

INSTITUTIONAL INVESTOR ACTIVISM: DOES THE PORTFOLIO MANAGEMENT SKILL MATTER? ♦

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JEL: G10, G21, G28, G30 and L20

KEYWORDS: Corporate Governance, Institutional Investor Activism, Universal Banking

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ABSTRACT

Institutional investors are often seen as potential solutions for corporate governance problems and are requested to have a more active role in the monitoring and control of listed companies. In this paper we develop a model that, within a universal banking framework, allows one to conclude that, the greater the capacity of a financial group to generate capital inflows that react to the performance of mutual funds, the more the said attitude is likely to succeed. The paper also concludes that the efforts of supervisory authorities should be directed in particular to the relations between universal financial groups and companies in which these financial groups do not have a relevant stake.

♦ We wish to thank comments by participants to the 3rd International Conference on Corporate Governance, hosted by Centre for Corporate Governance Research, Birmingham. The usual disclaimer applies.

• CEMPRE is supported by FCT through POCTI of the QCAIII, which is financed by FEDER and Portuguese funds.

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Institutional investors are often seen as potential solutions for corporate governance problems and are requested to have a more active role in the monitoring and control of listed companies. In this paper we develop a model that, within a universal banking framework, allows one to conclude that, the greater the capacity of a financial group to generate capital inflows that react to the performance of mutual funds, the more the said attitude is likely to succeed. The paper also concludes that the efforts of supervisory authorities should be directed in particular to the relations between universal financial groups and companies in which these financial groups do not have a relevant stake.

INTRODUCTION

This study focuses on the participation of institutional investors in the corporate governance mechanisms. It broaches issues related to conflicts of interest between the mutual funds investors and the financial group responsible for the fiduciary management of these instruments.

The activism of institutional investors in corporate governance is considered to be a means of minimising agency costs and safeguarding the interests of shareholders. Calls to this end originate as much from the academic field (Porter (1992)) as from the Codes of Good Practice (Cadbury Report (1992) and Hampel Report (1998)) and international institutions operating in the regulatory and supervisory fields (IOSCO (2003)). Nevertheless, it is not certain that institutional investors are motivated and orientated towards performing this role (Short and Keasey (1997) and Suto and Toshino (2005)), nor certain that they do perform it (Gillan and Starks (2000)) or, if they do, that they are effective in raising the long term performance of the target firms (Karpoff et al. (1996), Wahal (1996), Smith (1996), Carleton et al. (1998), Del Guercio and Hawkins (1999) and Prevost and Rao (2000)). In addition, the relationships that some institutional investors have with the firms in which a stake is held can be characterised as being more of interest to the respective managers than in the interest of the mutual fund investors (Romano (1993) and Murphy and van Nuys (1994)).

In the context of a universal banking system – as is the scenario for this study - in which the financial group acts in other areas besides the fiduciary activities, the safeguard of the interests of the group's shareholders may clash with the defence of the interests of the shareholders of another firm (including the investors of mutual funds that are

fiduciary managed by the group). Consequently, in certain conditions, instead of adopting an adverse stance when confronted with the bad corporate governance of a third party firm, the institutional investor may opt to take a complacent and cooperative standpoint, thereby deciding in a manner that is antagonistic to the interests of the collective investment instrument but favourable to the interests of the shareholders of the financial group that manages said instrument. Nevertheless, the performance of the supervisory authorities as well as the performance reaction of the mutual fund investors may lead to the alignment of interests between shareholders and clients, thereby steering the financial group to adopt a position that is conducive to the minimisation of the agency costs of firms in which the institutional investor has a stake.

In fact, there is sufficient evidence that investors in mutual funds do react to past performance (Ippolito (1992), Goetzmann and Peles (1997), Sirri and Tufano (1998) and Christoffersen (2001)). There is also evidence of the 'smart money' phenomenon which shows that some investors are able to identify funds with a better future performance by using past performance information (Gruber (1996), Zheng (1999)).

