

Financialization, Loyalty and the Rise of Short-Term Shareholder Value

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Abstract

This paper takes the issue of the financialization of competitiveness as being concerned with the link between increased financialization and the reduced autonomy of company management. The paper understands financialization to mean the increased ability to trade risk, resulting from changes in the structure of financial markets and in the financial market actors active in those markets. The paper's starting point is the focus in comparative political economy on national financial structures (e.g, Zysman 1982), and the view in that literature of capital market-based financial systems as increasing the autonomy of companies from the providers of financing, when compared to bank-based systems. Such a view appears at odds with the rise of shareholder value. The study seeks to address this inconsistency through a clearer understanding of the nature of different equity investor and market types. The ability to trade risk is linked to loyalty (Hirschman 1970). The paper considers the varying levels of loyalty of tracker funds, individuals, pension funds, insurance companies, hedge funds, private equity and international investors. It argues that these actors' varying levels of loyalty, when combined with an understanding of which investors are active in which equity markets, help an understanding of companies' levels of autonomy from short-term shareholder value pressures.

FIRST DRAFT: PLEASE DO NOT CITE WITHOUT AGREEMENT

Introduction

The rise of the concept of shareholder value, with its prioritizing of return on equity and the concomitant rise of ‘a different and more carnivorous type of capitalism’ (Williams 2000: 1), has attracted considerable academic attention in recent years (see, for example, the *Economy and Society* special edition, 29: 1 in February 2000). As Williams (2000: 1) argues, a focus on shareholder value involves a focus on various issues surrounding change in financial markets. While accepting the difficulties of a precise definition of shareholder value (Froud et al. 2000: 81), this paper takes as the central issue surrounding the rise of a focus to be the question of corporate autonomy from the demands of their shareholders. The rise of shareholder value is inextricably linked to the willingness, and most importantly the ability, of shareholders to demand that they, as the owners of the company, should see their interests predominate over those of other stakeholders. This paper does not attempt to focus on what a focus on shareholder value might mean to terms of management decisions, but it should be recognized that this can cover a wide range of policies. Shareholders can equally see excessive executive pay as an issue to be addressed (although the record is not good in this regard) as demand a reduced influence for the interests of stakeholders such as labour.

A focus on corporate autonomy, however, serves to highlight an apparent contradiction, between the conclusions of the Comparative Political Economy literature (I focus here on Zysman) and the work on shareholder value and financialization. Zysman (1983: 70) suggests that the move from a bank-based to a capital markets-based system increases corporate autonomy from their financiers,¹ because capital market-based systems ‘tend to limit the influence of financial institutions on (non-financial) firms’. In the United States, for example, an arm’s-length financial system ‘insulates firms from outside influences’ (1983: 270). This is problematic if the central issue of the rise of shareholder value is taken to be one of corporate autonomy, because the issue would appear to be one of decreasing corporate autonomy in more highly financialized financial systems.

¹ And, Zysman’s main focus, from government.

This also serves to highlight a further potential criticism of the CPE ‘varieties of capitalism’ literature. Zysman, in his analysis, assumes financial systems are unchanged ‘in the thirty to thirty-five years after the Second World War’ (1983: 287). While this is arguably (though debatably) true for the period Zysman considers, it is clearly not true now. In the period since, a focus on questions as to the extent, or indeed inevitability, of convergence in national economic policy (e.g., Berger and Dore 1996) has concentrated on the movement of capital across borders: ‘convergence came to be synonymous with the global mobility of the factors of production, and above all of finance’ (Berger 1996: 5). What is missing in both these approaches is a closer examination of capital markets-based systems, and specifically at processes of change within such systems. Zysman focuses on differences between bank-based and capital markets-based system, whilst the convergence literature focuses on international capital mobility, or, more broadly, on the internationalization of financial systems. Engelen and Konings (2008) see this as the result of weaknesses in the approach of both comparative and international political economy:

External openness is only one dimension of the process of financial globalization; conceived in a broader sense, global financial expansion also involves processes of innovation, growing market depth and the penetration of financial relations into ever more social spheres. In this sense, those aspects of financial globalization that CPE and IPE focus on represent only the tip of the iceberg. Beneath the surface we find processes of market expansion that are profoundly dependent on the construction of a range of new institutions that precisely facilitate and promote the growth of financial relations

Like Engelen and Konings, this paper sees these deficiencies in CPE and IPE literature as best overcome through a focus on processes of financialization: ‘The sui generis analysis of specifically financial institutions we take to be the key strength of the financialization literature’. This paper focuses both on the involvement of new types of investors in equity markets (the UK market is studied here) and, importantly, on changes in the investment activities of existing investor types, such as pension funds and insurance companies.

