



Does institutional activism increase shareholder wealth? Evidence from spillovers on non-target companies[☆]

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ABSTRACT

This paper presents evidence of the shareholder wealth effect of institutional activism using its spillovers on non-target companies. The spillovers are instructive because they are a response to an exogenous shock and thus create an environment to conduct a clean event study. In particular, we examine the spillover effects of the first target announcement of the Korea Corporate Governance Fund. As the very first sign of institutional activism in the country, this announcement creates an expectation of similar governance efforts even in non-target companies, especially in those companies whose governance is currently poorer and thus the scope for future activism is greater. Consistent with institutional activism contributing to shareholder wealth, we find that, among non-targets, those firms granting fewer rights to outside shareholders experience a more positive stock price reaction. Further analysis lends additional support to the positive wealth effect of institutional activism.

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1. Introduction

With their growing presence in financial markets, institutional investors have become the focus of increased academic attention (e.g., Schwartz and Shapiro, 1992; Gompers and Metrick, 2001; Bennett et al., 2003). From the corporate finance perspective, one important issue in understanding the role of institutional investors in the economy is whether institutional activism—i.e., the involvement of institutional investors in firm management—can contribute to shareholder wealth. It might be surprising that this inquiry remains an open question, as theory is inconclusive and existing empirical evidence is mixed without adequately addressing econometric issues such as endogeneity and selection bias (e.g., Karpoff, 2001; Gillan and Starks, 2007).

In this paper, we present evidence of the shareholder wealth effect of institutional activism using its spillovers on non-target companies. Spillovers are instructive in this regard since they constitute a response to an exogenous shock. In other words, they allow for a “clean” event study to be conducted on a random sample that is not pre-selected by any firm conditions or characteristics.¹ In particular, we examine how the stock prices of non-target companies are affected by the first target announcement of the Korea Corporate Governance Fund (hereafter, the Fund). As the Fund follows the strategy of investing in companies whose stocks are discounted due to governance problems and of generating profits by actively addressing those problems without control contests, its target announcement marks the very first sign of institutional activism in the country. More

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¹ See Schultz (2003) or Viswanathan and Wei (2008) for a discussion on “endogenous” events.