Then, given that mutual fund management companies usually receive a fixed percentage of the assets under their management, the flow-performance ratio is an inducement contract, for it encourages fund managers to attain good levels of performance in order to benefit the flow of capital that is channelled towards the better performing funds (Brown et al. (1996) and Chevalier and Ellison (1997)).

Thus, the business value of fiduciary management depends on the performance of the

managed funds. In turn, the performance of each fund depends on the performance of each participated asset. Any decision made in any firm held by the fund that influences its performance may impact the future capital inflows that are directed to that specific fund and the value of the company that manages the fund. A decision with negative implications for the value of the firm implies a performance loss (at least a potential one) for the fund as well as value loss for the managing entity. Thus the managing company should oppose such negative producing decisions.

However, should the financial group have any other interests in that firm, i.e. loan credit, it may well be that the value of those interests will surpass the negative effect on the fiduciary management of assets. Under these circumstances, those negative producing decisions will not be opposed if the interests of the financial group shareholders are to be defended. Thus, the poor governance of a specific firm may instigate conflicts of interests between the shareholders of the financial group and the clients of the asset management division.

This paper investigates the ability of a financial group to obtain capital flows from investors that react to performance, and how this influences them. The ability to manage each fund portfolio and the further capacity to obtain new capital inflows from investors that react to performance may well be considered as a financial group strategic issue. To this end, should the financial group decide to concentrate on the fiduciary management area, it may hire qualified personal that are able to obtain positive and competitive performances¹. Thus, investigating the presumed ability of the financial group to capture capital flows from performance reacting investors is equivalent to

studying just how much greater importance bestowed to the asset management area within the universal banks is susceptible of inducing the alignment of the interests of shareholders and fund clients. This alignment, in turn, will allow the financial group to oppose bad governance decisions in third-party firms.

The main purpose of this study is to create a tool that analyses how the ability and the resulting competitive capacity in the asset management area of the financial group, influences its attitude towards the bad governance of a third-party company in which the financial group has business and shareholding interests. To put it differently, one aims to examine to what extent does a greater relevance of the asset management area create conditions for the promotion of better governance in that third-party company.

Our results show that good governance in third-party firms tends to be more likely when financial groups concentrate more intensely in the asset management area, although such effect may be less intense if the financial group possesses increased direct shareholding positions in the firm. Furthermore, the model shows that other shareholders and the supervisory authorities should pay special attention to the relations between firms and financial groups to whom fiduciary management is secondary and that have lower direct stakes in the firm.

THE MODEL

THE SEQUENCE OF EVENTS

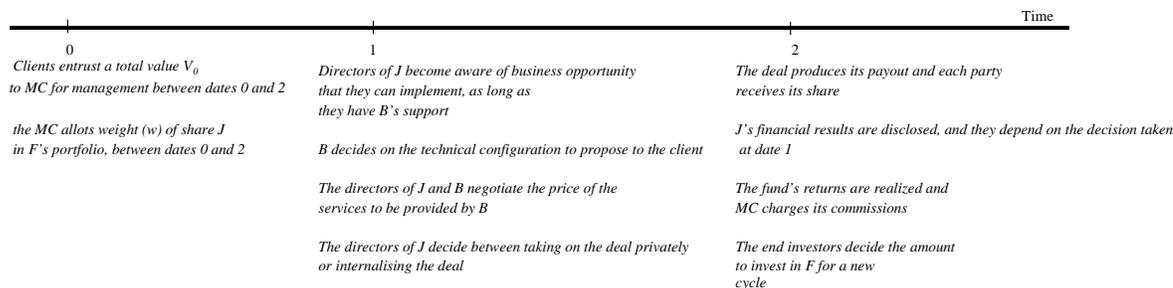
The model assumes an economy, with risk-neutral economic agents, in which there are multiple financial assets and multiple intermediaries that fiduciary manage capitals. Amongst these agents there exists a financial group, headed by a bank (B), which holds a 100 percent stake in a mutual fund management company (MC) that manages a (sole) mutual fund (F). Amongst the financial assets are shares in firm J , the standardised quantity of shares issued being I . Part of the shares of this firm are held by the firm's insider directors (q_A), another part incorporates B 's own portfolio (q_B), one other block of shares is held by fund F (q_F) and the remaining shares ($1 - q_A - q_B - q_F$) are scattered amongst market investors.