However, the paper also takes advantage of one of the possible weaknesses of the financialization literature, by choosing its own definition of the term. Financialization is defined here simply as the increased ability to trade risk. As will be demonstrated, the ability to trade risk is influenced by multiple constraints. The overall financialization of a financial market (in this case, an equity market) is the result of the financialization of the financial actors in the market (i.e., the ability of the actors themselves to trade risk) and the financialization of the structure of the financial market itself (i.e., the constraints on the trading of risk in the particular market). Examples of factors that might influence the financialization of the financial actors include the investment mandates which control how they can invest, the nature of their liabilities and the amount available to invest. The financialization of the structure of the equity market itself is influenced by factors that include the market's size, the financial instruments that exist, and the ease of the settlement of transactions.² These two facets of financialization interact to determine the overall level of financialization of a particular financial market. This overall level is determined by the ability of the investors that dominate the market to trade risk. A hedge fund may itself be able to follow complex, short term trading strategies, but will only be able to do so if the financial instruments exist to facilitate such strategies. Similarly, the instruments may exist, but if the investors able to follow these strategies are not interested in a particular financial market, the strategies will not be followed.

Financialization has been used to mean a variety of different developments within domestic and international economies (see Krippner 2005: 181; Epstein 2005: 3), including the dominance of shareholder value itself in corporate governance, 'a change in orientation towards financial results' (Froud *et al.* 2000: 104³), a part of the developments leading to 'finance-led growth' (Boyer 2000),⁴ 'a pattern of accumulation in which profit-making occurs increasingly through financial channels rather than through trade and commodity production' (Krippner 2005: 181); the increasing sophistication of financial markets (closest to its use in this paper); or the increasing entry

² Settlement refers to the process by which ownership of securities and cash payments are transferred.

³ Froud *et al.* also note 'a kind of speed up in management work' (2000: 104) which can be seen as the result of a more short-term focus from shareholders.

⁴ Froud *et al.* (2002) contrast their approach from Boyer's (see also Ertürk 2003).

of financial markets into our everyday lives (Martin 2002; Langley 2007⁵). Epstein, in a deliberately broad definition, terms financialization ‘the increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies’ (2005: 3). The definition of financialization in this paper is closest to the process described by Aglietta and Breton (2001), although financialization is not a term they employ. They (2001:437) link the change to a market-based from a bank-based financial system to financial liberalization and financial innovation linked to the increasing power of technology.

The argument in this paper is that the increase in financialization of equity markets has, by increasing the ability of investors to exit, led to decreased loyalty. Not only this, but increased financialization has given investors, through the ability to short (i.e., sell securities they do not own), the possibility to express what is termed here ‘disloyalty’. The paper therefore seeks to move away, in the consideration of Hirschman’s (1970) ideas, from an excessive focus on voice and exit. The use of Hirschman’s ideas in discussions of financial markets is common (e.g., Cohen 1996: 285; Pollin 1998;⁶ Cutler *et al.* 1999; Cerny 2001; Santiso 2003). The focus of such studies is on variations in voice and exit, with the two seen as alternative courses of action. An investor, faced with an actual or prospective management decision with which s/he disagrees, chooses either to express that disagreement (in this case to company management), or to sell their investment. Zysman (1983) contrasts the voice employed within bank-based systems with the predominance of exit in capital market-based systems. Cosh *et al.* 1997 and Grahl 2001 see a general decline in the choice of voice over exit among investors. Voice can be seen as taking too long to be effective to deter exit (Santiso 2003: 23).

In contrast to voice and exit, loyalty is rarely considered in the literature. When it is included, it is either dismissed as almost non-existent (e.g., Santiso 2003: 24) or only important if enforced by government regulation (Cohen 1998). To see loyalty in financial markets as nothing more than the result of government regulation has the effect of

⁵ Strange (1997c) sees the same development, but without terming it financialization.

⁶ Pollin sees the key difference between financial systems not in bank-based or market-based structures, but in whether voice or exit dominates, ‘dedicated’ or ‘fluid’ capital systems.

subsuming loyalty within an overly-narrow consideration of exit. Investors are seen as loyal only to the extent that they are forced to be. This paper takes a different approach, and one more suited to the analysis of modern financial markets. Loyalty is given far greater consideration. Prioritising a consideration of loyalty is not to deny the importance of exit, but serves to emphasise a number of important points that run throughout the study. The first is to see exit in far broader terms than the literature has to date (Maxfield 1998 being a partial exception). The inability to exit can indeed 'enforce' loyalty, but an analysis that focuses on loyalty rather than exit serves to emphasise that the decision to exit is far more nuanced than simply regulation. In particular, a strong emphasis in this paper, and one more in line with financialization literature than CPE or IPE, is on ways in which the nature of the different investor types engenders different levels of loyalty. Regulation is part of the reason for these differences, but only a part.

How, then, would loyalty manifest itself in behaviour by investors in equity markets? Most obviously, loyalty 'makes exit less likely' (Hirschman 1970: 77). A more loyal investor is less likely to sell their shares in the event of unwelcome actions by corporate management, or as a result of a fall in the share price. Increased loyalty therefore leads directly to increased corporate autonomy. However, equity markets are unusual relative to other financial markets in that shareholders' ability to vote gives them direct influence through voice, rather than just the aggregated voice of a share price as a result of exit. An equity investor can therefore cause change that management cares about – changes in the management personnel or strategy – without exit. It is argued in this paper that the level of financialization has an impact also on the willingness to utilise this aspect of voice. A more loyal investor is focused, of necessity, on longer term share price performance, or, indeed, in the case of the most loyal investors, index trackers, is hardly focused on individual share price performance at all. Therefore, a less loyal investor is more likely to vote in favour of change designed to precipitate short term price rises. More loyal investors are more likely to be patient.