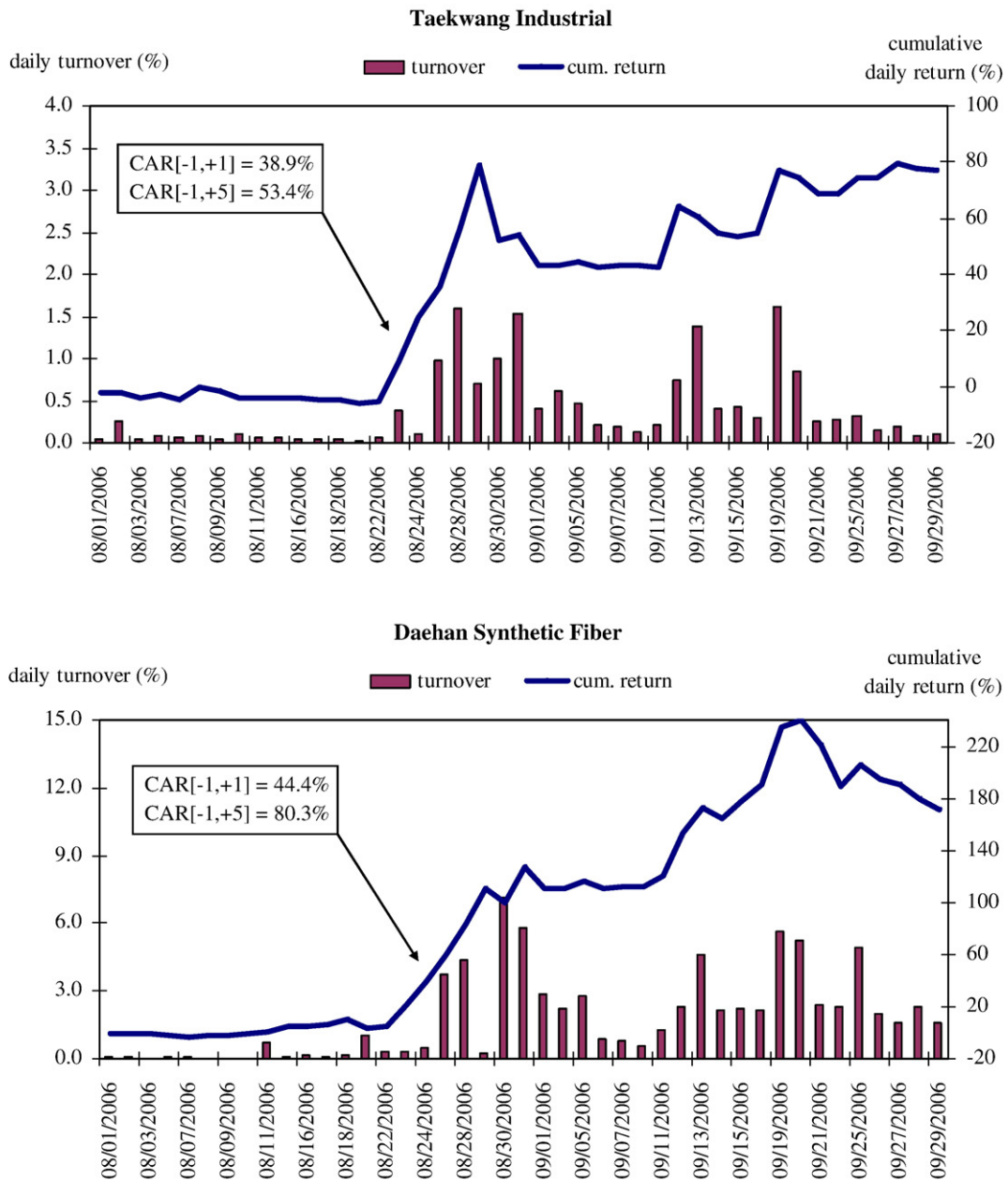


Fig. 1. Daily turnover and compounded stock returns of two firms that are first announced to be the target of Korea Corporate Governance Fund.

importantly, the announcement is made at a time when various governance-related laws and regulations had already been established. Consequently, the announcement creates an expectation that similar activism will be aimed at other companies and, further, the country-level governance provisions will facilitate such firm-level governance efforts.² As the anticipated activism varies from company to company—with those with poorer governance at present being more likely to be a target in the future—the cross-section of the stock price reaction of non-target companies enables us to measure *changes* in shareholder wealth in response to the *changes* in activism, both of which are created by an exogenous shock and measured across a large number of randomly selected companies.

The effectiveness of our setting is highlighted further by the readily identifiable event date and its economic significance, both of which are verified by the daily cumulative stock returns of the two announced targets (Fig. 1). Until the Fund revealed two of its targets on August 23, 2006, their stock prices had remained virtually unchanged, suggesting that the news was completely

² The institutional details of the Fund and the general governance environment of the country are provided in Section 2.2.

unexpected in the market. Upon receiving the news, the market bids up the stocks of the two targets such that their prices almost doubled during the first few days without any sign of subsequent reversal. This enormous impact of the announcement on the targets indicates that its spillover effects are non-negligible and are also measurable over a short period of time.

We find that, among non-target companies, those firms that grant fewer rights to outside shareholders experience a more positive stock price reaction to the announcement. This result is consistent with the existence of gains to outside shareholders from institutional activism, since the companies that are poorly governed at present are more likely to come under disciplinary pressure from institutional investors in the future. We also find that this negative relation between the abnormal return of non-target firms and the quality of their governance is more pronounced in small firms and low-valuation-ratio firms. Since small firms provide weaker investor protection in the Korean market (see, e.g., [Black et al., 2005a, 2006](#)) and greater value is restorable in companies with low stock valuations, this result lends additional support to the positive wealth effect of institutional activism. We also confirm that the results are not attributable to the increased trading volume around the target announcement. In order to demonstrate that we are not merely picking up a general pattern between stock returns and governance, we also examine their relation during non-event windows and find that the negative relation between the abnormal stock return of non-targets and their governance is extremely rare.