At the start of each investment cycle (date 0) MC distributes the fund's total value (V_0) amongst N available assets - the model's sequence of events is summarised in Figure 1. In particular, MC will have to decide the weight (w) to attribute to asset J . The choice made by MC is not influenced by B . For reasons of simplification, it is assumed that F uses a buy and hold strategy. In addition, insider trading is not permitted. Lastly, it is assumed that MC and B seek to maximise the consolidated value of their business.

On date 1, the insider directors of J detect a business opportunity that would bring about a payout of π ($\pi > 0$) on date 2. The business opportunity is sporadic, for which reason if the firm's directors disclose the information, the market will not alter its rating of the risk of share J . As an alternative to the disclosure of the deal, J 's insider directors may decide to privately take the deal on themselves, to which end they shall require the know-how and technical and/or financial support of B . This may include financing, the

implementation of one or more financial operations, entering into a partnership in an off-shore business deal, or a mix of any of the usual services it provides in its day-to-day activity, which are not in risk of infringing legislation.

FIGURE 1 – SEQUENCE OF EVENTS



The insider directors of J chose B for reasons of trust². Not only do they trust the technical competence of B but they also believe that B will comply with its duty of professional secrecy. B , on the other hand, knows that if it refuses to carry out the operation (alleging technical difficulties, for example), it will not lose a future client³, and the insider directors of J will not look for any other bank to carry out the operation⁴.

On date 2, the financial statements of the firm J are published, and the payment of an extraordinary dividend will be made, or not, depending on the course of action decided on at date 1. Likewise, the misappropriation of the earnings subtracted from the firm for personal gain will be implemented at this time, depending too on the course of action decided on at date 1. In addition, B will be paid on this date for the services provided. Lastly, on date 2, the returns of F are calculated, MC charges its commissions, and a new decision regarding the distribution of the funds for the following cycle is made by mutual fund investors.

On date 1 B has to decide whether it will provide services or not to its clients. It is possible that B may study technical solutions that lead to only a certain part of π being misappropriated for personal gain, and that the remaining part is disclosed, thereby influencing J 's earnings calculated on date 2 and giving rise to an extraordinary dividend to be paid out on this date. More specifically, instead of the total amount of π being misappropriated from the firm's profits, a certain proportion, δ , may be misappropriated, which is subject to the choice made by B . It is assumed that B can choose any value for δ ($0 \leq \delta \leq 1$). As a result of the choice made, $\delta\pi$ monetary units shall be misappropriated, while the remaining $(1-\delta)\pi$ shall be disclosed and distributed to J 's shareholders.

The insider directors of J will not receive all the misappropriated funds. Right from the beginning it is necessary to hide the deal from the public domain, in order to prevent the monitoring bodies, other shareholders and the supervisory authorities from becoming aware of the deal. This implies the assumption of costs. For each misappropriated monetary unit only η ($0 < \eta < 1$) shall arrive at its final destination⁵. The payment of B services must also be considered. If λ represents the payment made to B for each misappropriated monetary unit, after the deduction of 'cover-up' costs, the final payout π of the deal shall be distributed as such:

- $(1-\delta)\pi$ delivered to the shareholders of J in the form of dividends;
- $(1-\eta)\delta\pi$ costs corresponding to the cover-up process;
- $\lambda\eta\delta\pi$ payment to B for services provided⁶;
- $(1-\lambda)\eta\delta\pi$ misappropriation by the insider directors of J .