There is a second area of (increasingly common) financial activity which makes an analysis based around loyalty rather than exit more appropriate, although needing a

broadening of Hirschman's approach. This financial activity is shorting. Taking a short position, selling a security one does not already own, is clearly not exit; nor is it the same as retaining an investment in the expectation of the price of that investment rising. The investor retains an interest in the performance of the security, but it is an interest in the price falling. I have termed this *disloyalty*. The ability to express disloyalty represents a significant increase in financialization, and reduction in corporate autonomy. Investors that can short have the potential ability to exert significantly more downward pressure on equity prices than investors that exit.⁷ This is not only a short position that involves outright risk on the performance of the stock market or of a particular sector within the market. An outright short position in British Petroleum, for example, is a short position in the company's share price, the UK stock market and the oil sector (and arguably therefore the oil price). A short position in BP, combined with a long position in Royal Dutch Shell removes a number of these risks, but can still be seen as 'disloyalty' *vis-à-vis* BP. Given the prevalence of comments that a company is 'underperforming its peers', the potential impact of such activity is clear. Of course, a short position must be 'covered' (i.e., the equity originally sold bought back) at some unknown future point, but by that time the damage may have been done. For these reasons, Hirschman's ideas, when applied to modern financial markets, should be updated to voice, exit, loyalty and disloyalty.

It is argued in this paper, therefore, that the focus of study in considering the reasons behind the rise in the focus on maximizing shareholder value should be on the loyalty of different investor types. What follows, therefore, is an analysis of some of the important investor types in the equity market. It is recognized that this analysis is incomplete, and that the differentiation by investor types is a simplification, albeit a necessary one. In particular, the analysis ignores an important recent development in financial markets: the increasing holdings by institutional investors in funds managed by other institutional investors. Pension funds, for example, increasingly invest in hedge funds and private equity funds, leading to the claim that '[w]hen a public company is taken private [by being taken over by a private equity fund] its ultimate ownership – pension funds and

⁷ As with exit, the possibility of shorting can act as a constraint without the activity actually taking place.

investment institutions – may in fact remain the same’ (Walker 2008). While recognizing this weakness in what follows, the typological approach taken serves to illustrate the different nature of investors and the implications for corporate autonomy. It should also be recognized that much of the investment by one type of institution in another is the result of increased financialization (the loosening of investment constraints on the activities of the investor) that serves to decrease investor loyalty (because the investee is a less loyal investor).

The paper now considers a number of the most important investor types, taking them in order of their loyalty both to particular corporate management and to the equities they hold.

Index Trackers

Index tracking funds (also known as ‘passive’ investors) offer investors a return linked to a particular index, and charge lower fees than active managers. Their appeal to their investors is based on these low fees, and the fact that active managers have generally, after fees, underperformed the market. The important point regarding index trackers is that they have to own the shares of the companies that make up the index. The nine largest companies in the FTSE 100 index comprise 44.27 per cent of that index.⁸ With BP, the largest, comprising 7.14 per cent of the index, a tracker fund that promises to investors that it will track the FTSE 100 must hold that percentage of their portfolio in BP shares. They can therefore be seen as loyal investors. The only exception to this loyalty would come in the event of a company falling out of the index that is being tracked. Although this could be seen as indirectly potentially being the result of not focusing on short term shareholder value, this would only be the result of other investors selling shares. A company that is all owned by tracker funds (obviously a hypothetical situation only) would have loyal investors and feel no reason to prioritise short term shareholder value.

⁸ Source www.ftse.com, as at 31 August 2007. The companies are BP, HSBC, Vodafone, GlaxoSmithkline, Royal Dutch Shell (A and B shares), Royal Bank of Scotland, Barclays, Anglo American and AstraZeneca.

Tracker funds saw an enormous increase in popularity in the 1990s. By the end of 2007 £27.1 billion was managed in UK Unit Trust and OEIC tracker funds, up from £8.4 billion at the end of 1998. As a percentage of total funds under management, however, the increase is less marked, from 4.6 to 5.4 per cent, with a peak at the end of 2006 of 5.8 per cent.⁹ However, UK institutional investors are more active users of passive investment strategies. Overall, about 20 per cent of institutional investment is in such passive strategies, with corporate pension funds over 30 per cent (Investment Management Association 2007: 22). Overall, one estimate suggests passive managers (both UK and foreign) own approximately 15 per cent of the shares of UK companies (Lacaille 2005). It remains one of the ironies of the current rise in a focus amongst institutional investors on short term shareholder value that passive investors are finding success with a message that active managers habitually under perform their respective indices.

It is important to note, within the context of the link between financialization and corporate autonomy, that tracker funds work most effectively in the most efficient markets. By efficient, in this context, is meant highly financialized. Tracker funds use complex statistical models to construct their portfolios, and need to be able to rebalance their portfolios at minimal cost. This is an example, therefore, of where the increase in the financialization of a market structure can be seen as facilitating the operations of a type of investor that are themselves unfinancialized (in that their ability to trade risk is constrained by an investment mandate which predetermines the shares they will hold).