We measure the quality of a firm's governance using an index that represents the incidences of nine governance provisions within the company. As detailed in [Section 3.2](#), those provisions are selected so that they can best represent the current extent of expropriation by corporate insiders and thus the room for firm-level activism efforts in the future.³ However, to ensure the robustness of our results, we employ four alternative indices, two of which are based on all nine provisions with different composition methods and the other two on a subset of three provisions. Across the four indices, the negative relation between the abnormal return of non-targets and the quality of their governance remains robust, and this relation continues to be stronger among small firms and low-valuation-ratio firms.

We also confirm our results using different event windows. First, instead of the standard three-day window surrounding the day when the Fund news first appears in newspapers, we employ a seven-day window and obtain virtually identical results. Given the readily identifiable event, these two windows should be long enough to detect the shareholder wealth effect while minimizing the bad model problem ([Fama, 1998](#)). However, it is possible that non-target companies either under- or overreact to the target announcement in these timescales. Hence, we create another alternative event window that spans one more calendar month over the seven-day window.⁴ Even with this longer event window, we are able to find a negative relation between the abnormal return of non-targets and the quality of their governance, particularly in small or low-valuation-ratio firms.

Finally, we examine the effect of the Fund's subsequent target announcements. Interestingly, they convey a somewhat different message to the stock market, since the targets revealed through the subsequent announcements tend to be undervalued companies rather than poorly governed ones. Hence, one might expect that the initial valuation level would play a larger role in explaining the cross-section of non-targets' abnormal return, whereas their governance characteristics would be irrelevant. Such a finding would indicate that our sample stocks show different reactions to different signals, thereby validating them as an effective experimental setting. Indeed, we find this to be the case.

In summary, our results provide strong evidence for a positive shareholder wealth effect of institutional activism. Again, we stress that our analysis draws on the spillovers of institutional activism, which arise in a market whose country-level provisions are already in place but have not yet been properly complemented by the governance efforts aimed at individual companies. That is, the temporary imbalance between country-level and firm-level governance allows the Fund's first target announcement to create spillovers. Ironically, this implies that as more investments are made in firm-level governance, it becomes more difficult to conduct a powerful test for activism. This notion helps explain why the empirical evidence for institutional activism in the U.S. market is weak (e.g., [Karpoff, 2001](#); [Gillan and Starks, 2007](#)). As firm-level investments in governance are fully supported by various country-level investor protection schemes in that market (e.g., [Aggarwal et al., in press](#)), the benefits from giving more rights to minority shareholders are likely to be already capitalized into stock prices. Consequently, it is difficult to identify an event upon which an expectation about minority shareholder protection changes significantly.⁵

This paper proceeds as follows. In the next section, we provide a detailed review of the related literature as well as the institutional background of the Fund and the governance environment of Korea. We also formalize the testing hypotheses at the end of this section. [Section 3](#) describes the sample and data, and [Section 4](#) provides the empirical results. Finally, [Section 5](#) concludes the paper.

2. Background and testing hypotheses

In this section, we first review the existing studies on institutional activism and discuss their limitations in documenting the shareholder wealth effect of activism. We then introduce our experimental setting and explain how it allows for a more powerful test. Finally, we develop our testing hypotheses.

³ In doing so, we take into consideration the fact that certain features of a firm's governance are not subject to change, as they are determined by external conditions, such as being in a certain industry or country. Other studies also acknowledge this point. They include: [Gillan et al. \(2003\)](#), [Lehn et al. \(2005\)](#), [Boone et al. \(2006\)](#), [Hermalin and Weisbach \(2006\)](#), [Coles et al. \(2008\)](#), and [Linck et al. \(2007\)](#). Country-level studies also reach the same conclusion. See, e.g., [Doidge et al. \(2007\)](#) and the references therein.

⁴ A political event that occurred in early October 2006—i.e., the nuclear missile tests of North Korea—makes it difficult to extend the event window further.

⁵ See also [Edmans et al. \(2008\)](#) for such feedback loops.