The product $(1-\lambda)\eta\delta\pi$ is the so-called 'personal benefit obtained by the insider

directors' or, if the insider directors are also larger shareholders, the 'personal control benefit'. The $\delta\pi$ product represents the total amount of agency costs.

THE BEHAVIOUR OF THE MUTUAL FUND INVESTORS

On date 2 the results of the firms and funds are published and families decide on how their assets will be invested. In particular, they decide which of the funds they will entrust more or less of their wealth to. Mutual fund investors allocate their assets to the different funds, favouring those that produced the best performances, using the rule⁷:

$$V_{t+2} = V_t (1 + g_1 + g_2 \alpha_{t+2} + \varepsilon_{t+2}) \text{ with } t = 0, 2, 4, \dots, \infty, \quad [1]$$

where V_t represents the total invested in fund F for the cycle between dates t and $t+2$; g_1 ($g_1 > 0$) is a growth rate that does not depend on the fund's performance; g_2 ($g_2 > 0$) is a performance bonus coefficient; α_{t+2} represents the abnormal return achieved by the fund in the previous cycle (between dates t and $t+2$); and ε is a random disturbance (i.i.d.).

THE PERFORMANCE OF THE MUTUAL FUND

On date 2 share J produces an abnormal payout of $(1-\delta)\pi/P_0$ (where P_0 is the standardised market price of the share on date 0). The marginal contribution of this payout to the abnormal return of F 's portfolio is⁸ $w(1-\delta)\pi/P_0$. This means that when B , on date 1, presents a technical solution to the insider directors of J it is indirectly conditioning the abnormal profitability of F . If it refuses to provide the services ($\delta=0$), it maximises the contribution of the event specified on date 1 towards the abnormal return; if it provides a solution that misappropriates all of the earnings ($\delta=1$), the business opportunity's contribution to the abnormal return is zero and a loss on the

return of $w\pi/P_0$ units is reported. Thus, the cost of opportunity borne by F is,

$$\Delta\alpha_2 = w\delta\pi/P_0. \quad [2]$$

THE PROBLEM OF J 'S INSIDER DIRECTORS

On date I the insider directors of J decide whether to disclose the deal or to take it on privately. They contact B to find out what technical solutions this can offer and to negotiate the value of λ . For each misappropriated monetary unit the insider directors of J suffer (as shareholders) a marginal cost equivalent to q_A . As a result, the misappropriation of $\delta\pi$ monetary units implies a marginal cost of $q_A\delta\pi$. On the other hand, for each misappropriated monetary unit, the insider directors' marginal income is $(1-\lambda)\eta$. The benefit for a total of $\delta\pi$ misappropriated monetary units is $(1-\lambda)\eta\delta\pi$. The payout of the deal for the insider directors of J (R_A) is, therefore, calculated by [3], and it is only advantageous to implement the deal when $R_A > 0$:

$$R_A = (1-\lambda)\eta\delta\pi - q_A\delta\pi. \quad [3]$$

THE PROBLEM OF THE BANK

B has to put forward δ and negotiate λ . To this end, it has to consider the effect that its decisions shall have on its assets, either directly, through the commissions it shall receive, or indirectly through the inherent effect of its shareholding in the capital of J and MC . If it decides to go along with the deal, then B shall have a direct marginal benefit of $\lambda\eta\delta\pi$ (the amount received for the services provided). On the other hand, as a shareholder B will have a marginal cost of $q_B\delta\pi$.

Additionally, for a total of $\delta\pi$ monetary units misappropriated from J , F has a marginal loss of abnormal income calculated by [2]. This loss affects F 's performance and,

consequently, the quantity of funds entrusted to *MC* for management at the start of the next investment cycle, as well as in the following cycles. The loss will, therefore, reflect on the amounts expected via management commissions and profits. This cost includes the effect that the subtraction of $\delta\pi$ monetary units causes on (i) the value of the future capital inflows and (ii) the value of the mutual fund management firm, *MC*.