In considering processes of change, in addition to the increased role of this type of investment, it should also be recognized that 'passive' investors appear to be becoming more active in takeover situations, the most dramatic example of constraint on management autonomy. 'Managers of these shares have become notably more activist with their shareholdings, with increased engagement and action during merger situations' (Lacaille 2005). Activism, even for passive investors, is a means to increase returns. Relatively, however, we should continue to see these investors as loyal. Their investment

⁹ Source: Investment Management Association. www.investmentfunds.org.uk, accessed 3 April 2008.

mandates constrain such activism considerably (*ibid.*). Outperforming the index is as much a tracking error as underperforming.

Individuals

The importance of individual investors is often overlooked, largely because of the trend towards the increasing institutionalization of investment. This trend has been apparent for many years; between 1963 and 1981, individual ownership of UK shares fell from 54 to 28 per cent (Hayri and Yilmaz 1997: 115), and this has continued, despite widespread privatisation. However, in 2006 individuals still owned 11 per cent of the UK stock market, more than the direct holdings of pension funds, investment trusts and unit trusts combined.¹⁰ In privatisation stocks, individual ownership has been higher (Hayri and Yilmaz 1997). Individuals should generally be seen as loyal investors. The study of individuals as investors can be divided into two distinct areas of analysis. One focuses on the transaction costs, including informational disadvantages, suffered by individual investors, and their attempts to overcome these deficiencies. The other, based around behavioural finance, considers less rational decision-making, which is generally seen as being more prevalent amongst individual than institutional investors. Individual investors are therefore commonly seen as the explanation for a number of apparently irrational market phenomena. Of importance to this paper are issues which fall in both areas, most notably the higher home bias of their investments relative to other investors; their willingness to maintain under-diversified portfolios; their ‘buy and hold’ investment strategy (particularly a reluctance to take losses); and the fact that individual investors are less likely or able to utilise voice. They are less likely to vote at annual or extraordinary general meetings, in person or by proxy, and do not have access to such means of exercising voice as one-on-one meetings.

Individual investors have an even stronger home bias than institutional investors (Zhu 2002; Kumar 2004; Goetzman and Kumar 2003, 2005). The explanations for this can be

¹⁰ Source: National Statistics Online. Available at www.statistics.gov.uk/statbase/TSDdownload2.asp, accessed 3 April 2008.

seen as either irrational or a rational reaction to the high transaction costs involved in diversification.¹¹ A home bias may be entirely rational: Ivković and Weisbenner (2005) demonstrate that local knowledge leads to superior investment returns. Regardless of the motivation, the effect is an increased loyalty to the equities they are familiar with. The resultant under-diversified portfolio is less likely to be of concern to individual investors than institutions (Hayri and Yilmaz 1997; De Bondt 1998; Goetzmann and Kumar 2003, 2005). When considering the reactions of individual investors to falls in the share price, individual investors are not only generally ‘buy and hold’ investors,¹² but have a reluctance to realise losses. ‘Loss realization aversion’ or a ‘disposition effect’ (see, for example, Odean 1998; Barber and Odean 1999; Shapira and Venezia 2000; Rangelova 2001; Dhar and Zhu undated) is important for management’s autonomy from the impact of short-term share price weakness. Investors would prefer to hold on to investments that are showing losses at prevailing prices, rather than sell them and crystallise the loss. Loss realisation aversion is a well-recorded behavioural trait of all traders, including in the Chicago futures pit for example (Zaloom 2006: 131), but is particularly noted amongst individual investors. The last issue of importance regarding individual investors is that they are less likely to vote on shareholder resolutions: they are less likely to exercise voice. Other ways of exercising voice, for example through one-on-one meetings, are entirely closed to individual investors (Mallin 2007: 82), or are much more difficult, such as organised voice such as industry associations. The cost of information gathering may mean that individual investors are not aware of the issues involved.

It is also important to consider processes of change in the behaviour of individual investors and the reasons behind these changes. This is analysed within the context of those factors that influence the level of financialization of individual investors. A key overall issue, as it is for all investors, is technology. Transaction costs are reduced by improved technology. This has an impact on the availability of information, and dealing costs, as well as the ease with which financial intermediaries can offer alternative

¹¹ Lease *et al.* (1974) show how little U.S. individual equity investors spent gathering information on a market in which they were invested, so the issue may be the cost of information relative to individuals’ low valuation of that information, rather than the absolute cost of information.

¹² Four years after privatization, 2.3 million investors still held British Gas shares, 1.4 million held shares of the Trustee Savings Bank, and 1.2 million those of British Telecom (Hayri and Yilmaz 1997: 116).

investment products, thereby allowing individual investors to take on different risks. The rise of ‘day traders’ individuals who seek to profit from very short term trading, is also an example of how technology, by increasing investors’ ability to trade risk, seeks to make those investors more short term. At the height of the internet bubble, day traders were estimated to be responsible for 15 per cent of total share trading volume (Martinson and Macalister 2000). It is doubtful, however, that day traders, while possibly contributory to intraday volatility, can be seen as placing significant pressure on corporate management, unless they are seen as contributing to the momentum of prices in one direction. By closing their positions so quickly, day trader involvement seems unlikely to translate into pressure upon management.