2.1. Prior studies on institutional activism and its shareholder wealth effect

Shareholder activism led by institutions has received enormous academic attention since its inception in the mid 1980s. While prior studies have examined various effects of institutional activism on the target companies, including accounting performance and governance structure, the shareholder wealth effect remains the focal point of this literature due to its direct correspondence to the axiomatic corporate goal, namely, shareholder value maximization. In particular, the short-term wealth effect in the event study setting has been extensively examined since it mitigates endogeneity and other estimation problems (see, e.g., [Gompers et al., 2003](#); p.108). However, it is indeed surprising that existing empirical studies have yet to provide a conclusive answer to the question of whether institutional activism increases shareholder wealth. A succinct assessment of this literature by [Gillan and Starks \(2007\)](#) is that “[t]he evidence provided by empirical studies of the effects of shareholder activism is mixed” (p.35).⁶

For example, [Smith \(1996\)](#) examines the effects of activism by the California Public Employees Retirement System (CalPERS), and finds no stock price reaction to the target announcement for the entire sample, but a significantly positive (negative) stock price reaction for the ex-post determined successful (unsuccessful) activism efforts. [Wahal \(1996\)](#) studies nine major institutions including CalPERS, and finds no significant announcement return for the full sample. As in [Smith \(1996\)](#), a positive announcement return is found only in the sub-sample for which activism does not involve shareholder proposals but is implemented through private negotiation. No-results for shareholder proposals are further confirmed by other studies, including [Karpoff et al. \(1996\)](#), [Del Guercio and Hawkins \(1999\)](#), and [Gillan and Starks \(2000\)](#).

Unlike the shareholder proposals, private negotiations appear to be positively welcomed by the stock market. Among others, [Strickland et al. \(1996\)](#) report a positive return at the time of the announcement of a negotiated agreement between activist investors and the target company. However, the magnitude is rather small, and is estimated to be only 0.9%. [Carleton et al. \(1998\)](#) find that, of their 45 sample events, 71% received private negotiation and only 29% went through public shareholder proposals, casting doubt on whether the results based on shareholder proposals are representative of the shareholder wealth effect of institutional activism. However, unlike [Strickland et al. \(1996\)](#), [Carleton et al. \(1998\)](#) do not find a consistently positive announcement return; rather, it varies depending on the type of targeted governance issues. [Prevost and Rao \(2000\)](#) posit that shareholder proposals are an implicit signal that private negotiations failed, which should then be associated with a negative abnormal stock return; they confirm this prediction empirically.

On the long-term side, [Smith \(1996\)](#) reports a positive long-run stock performance of the target company, and a clearer long-run result is found in [Nesbitt \(1994\)](#) who reports a more than 40% abnormal stock return over the five-year period after becoming the target. This result, however, is in sharp contrast with [Del Guercio and Hawkins \(1999\)](#) who report no positive abnormal return over the three-year period after being the target. It is also obvious that these long-run results are inevitably subject to the bad-model problem ([Fama, 1998](#)).

As [Karpoff \(2001\)](#) points out, all the short-term event studies suffer from ambiguity of the true event date when the news of activism first arrives in the market. In addition, shareholder proposals and private negotiations are received differently by the stock market, contributing to discrepancies in existing empirical results. [English et al. \(2004\)](#) therefore use the announcement of the CalPERS annual target list in the *Wall Street Journal*, which the authors claim resolves the two problems. Although they report a significant positive announcement return, the magnitude is smaller than 1%. (Besides, they fail to find any long-term positive effects on shareholder wealth.) In summary, the literature is plagued with the inconclusiveness of empirical evidence for a positive shareholder wealth effect of institutional activism.