The Effect on the Capital Flows

If the service is offered ($0 < \delta \leq 1$), on date *I* the expected (by *B*) value for V_2 is:

$$E[V_2/E(\alpha_2) = \alpha - w\pi\delta/P_0] = V_0[1 + g_1 + g_2(\alpha - w\pi\delta/P_0)]. \quad [4]$$

Should *B* decide not to offer the service ($\delta=0$), we will have $E(\alpha_2) = \alpha$, and

$$E[V_2/E(\alpha_2) = \alpha] = V_0(1 + g_1 + g_2\alpha). \quad [5]$$

Subtracting [4] from [5] we obtain the expected variation of V_2 resulting from the service: $E[\Delta V_2/E(\alpha_2) = \alpha - w\pi\delta/P_0] = V_0g_2w\pi\delta/P_0$.

Given [1], the decision has an impact on $V_2, V_4, V_6, V_8, \dots, V_\infty$. Thus:

$$E(\Delta V_{t+2}/\Delta V_2) = (V_0g_2w\pi\delta/P_0)(1+g_1+g_2\alpha)^{t/2}, \text{ with } t = 2, 4, 6, \dots, \infty. \quad [6]$$

The Effect on Profits and on the Value of MC (VMC)

Equation [6] gives the expected impact on the values under management of *MC*, which, when multiplied by the profit achieved per fund per each monetary unit managed (ϕ), results in the expected variation in the dividends (*D*) of *B* at the end of each management cycle. Hence:

$$E[\Delta D_4/E(\alpha_2) = \alpha - w\pi\delta/P_0] = V_0g_2w\pi\delta\phi/P_0 = E[\Delta V_2]\phi; \quad [7]$$

$$E(\Delta D_{t+4}/\Delta V_2) = (V_0g_2w\pi\delta\phi/P_0)(1 + g_1 + g_2\alpha)^{t/2}, \text{ com } t = 2, 4, 6, \dots, \infty. \quad [8]$$

Combining [7] and [8] we have a perpetuity with an initial value of $V_0g_2w\pi\delta\phi/P_0$ (with

the first cash-flow paid on date 4), and a periodic growth rate $g_1 + g_2\alpha$. Using the Gordon method of discounting dividends, we get:

$$E[\Delta VMC / E(\alpha_2) = \alpha - w\pi\delta/P_0] = V_0g_2w\pi\delta\phi/P_0(R - g_1 - g_2\alpha), \quad [9]$$

where R ($R > g_1 + g_2\alpha$) represents the discount rate that is appropriate to the level of risk of MC 's business¹⁰.

The Result of the Bank

B 's result (R_B) can now be calculated, subtracting the loss incurred as a shareholder ($q_B\delta\pi$) and the loss of value of MC [9], from the direct income of the deal ($\lambda\eta\delta\pi$):

$$R_B = \lambda\eta\pi\delta - q_B\pi\delta - V_0g_2w\pi\delta\phi/P_0(R - g_1 - g_2\alpha). \quad [10]$$

SOLUTIONS AND EQUILIBRIUM CONDITIONS

As seen in [3], J 's insider directors accept the deal if $R_A > 0$, ie, if $\lambda < (\eta - q_A)/\eta$. On the other hand, from [10] we conclude that B shall only accept the deal if $\lambda > q_B/\eta + V_0g_2w\phi/\eta P_0(R - g_1 - g_2\alpha)$. Juggling the conditions so that the deal is advantageous for both B and the insider directors of J , we conclude that:

LEMMA 1 – The existence of the deal depends upon the structure of ownership of J .

In fact, the deal is only advantageous for the insider directors of J and for B , if λ ($0 < \lambda < 1$) is such that $q_B/\eta + V_0g_2w\phi/\eta P_0(R - g_1 - g_2\alpha) < \lambda < (\eta - q_A)/\eta$. The lower threshold corresponds to the price that leads to a null result for B ; B has a positive profit

if it receives an amount above this level. The upper threshold corresponds to the price that would cause a null result for the insider directors of J ; these shall only obtain a positive result if a lower price is agreed on.