Overall, however, individual investors must be seen as relatively loyal, even if the direction is towards a reduction in this loyalty. The reduction comes from their increased financialization through the availability of alternative investment products that reduce the focus on (especially larger) UK companies and technology that decreases transaction costs.

Pension Funds and Insurance Companies

The nature of pension funds and insurance companies makes them more loyal investors. They generally seek longer term assets (Borensztein *et al.* 2006), and are also more naturally ‘buy and hold’, rather than active traders of securities (*ibid.*). The evidence as to whether institutionalisation in general has led to more long term saving is inconclusive, although Davis and Steil (2001: 293) conclude that ‘on balance’ it has. What can be said is that within the process of institutionalisation, pension funds and insurance companies should have a greater impact on making savings more long term than other institutional investor types. The nature of pension funds’ and insurance companies’ liabilities (to pay pensions and insurance claims denominated in local currency) means that they favour their own domestic currency as the denomination of investments (Levy-Yeyati 2004; Borenszstein *et al.* 2007: 157), and so the domestic equity market. Reisen and

Williamson (1997) note this home bias of pension funds, but also suggest that defined contribution pensions may make them less conservative.

Governments are able to regulate pension funds and life insurance, with prudential justification, in ways that can have a significant impact on funds' investment decisions, and which can be seen to be closer to the regulatory approach to banks than to other institutions. In the UK, recent regulation of pension funds has in fact served to push these funds away from the stock market, in favour of the UK government bond market, Gilts. From owning 17.7 per cent of UK shares in 1998, pension fund ownership has declined steadily to only 4.7 per cent at the end of 2006. Insurance company ownership has also declined, from 24.2 to 14.4 per cent. Recent years, therefore, have seen a significant decline in the ownership of UK shares by natural long term holders of equities; although it should be noted that in 1963 share ownership by the two groups was 6 and 10 per cent respectively (Mallin 2007: 77).

A particular way pension funds have been regulated is in restrictions on the amount that can be invested abroad. The trend towards investment abroad, both as a result of deregulation and of decisions taken to widen the range of investments permissible under internal pension fund and insurance company rules, is a further example of increased financialization, the increased ability to trade risk. Importantly for the focus of study, regulations do not always limit diversification, meaning that part of the explanation must lie in the nature of pension fund investment. Of particular importance in this regard, Coote (1993, cited by Reisen and Williamson 1997) found, in the relatively unrestricted markets of Australia, the Netherlands, Switzerland and the U.K., that the internal restrictions of life insurance and pension funds set both a minimum and a maximum amount of foreign investment, and that the purpose of such investment was risk-reduction through diversification, not profit-maximisation.¹³ Whether the restrictions on overseas investment are the result of regulation or internal investment guidelines, the trend has

¹³ Davis (1998: 383) finds that in those countries which apply 'prudent investor' rules (requiring only that pension funds make investments that a prudent person would make; see Bodie *et al.* 2005: 944 for a definition) rather than quantitative regulations, both equity and foreign investment are higher, but this may be linked to the size of pension funds in countries that apply such rules (see below).

been for increased diversification abroad. Domestic equities in 2004 made up under 60 per cent of UK pension funds' (reduced) equity portfolio, down from over 71 per cent in 1998 (Lacaille 2005).

In addition to this reduced loyalty to holding UK equities, there is also considerable evidence of pension funds, while remaining owners of shares, putting more pressure on company managements. This is in part the result of official encouragement. The Myners Report (2001), issued by the UK Treasury 'expects that institutional investors should be more proactive especially in the stance they take with under-performing companies' (Mallin 2007: 80). Importantly, the report focused on the legal requirements for trustees, providing a strong incentive for activism. The Institutional Shareholders' Committee (ISC), a group with members from various institutional investor groups, including pension funds and insurance companies, went further in 2002, describing policies on activism that 'do not constitute an obligation to micro-manage the affairs of investee companies, but rather relate to procedures designed to ensure that shareholders derive value from their investments by dealing effectively with concerns over under-performance' (quoted by Mallin 2007: 81). Overall, the recommendation is that investors are proactive in their attempts to have managers prioritise shareholder value. Performance monitoring is recommended, 'to identify problems at an early stage and minimize any loss of shareholder value' (*ibid.*). Further, 'Nor do they preclude a decision to sell a holding, where this is the most effective response to such concerns' (*ibid.*). The ISC is recommended a reduced level of loyalty, both to managers' strategy and to the shareholding itself.

Although this trend is significant, it is important, especially when contrasting this group of investors with others, not to overemphasise the activism of pension funds and insurance companies. Voting against management is rare:

Generally an institutional investor will try to sort out any contentious issues with management 'behind the scenes', however if this fails, then they may abstain from voting on a particular issue (rather than voting with incumbent management as

they generally would) or they may actually vote against a resolution... It tends to be corporate governance issues that are the most contentious, particularly directors' remuneration and lengths of contract (Mallin 2007: 83).