Several recent studies provide stronger evidence that addresses these estimation issues more carefully. In particular, these studies pay attention to the 13D filings by activist blockholders like hedge funds, which make a relatively unambiguous event and also encompass both (actually all) types of activism (e.g., [Klein and Zur, 2006](#); [Brav et al., 2007](#)). While these studies report a positive announcement return consistent with the positive wealth effect of institutional activism, one problem with their results is the self-selection bias that the event itself is “driven by contemporaneous conditions at the firm” ([Gompers et al., 2003](#); p.108). In other words, the event arises endogenously so that the sample of event firms is not random but pre-selected. Such a sample would generate a biased result for which the causality would be difficult to determine. Another problem is that this event is still subject to information leakage. As an illustration, these studies typically employ an event window starting 20 days ([Brav et al., 2007](#)) or 30 days ([Bethel et al., 1998](#); [Klein and Zur, 2006](#)) before the filing date. In fact, the two problems are intertwined, since a long event window due to potential information leakage actually exacerbates the endogeneity issue embedded in a pre-selected sample.

Hence, two critical conditions for a cleaner event study emerge. First, the event should be as unexpected as possible, so that the changes in shareholder wealth measured over a short period around the event can be correctly attributed to the event alone. Second, and more important, the event should be exogenous, so that the changes in shareholder wealth are observed in an unbiased sample of companies that are not pre-conditioned by certain characteristics. In the next sub-section, we detail our experimental setting with particular attention to how it satisfies these conditions.

2.2. Korea Corporate Governance Fund and the governance environment in Korea

The Fund was first launched in April 2006 with the explicit strategy of investing in Korean companies whose stocks are discounted due to governance problems. The Fund clearly states its intention to actively address the governance problems in the

⁶ Other survey papers echo the same conclusion. They include [Black \(1998\)](#), [Karpoff \(2001\)](#), [Romano \(2001\)](#), [Barber \(2006\)](#), and [Del Guercio et al. \(2006\)](#).

target companies, and to profit from the subsequent restoration of their stock prices. However, it is also made clear that the Fund will do so only by exercising the rights entitled to minority shareholders without any attempt to take over the target companies. In a nutshell, the Fund epitomizes the institutional activism focusing on firm-level governance issues.

However, the Fund was not visible in the Korean stock market until its first target announcement in August 2006. In fact, the Fund appears to have intentionally maintained a low profile. This is supported by the manner in which it accumulated the shares of one of its target companies (Daehan Synthetic Fiber). According to the disclosure document filed with the regulatory agency, the Fund bought the shares of this target beginning April 2006 through as many as 34 open market purchases. It is also remarkable that although there were two open market purchases even in August 2006 (one on the 16th and the other on the 17th), neither the trading volume nor the stock price of the target company changed (see Fig. 1).

The Fund's targeting of this company was known to the market through the mandatory disclosure for a 5% beneficiary ownership (Korean equivalent to the 13D filing), which was filed on August 23, 2006, in compliance with the five-business-day rule after the triggering event on the 16th.⁷ This news did not arrive in the market as an ordinary 13D filing: it was immediately splashed in headlines across the media. For example, *Chosun Daily*, the Korean newspaper with the largest readership reported the news on the front page of its business/economy section on August 24, 2006. Approximately two-thirds of this page (excluding advertisements) was devoted to the Fund news. Similarly, an economy newspaper (*Hankook Economy Daily*) reported this event on the front page (spending approximately one-quarter of the space) and supplemented its coverage on page 3, approximately one-half of which was allotted to the Fund news. The stock price and trading volume shown in Fig. 1 aptly demonstrate that the news came as a complete surprise and had enormous economic significance.

Another target company, Taekwang Industrial, was not disclosed through a 13D filing. However, due to its close relationship with Daehan Synthetic Fiber through cross-holdings (the former is the parent company of the latter), the stock market immediately considered Taekwang to be the Fund's target *de facto*; and the Fund confirmed this speculation right away. Like the other target, the trading volume and stock price pattern of Taekwang during August and September 2006 (also shown in Fig. 1) clearly shows that our event is readily identified without any sign of leakage, thereby satisfying one of the conditions for a clean event study.

The Fund's target announcement also meets the second condition thanks to its potential for spillover effects. To understand this, note that the Fund is the country's very first sign of genuine institutional activism, which arises amid the significant improvement in, but underutilization of, governance provisions at the country level. After the 1997 financial crisis, Korea had embarked on a massive campaign to improve the corporate governance practices that have often been blamed for having caused the crisis (Johnson et al., 2000). Various laws and regulations had been introduced since then, and by the mid 2000s, the country-level governance provisions were well established.⁸ However, the utilization of those provisions by outside investors aimed at individual companies has been virtually non-existent.

