...and it is also affected by the mkt power bestowed to companies with low comovement with the mkt.

- Extensions
  - richer model to avoid pitfall of $p = 1/2$
  - ownership structure data
  - address endogeneity issues
=> \[2\gamma p(1 - p)H - (2p - 1) - 2] > 0

=>

\[
\frac{ds^*_1}{d\lambda} = \frac{2\gamma p(1 - p)H - (2p - 1) - 2}{2\gamma p(1 - p)H(1 - \lambda)^2} > 0
\]

If protection of minority shareholder worsens equilibrium control benefits ↑
\[ \beta_1 = \frac{2[1 - \gamma p(1 - p)H \lambda]}{2p - 1} = -\beta_2 \]