There are two important points raised here. First, the willingness of UK institutional investors to actually vote against the board is low. Even abstaining is a strong statement of disapproval. This is clearly in marked contrast to, for example, activist hedge funds (see below). It should be emphasised, however, that this unwillingness to engage in very public conflict does not mean change cannot result from the wishes of UK institutional investors. For example, board changes at HSBC (Larson and Burgess 2008) and Morrison (Rigby and Tucker 2005) were seen as the result of shareholder pressure. The second point, however, is the nature of shareholder pressure in these circumstances. The focus is on questions of corporate governance. Even academic observers might find such questions at times somewhat esoteric (the question of whether the Marks and Spencer Chief Executive should be promoted to Executive Chairman, for example); at other times, in attempts at action over executive pay for example, the actions of institutional shareholders might be considered laudable, at least in intent. It is often the case, also, that shareholder concerns surface after poor share price performance. Nevertheless, the most active shareholder actions by UK institutional investors would appear to have been based fairly narrowly on corporate governance issues. And despite this focus, one report concluded that only a third of the largest 350 UK companies complied with the UK's Combined Code on corporate governance (Burgess 2006). It is hard to avoid the conclusion that UK institutional investors are not strongly pressuring UK management in the direction of prioritising shareholder value. These investors remain relatively, though arguably decreasingly, loyal to management and to their shareholdings.

The decrease in this loyalty is coming from an increased ability to trade other risks, as well as government regulation driving investment into the UK Gilts market. As discussed above, pension funds have invested increasingly in other types of institutional investors, such as hedge funds and private equity. They have also invested larger parts of their portfolio abroad. As the investment mandates of pension funds have become more

accommodative, the loyalty to UK equities has declined. The more accommodative nature of investment mandates has involved another important group of financial market actors, trustees. In part driven by the Pensions Regulator established by the 2004 Pension Act, trustees are more focused on performance and more willing to ‘trade’ fund managers. Their increasingly short term focus is another reason pension funds are becoming more short term in their focus, and therefore pressuring company managements more.

Hedge Funds

The development of hedge funds is inextricably linked to the rising focus on short term shareholder value. Hedge funds represent a complex investor type to analyse, because of their enormous variety of investment strategies. One guide, for example, lists 14 different investment strategies.¹⁴ The conclusion of a study of one of the 14 is that ‘there is no simple way to define what the top global macro managers actually do’ (Drobny 2006: xiii). For the purposes of this paper, the distinction must be between those that can be seen as actively increasing the pressure for an increased focus on short term shareholder value, and those that do not. Overall, however, this is a relatively less loyal, and on occasions disloyal, investor base.

A significant proportion of hedge funds use sophisticated model based strategies that take little or no account of the underlying business strategies of the companies in which they invest, but are looking rather for short term pricing anomalies in the market. These anomalies are then exploited through complicated trading strategies which depend on a financialised underlying market structure. Their interest in company management and strategy is, however, small at best. They should not therefore be seen as a driving force for the increased focus on shareholder value.

¹⁴ www.magnum.com/hedgefunds/about/hedgefunds.asp, accessed 3 April 2008.

Although one estimate suggests hedge funds held only 3.8 per cent of UK equities in 2004 (Lacaille 2005), they are far more influential in the trading of the shares.¹⁵ Hedge funds are responsible for between a quarter and a third of trading on the US and UK stock markets (*Financial Times*, 12 May 2005). Furthermore, it is clearly in the area of mergers and acquisitions that the activities of hedge funds has been seen most obviously, with the high profile involvement of the activist hedge fund Children's Investment Fund ('TCI') in the cases of Deutsche Börse's failed takeover of the London Stock Exchange, and the takeover of ABN Amro by a consortium led by the Royal Bank of Scotland, against the wishes of a management that preferred a merger with Barclays. In the case of Deutsche Börse, the CEO observed that 'a significant portion of our shareholder base is focused on return of capital in the short term' (Hatchard 2007: 1). Even more apparent has been the willingness of activist hedge funds to say very publicly what they wish to see happen. Examples include not only those above, but the takeover of Arcelor by Mittal Steel and ongoing campaigns for change at the Italian insurer Generali and at Hong Kong and Shanghai Banking Corporation.

On the face of it, the activities of activist hedge funds would appear to demonstrate the reemergence of voice as a viable alternative to exit, reinforcing the traditional dyadic use of Hirschman's ideas. Activist hedge funds appear to buy shares in a company, make the case for change, and succeed or fail based on their advocacy. The persuasiveness of their case is indeed important. However, this paper argues that any consideration of the success of activist hedge funds must examine other developments in the market. We must start by asking why activist hedge funds succeed. It is certainly generally not, based on the evidence, because they are successful in persuading management of the validity of their arguments. Agreement between activist hedge funds and company management appears based far more on a largely coincidental confluence of interests, primarily in the event of competing bids for a company, where one company bidder offers greater short term profit, especially by way of a high cash component to the bid. An example is Royal

¹⁵ They have higher ownership of other equity markets, including, in September 2005, between a seventh and a quarter of the shares of leading German companies (Jenkins and Milne 2005). It may also be that the 'other financial institution' classification in the National Statistics data, owners of 12 per cent of UK shares in 2006, is in large part hedge funds.

Bank of Scotland's takeover of ABN Amro, which received considerable hedge fund support.¹⁶ The fact that such agreement between RBS and hedge funds might occur should not be seen as a reason to see pressures for a prioritising of shareholder value as diminishing.