As Gillan and Starks (2003), Doidge et al. (2007), Aggarwal et al. (in press), and many other scholars recognize, country-level and firm-level governance oversights are complementary. That is, the ability of outside shareholders to monitor firm management is both constrained and facilitated by the legal and regulatory environment of the country.⁹ Consequently, the target announcement of the Fund is an indication that the time is ripe for investing more in firm-level governance and, in cooperation with the country-level governance provisions, such investments can make a meaningful change to the governance practices of target companies. This implication is relevant for non-target companies (as well as for the announced targets, of course), especially for those firms whose governance is poorer at present.¹⁰ Since the target announcement is an exogenous shock to non-target companies, these “non-event” firms constitute a sample that is not pre-selected by any firm conditions or characteristics, thereby satisfying the second condition.

One related observation is that, prior to the Fund, the country had seen an earlier activism effort led by a non-government organization, namely, the People's Solidarity for Participatory Democracy (PSPD). While this movement may be viewed as the first instance of shareholder activism in the country, it is important to note that its emphasis was on corporate social responsibilities of the large business groups or *chaebols* (Choi and Cho, 2003). In addition, when this organization was founded in 1994 and began its campaign in earnest in 1997, the country-level governance system was still incipient and thus could not provide the necessary support. All in all, this activism effort is judged to have been a limited success (Choi and Cho, 2003). These features of the PSPD are

⁷ Unlike the U.S. in which two different filing forms exist—i.e., 13D and 13G (see, e.g., Bethel et al., 1998), only one type of filing document is used in Korea. Using that form, the filers self-select by detailing their intention to purchase the block ownership. Of course, the Fund made clear its plan to be actively involved in firm management.

⁸ See, e.g., FKI (2006) for details of these provisions. To cite a few examples, laws now require that all listed companies fill one-half (or one-quarter, depending on firm size) of the Board with outsiders and, for large firms, a separate audit committee needs to be set up. The cumulative voting system has been in place since 1998, although companies can individually opt out. In nominating an auditor, the controlling shareholders can only exercise their voting rights up to 3%, and anyone with 1% ownership can recommend an outside director. A class-action suit can be initiated by a group of as few as 50 investors with a collective ownership of 0.01%. Finally, combined financial statements are mandatory for large business groups.

⁹ There is a growing literature documenting the complementary relationship between country-level and firm-level governance provisions (e.g., Klapper and Love, 2004; Durnev and Kim, 2005; Francis et al., 2005). The rationale is that the country-level environment determines the costs and benefits of firm-level investment in governance, and that only those companies in a good environment find it profitable to expend resources to improve governance. Such environment includes the accounting and disclosure system in the country (Ball, 2001; Black, 2001) and the general financial market development (Doidge et al., 2007). These studies generally treat the cross-country difference in governance as exogenously given and instead focus on its implication for individual companies' governance policy. See also Bergman and Nicolaievsky (2007) for a theoretical work.

¹⁰ An analogy is that the first American Depositary Receipt (ADR) program from a country is frequently viewed as the country's financial market opening event, since other firms are expected to follow suit and thus make the country itself financially integrated with other countries. See, e.g., Bekaert and Harvey (2000).

in stark contrast with the Fund whose intention is to maximize shareholder wealth. The massive announcement return accruing to the targets also attests to a substantial gain to outside shareholders from the Fund's involvement in firm management, further illustrating the uniqueness of the Fund.