Therefore, the space available for the implementation of the deal depends on the structure of ownership of J (q_A and q_B). However, the higher q_A , *ceteris paribus*, the greater is the opportunity cost that the insider directors of J are faced with regarding the realization of deals that misappropriate funds from the firm's operational accounts, given that they, being shareholders, also suffer from the effects of misappropriation. Similarly, the higher q_B , the greater is the lower threshold and, therefore, the lower is the equilibrium space. These results are consistent with the empirical evidence (vg, Morck et al. (1988), McConnell and Servaes (1990) and Chaganti and Damanpur (1991)).

The result put forth in Lemma 1 is independent of δ . One may even state that:

LEMMA 2 – If there is a deal, the agency costs will be maximized.

In fact, for each λ , R_B is a linear function of δ ($0 \leq \delta \leq 1$), with a positive slope when $R_B > 0$. Thus, $\delta=1$ maximizes R_B .

Using Lemma 1 we can see that the greater α , the higher the lower threshold of the equilibrium space will be and the tighter the space of the profitable deal will be. Thus, the higher the capacity of the financial group headed by B to obtain investment inflows that react to performance, the lower the space for the existence of the deal. In other

words, the higher the relevance of the asset management area, the lower the degree of conflicts of interest between the financial group shareholders and the mutual fund clients. There is actually a threshold for α which prevents the deal from taking place and allows the full convergence of the interests of the shareholders and fund clients. This threshold is obtained equating the upper and lower thresholds in Lemma 1 and solving for α . The following can then be stated:

PROPOSITION – The relevance of the asset management area may prevent the existence of the deal.

In fact, if $\alpha \geq (R-g_1)/g_2 - V_0w\phi/P_0(\eta-q_A - q_B)$, there is no possible deal. This threshold includes two elements. The first element depends on the own capital cost (R) and the parameters that define the reaction of investors to performance (g_1 and g_2). The second depends on the profit rate of the fiduciary management area (ϕ), the efficiency of the supervisory mechanisms (η) and the shareholding structure of J (q_A , q_B , V_0w/P_0)¹¹.

Several conclusions can be drawn. Firstly, the higher (lower) the g_2 , the lower (higher) the alpha threshold that cuts down the possible profitability of the deal. In other words, the more intensely the fund investors react, the greater is the converging space of the interests of the financial company shareholders and those of fund investors.

Furthermore, the higher (lower) number of shares of J held by fund F (V_0w/P_0), the lower is the alpha value that is necessary to eliminate the agency costs. Thirdly, the higher (lower) q_B , the lower the alpha threshold will be. In a universal banking system

there might be banks that rely less on the asset management area (lower alphas). If this is the case, then there is a greater probability for conflicts of interests between the holders of the funds and the shareholders of the bank. This may however be compensated if the bank has a relevant stake in firm *J*. In other words, the interests of the bank shareholders and of the fund clients are more (less) aligned when the bank relies more (less) heavily on the asset management area. This would mean that one would expect a higher (lower) contribution for the good governance of third-party companies from banks with higher (lower) interests in the asset management area. However, if the bank relies less heavily on the asset management area but has a relevant stake in a third-party firm, then there might be a superior alignment of the interests of fund holders and bank shareholders.

Finally, the lower (higher) η is¹², the lower (higher) is the alpha threshold necessary to eliminate the deal. Thus, one may conclude that the efforts of the supervisory authorities should be particularly directed towards the relationships between universal financial groups (with reduced asset management interests) and companies in which the direct shareholding interests of those financial groups are reduced. By doing so, they would contribute to ensuring a greater convergence of interests between all the shareholders of a third-party firm and the interests of the shareholders and clients of the financial group, in situations in which initially this convergence is less likely to occur.