In order to succeed, activist hedge funds must have the votes to influence management. What is of importance is the ability of certain investors to have greater voting power relative to others, and the nature of those investors. This is the result of the financialization of both the investors and of the market structure. Most obviously, the ability of the activist hedge funds themselves to use leverage, and the structure of the market that makes such leverage available to them, increases the volume of shares they can buy. Also, innovations in the market increase the influence of the most financialized investors (see discussion of contracts for difference below). Furthermore, what commonly happens in merger situations is that greater volumes of the voting power moves under the control of hedge funds: 'it is quite common to see large volumes of shares being sold by institutional investors to hedge funds after rumours of M&A activity' (Braham et al. 2005). This is not hedge funds following an explicitly activist investment strategy. It includes hedge funds following specific merger strategies, only some of which involve the use of voice, or those following strategies such as long-short equities.¹⁷ In the case of the takeover of Arcelor by Mittal Steel:

[O]ne investment banker ventured that "just about every hedge fund in the UK and the US was in Arcelor" and the successful bet that the steelmaker would agree¹⁸ to the Mittal offer helped offset losses European long-short managers have faced in other markets. (Source: FT.com Hedge Funds face harder time, 28 June 2006.) (Hatchard 2007: 1).

'Every' hedge fund (ignoring the obvious hyperbole) could be involved because of the highly financialized nature of these funds, able to follow a very broad range of

¹⁶ www.independent.co.uk/news/business/comment/jeremy-warners-outlook-hedge-funds-are-royal-bank-of-scotlands-best-friends-best-not-to-get-too-close-447000.html, accessed 3 April 2008.

¹⁷ These are hedge funds that go long one company and short another in a relative value trade. It includes those funds that use the strategy to try to create returns regardless of the performance of the overall market.

¹⁸ More accurately, I would argue, was forced to agree.

investments and with a priority on short term returns, without the restrictions on their investment strategies that are common across other investor types. In a management buyout of DFS, hedge funds were estimated to own about 50 per cent of the free float of the company (Braham et al. 2005). They are also disproportionately influential because of two other aspects of the financialization of the market and of investors: hedge funds are able to utilize, and the financialization of the market ensures the availability of, leverage and a derivative structure called ‘contracts for differences’.

The influence of leverage (borrowing to increase the size of investments) is obvious. A £100 million fund that can borrow nine times its equity can invest enormously more £100 million fund that cannot employ leverage at all.¹⁹ For leverage to be employed, there must be financialization of both the investor, so that investment mandates allow leverage, and of the market, which must be sufficiently financialized for such lending, collateralized on securities bought by the hedge fund, to be available. Leverage can also be the result of the use of derivatives such as futures and contracts for differences.

Contracts for differences (CFDs) are also significant because they allow investors to control voting rights without actually owning the shares. In the case of the proposal to take Telent private, the hedge fund Polygon was able to block the proposal as a result of owning only 10 per cent of the shares, but controlling 23.9 per cent (Hatchard 2007: 1). A CFD is a contract whereby the counterparties agree, at the close of the contract, to pay or receive the difference between the price of the underlying shares at the start and end of the contract. Investors can therefore take both long and short positions in a similar way to a futures contract. They are also similarly a leveraged, margin product allowing a high exposure to the movement in the reference share price with only a small initial outlay. Also significant to their development was the fact that in the United Kingdom they were not subject to stamp duty. Most importantly for this paper, the ‘virtual positions’ (Braham et al 2005) in CFDs allow hedge funds to control voting rights without actually owning the shares. When a hedge fund buys a CFD (i.e., takes a long position in the price

¹⁹ It is not necessarily ten times more because of the need for the fund borrowing to provide collateral in excess of the borrowing.

performance of the underlying equity), the seller (usually an investment bank) will buy shares to hedge (balance) its position. Because the hedge fund retains the economic exposure to the price performance of the shares, the investment bank will vote in line with the hedge fund's wishes. An example of how this can have an impact was the takeover of Alvis:

[I]n June 2004, hedge funds holding a virtual position in Alvis persuaded BAe Systems to announce a competing takeover for Alvis because they were unhappy with the terms being offered by General Dynamics. *Despite not owning the underlying shares in Alvis*, those hedge funds gave Alvis irrevocable commitments to request physical settlement [i.e., to take the shares, not a cash payment] of the CFDs (Braham et al. 2005, my italics).

A similar situation occurred when Philip Green attempted to take over Marks & Spencer. There is an exercise of voice here, but the persuading of BAe Systems depends on the fact that the hedge funds control the voting rights on the Alvis shares. Their control is dependent on their financialization – the hedge funds' ability to use CFDs – and on the financialization of the UK equity market, the existence of CFDs. CFDs are now estimated to account for a third of UK equity market trades (Braham et al. 2005). The result is that 'hedge funds... can have much greater potential voting interest than if they were to pay the full price for the actual underlying shares. As such, their already substantial interest can be increased' (*ibid.*).

There is an additional potential advantage in the use of derivatives such as CFDs in a takeover situation. This lies in non-disclosure. Users of CFDs can acquire substantial shareholdings without having to disclose the fact. The UK Takeover Panel considered this lack of disclosure 'can prejudice targets and bidders' (*ibid.*).