Interestingly, the Fund was founded by some of the local governance experts who were once involved in the PSPD campaign. Hence, although the Fund is technically a foreign fund that is managed by Lazard Asset Management and is headquartered in Ireland, it distances itself from ordinary foreign investors who suffer from informational disadvantages (e.g., Kang and Stulz, 1997; Brennan and Cao, 1997). In addition, the Fund has been identified with those local governance experts from the beginning and thus earned its credibility as a governance-oriented investment vehicle.¹¹ These observations explain why this small fund with only 72 billion Korean won (as of June 30, 2006) could serve as the harbinger of a new governance environment. Given the size of Korean companies—e.g., the then median market capitalization in the Korean Stock Exchange was 88 billion Korean won—, an ordinary fund of this size would not have been able to create a spillover effect.¹²

2.3. Testing hypotheses

Our experimental setting enables us to associate *changes* in shareholder wealth with *changes* in activism. To demonstrate this, we begin by expressing the market value of a company's common stock, V , as follows:

$$V = V_0 + P_{IA}V_{IA},$$

where P_{IA} is the probability of the company becoming a target of institutional activism, and V_{IA} is the gains from being a target. Hence, without any sign of activism in the country (i.e., prior to the Fund's first target announcement), V_0 is the stock price of non-target companies, and their abnormal stock return at the time of the target announcement, or changes in shareholder wealth, is:

$$AR = P_{IA}V_{IA}.$$

Since activists will focus on companies from which they can make profits, the probability of being a target will be significantly (but not necessarily completely) affected by the potential gains from being a target.

In our setting, changes in activism are measured by the current quality of governance. This is because companies whose current governance system is poorer are more likely to be targeted by institutional activists in the future. Consequently, a causal relationship between activism and shareholder wealth—i.e., an increased level of activism results in a higher stock price—implies that a more positive abnormal return will accrue to the companies with a poorer governance system.

An alternative story is that V_{IA} is not a governance-related discount but an undervaluation attributable to some other factors. That is, the Fund is in fact a stock-picker like an actively managed mutual fund. If this were the case, then V_0 alone will be able to explain the gain. We are not arguing that low- V_0 stocks are undervalued in absolute terms. We only conjecture that investors tend to perceive stocks with a lower valuation to be relatively more undervalued than those with a higher valuation.¹³ Temporarily ignoring P_{IA} , we summarize the first testing hypothesis as follows:

H1. There will be a negative relation between the abnormal stock return of non-target companies and the quality of their governance structure, even after controlling for V_0 .

We now consider the role of P_{IA} . Since small firms are more poorly governed in the Korean market (e.g., Black et al., 2005a, 2006), they are more likely to be the target of future activism. Additionally, since companies with lower stock valuation at present offer greater room for future price increases, a valuation measure like the market-to-book ratio can also help identify the targets of future institutional activism. Based on this discussion, we derive our second testing hypothesis:

H2-1. The hypothesized negative relation between the abnormal stock return of non-target companies and the quality of their governance structure (after controlling for V_0) will be more pronounced among small firms rather than among large firms.

H2-2. In addition, such negative relation will be more pronounced among low-valuation-ratio stocks rather than among high-valuation-ratio stocks.

Besides firm size and valuation ratio, one may also wish to consider ownership concentration to further identify future targets of activism. Recall, however, that the Fund plans to achieve its goals by exercising the rights entitled to minority shareholders and has no intention of taking over the target. In other words, a highly concentrated ownership will not be an effective deterrent to institutional activism. In accordance with this notion, the controlling shareholders of the two announced target firms are observed to hold as much as 70% of the company ownership.

¹¹ See, e.g., the "Activist Investors" series in the *Financial Times*, May 24, 2007, page 18.

¹² Although the Fund increased in size later, it remained relatively small. For example, assets under its management grew to 149 billion Korean won toward the end of October 2006. Hence, the size of the Fund cannot explain the spillover effects.

¹³ Since some scaling is necessary for cross-sectional comparisons, the later empirical analysis uses a valuation ratio, such as market-to-book ratio, in place of V_0 .

3. Sample and data

3.1. Sample

To construct the sample, we begin with all stocks listed on the Korean Stock Exchange (KSE). We then require their governance information, daily stock returns, and accounting data to be available. The governance information is provided by the Korea Corporate Governance Services (KCGS), a non-profit organization that has compiled the governance information for all Korean companies on the KSE at annual frequency since 2002.¹⁴ Stock return and accounting data are from the *FnGuide*, a Korean financial data provider. Of the 718 firms on the KSE with valid stock return and accounting data, 660 companies have the governance data, and they account for approximately 97.5% of the market capitalization of the 718 companies. Hence, requiring the KCGS data is not a costly constraint in constructing the sample. After excluding companies whose book value of equity is negative (since they are mostly distressed firms), the final sample comprises 639 firms. In the later analysis, we employ a subset of 587 non-financial companies to ensure the robustness of our results. Note that the two targets revealed through the announcement in August 2006 are excluded from our sample.