CONCLUDING REMARKS

The activism of institutional investors in the control and monitoring of the corporate governance of firms in which they have a stake is seen by professional and academic

circles as a possible means of solving problems related to the separation of ownership and management. This possibility has, however, raised scepticism amongst some authors, who have brought into question the motivation, availability and interest on the part of institutional investors to play such a role.

The model developed in this paper allows one to conclude that if there do exist business opportunities that are simultaneously profitable for the insider directors of a firm and for the shareholders of the financial group that supplies the services, the bank will not prevent the firm's bad governance but will also propose technical solutions that maximize agency costs.

However, the higher the capacity of the financial group in obtaining new capital inflows that react to mutual fund performance, the lower the equilibrium space. This leads us to the conclusion that, *ceteris paribus*, between two different financial groups, opposition to bad governance is most often expected from the bank with a stronger asset management area. However, the holding of a stake in the third-party firm may reverse this conclusion. Such is the case of two banks in which one of them concentrates more on asset management but the other has a higher stake in the firm. In this case, one can not beforehand say which of the two banks show a greater probability of refusing the deal and act as a good governance inducer agent.

We also conclude that an increase in efficient monitoring by third-party firm shareholders and supervisory authorities results in the decrease of the critical alpha threshold that prevents the existence of agency costs. Therefore, the efforts of

shareholders and supervisory authorities should be directed in particular to the relations between the companies and universal financial groups in which the most important interests are not the asset management area, or when these financial groups do not have relevant stakes in the third-party firms.

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¹ Chevalier and Ellison (1999) documented evidence that shows that funds that recruit the best qualified managers do obtain higher performances. Furthermore, certain studies have documented the ability of certain funds in obtaining constant high profitability (Grinblatt e Titman (1992), Hendricks et al. (1993), Elton et al. (1996) and Otten and Bams (2002)), whilst others show constant low performances (Hendricks et al. (1993), Shukla and Trzcinka (1994), Gruber (1996) and Carhart (1997)).

² The Enron case and other similar cases have shown that it is possible for investment banks and firms to collaborate in hiding deals from shareholders even in developed markets that are subject to supervision and regulation.

³ This assumption permits any future costs regarding a client's losses to be ignored.

⁴ Therefore, there is no danger of suffering the consequences of the operation in the capacity of shareholder and in the capacity of fund manager and not benefiting from the operation as a supplier of banking services. Assuming the exact opposite is not very plausible given that B , possessing information regarding the plans of the insider directors and having direct and indirect interests in J , would be in a position to pressurise the board of directors not to privately take on the deal.

⁵ This parameter – exogenous to the model - shall be increasingly more diminished the greater the level of monitoring of the firm by the different investors, in addition to being increasingly more diminished the greater the level of legal protection provided to the shareholders' interests (*vide*, La Porta et al. (1998)). It shall be increasingly more effective the greater the level of intervention carried out by the supervisory authorities.

⁶ The amount paid to B for its services includes the deduction of taxes, given that there is no need to hide this income from the supervisory authorities. From B 's viewpoint, this is a legal income just like any other earnings.

⁷ The model assumes, in harmony with the available empirical evidence, that economic agents react to past performances (Ippolito (1992), Goetzmann and Peles (1997), Sirri and Tufano (1998) and Christoffersen (2001), among others).

⁸ It is assumed that the purchase price of q_F units of J held by F is the market price as of date θ .

⁹ It is assumed that the insider directors' salaries do not depend on the firm's performance. If this is the case then this fact should be added to the opportunity cost. However, profit sharing has the same effect as the ownership of shares, for which reason this possibility was not explicitly considered so as not to overload the notes.

¹⁰ We assume that the period of effective capitalisation is equal to one investment cycle.

¹¹ V_0W/P_0 is the number of shares of J held by F (q_F).

¹² In other words, the higher (lower) the monitoring efficiency of the supervisory authorities.