Private Equity

Private equity funds are, in the terms of this paper, the most financialized of the financial market actors considered. Through the use of leverage²⁰ and other financial engineering, the risk they are able to trade is a whole company (the focus in this paper is clearly on private equity's takeover of public companies, not their other activities). They are therefore the least loyal to a company's existing management and strategy, as their business is largely predicated on a change of management control (through a change of ownership) and of strategy. The potential change of management personnel (see Lerner and Gurung 2008: 5) is perhaps the most important reason for private equity influence. As a result, their representative association suggests, '[p]rivate equity has stemmed the tide of shareholder marginalization and genuinely advanced corporate democracy' (Walker 2008). In other words, private equity is the most constraining on existing corporate management autonomy.

There is a debate regarding the extent to which private equity owned companies are able to be more long term in their strategy (e.g., Apax Partners 2006; Lerner and Gurung 2008), but the focus here is on the influence of potential takeover by private equity on existing management prioritizing of shareholder value. It is possible to overstate the influence of private equity, even if the growth has been 'spectacular' (Froud and Williams 2007: 405). In 2003/04, only in the UK did private equity represent over 1 per cent of GDP (Apax Partners 2006: 4). However, their influence, at least prior to the credit crunch, has clearly been significant. This significance is strongly connected to the threat, as much as the reality, of takeover by private equity. The increasing size of their potential bids represents, therefore, a central part of the increasing pressure on the managements of the largest UK companies.

Space precludes a full discussion of the reasons behind the increasing size of these bids, but these reasons are again closely related to increased financialization. The size of the

²⁰ 'Private equity *has* taken advantage of cheap debt over the last few years, and plcs have sometimes neglected shareholders by failing to do so' (Walker 2008).

bids is related to the increasing size of private equity funds, which is in turn the result of other institutional investors' changing investment mandates allowing investment in such funds. In addition, private equity markets have been able to raise increasing amounts of debt to support their bids. General international liquidity conditions and (in particular, US) monetary policy play an important role in this ability, but so does the financialization of the loan market connected to such innovations as credit default swaps and collateralized debt obligations. The rise of private equity is both an influence on, and a result of, increased financialization.

International Investors

A notable feature of ownership of the UK equity market has been the increasing involvement of international investors. In 1963, they owned 7 per cent of UK shares, but by 2004 this had risen to 32 per cent (Mallin 2007: 77). By 2006, this figure was 46 per cent.²¹ International investors therefore owned more than three times as many shares by value as the next largest category of investor, insurance companies. I have argued elsewhere that the type of investor matters more than the domicile (Hardie 2007) – in other words that financialization is of greater importance than internationalization – so a full analysis of the influence of international investors requires knowledge of investor types. As of 2004, European and North American investors held similar volumes of shares (Mallin 2007: 77), while Lacaille (2005) sees between a third and a half of overseas investment in UK equities as coming from North America. Mallin notes that US investors are generally 'more proactive in corporate governance' (*ibid.*), suggesting some foreign investors could increase the limitations on corporate autonomy. However, without more complete data, any analysis of foreign investors must be somewhat tentative.

What can clearly be argued, however, is that international investors have lower loyalty to their holdings of UK equities than their domestic counterparts. They are clearly not subject to the same home bias as UK investors, and have fewer limitations on their ability

²¹ Source: National Statistics Online. Available at www.statistics.gov.uk/statbase/TSDdownload2.asp, accessed 3 April 2008. This source puts the figure for 2004 higher than Mallin, at 42 per cent.

to sell their holdings in the event of management actions they dislike (although a proportion of overseas investors are index trackers [Lacaille 2005]). We should therefore see the increase in international ownership of UK shares as a limitation on UK companies' autonomy, from both a reduced loyalty to existing management relative to UK investors of the same institutional type, and a lower level of loyalty to a continued ownership of shares.

Conclusion

This paper suggests that the financialization of UK equity market investors and the UK equity market structure is serving to increase the constraints on the autonomy of the management of UK companies. This serves to reverse what Zysman (1983) saw as the greater autonomy of companies under a capital markets-based financial system. Higher financialization increases the ability of equity investors to trade risk. This reduces investor loyalty to the shares they hold, by making it easier to move to alternative investments. A simultaneous development has been the reduction in loyalty to the existing management of companies. The reason for this development is similarly the increased ability to trade risk. In the case of pressure on management, this is the result of a number of developments. Pressure on fund managers of all types, including supposedly longer-term pension and insurance funds, is increasingly coming from trustees focused more on short-term performance and willing to change ('trade') fund managers. This translates into a greater focus on short-term shareholder value on the part of fund managers. These fund managers are both more willing to demand that focus from company management, and to sell their holdings, including to hedge funds, highly financialized investors, in the case of takeover situations.

The focus then, of research, as with much of the financialization literature, should be as much on the less prominent changes within capital market-based systems, as much as on the contrast between bank-based and capital markets-based financial systems (for a similar argument in favour of a focus on financialization, see Engelen and Konings 2008). These changes include the loosening of investment mandates, the more short-term

focus of trustees and financial innovation. Importantly, this paper also argues that a disaggregation of the financial market actors involved in equity markets (both as owners and, as with private equity, potential owners), and the changes in the ownership of UK equities, is essential to understanding the changing nature of corporate autonomy and the rise of the focus on short-term shareholder value.

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