3.2. Governance index

As detailed in Section 2, the empirical strategy of this paper is to use the *current* governance characteristics of a company as an *inverse* measure of *future* activism efforts aimed at the company. Almost tautologically, it is on the grounds that activist investors can restore more value by improving governance especially when there are governance problems. Hence, our approach requires those governance problems to be “fixable” by investors with a minority stake. We thus carefully review and select governance provisions that most accurately represent the magnitude of expropriation by corporate insiders and are, at the same time, subjected to the disciplinary pressure from activist investors. Below we detail those provisions and the way they are aggregated into our governance index.

First, we consider various aspects of the board of directors, since activist investors typically influence firm management through their presence on the board. Specifically, to describe the current board structure and gauge room for future activism, we examine: (1) whether the board is *not* staggered; (2) whether a director has been elected by minority shareholders or whether an outsider director has ever expressed an opposing or different view during the board meetings; (3) whether the number of outside directors is greater than what is required; and (4) whether there is a foreign director. Note that the second provision includes two governance characteristics, since they are the same in spirit and separately there are too few incidences.

Second, we consider the firm-level disclosure practices, since various expropriation schemes are made possible by the informational opacity or asymmetry between corporate insiders and outside investors. Consequently, corporate transparency serves as an important commitment device (e.g., [Durnev and Kim, 2005](#)). Specifically, we examine: (1) whether the company voluntarily complies with the international accounting standards or provides certain disclosure documents—such as audit reports—in English; and (2) whether the company voluntarily makes available the governance evaluation results or the differences from the suggested practices on its web-page. Again, each of the disclosure provisions consists of two similar characteristics.

Third, we consider the payout practices, since they determine the amount of corporate resources in the hands of corporate insiders. [La Porta et al. \(2000\)](#), for example, show that poorly governed companies pay out less to minority shareholders, leaving more funds under the discretion of self-interested controlling shareholders. Consistent with this finding, [Pinkowitz et al. \(2006\)](#) find that dividends contribute more to minority shareholders' wealth in countries with poorer corporate governance than in countries with better governance.¹⁵ Specifically, we examine: (1) whether the dividend yield is greater than 3%; (2) whether the payout ratio over the past three years is greater than 30%; and (3) whether there has ever been an interim dividend payment.¹⁶

Firm-level information about these governance characteristics is provided by KCGS with a particular score attached. For example, companies complying with the international accounting standards are given two points, and zero otherwise. To construct our governance index, however, we count only the existence of those characteristics within the company. The frequency of those nine provisions in our sample is reported in Panel A of [Table 1](#). A non-staggered board is most frequently found in 204 of the 639 sample firms, whereas the interim dividend (either semi-annual or quarterly) is at the other extreme, appearing only in 18 companies. Not surprisingly, most of the governance provisions are positively correlated with each other (Panel B).

Since we count the existence of the nine provisions, the resultant index can have a value from zero to nine. As shown in Panel C, however, very few companies have more than three or four governance provisions. We thus construct the index by winsorizing at three. Of course, this four-value index is far from being a perfect description of how well a company is governed. Yet, [Table 2](#) shows that this simple index is still highly correlated with stock valuation and other firm characteristics known to be related to governance, such as firm size and foreign ownership (see, e.g., [Black et al., 2005a, 2006](#); [Black et al., 2005b](#); [Leuz et al., 2006](#)).

¹⁴ For more information, we refer the reader to KCGS's web-page: <http://www.cgs.or.kr/eng/index.asp>.

¹⁵ As in those studies, we control for growth opportunities to correctly use the payout practices as a governance proxy.

¹⁶ The original governance data categorize companies into four groups based on dividend yield (below 1%; between 1 and 3%; between 3 and 5%; and above 5%), and into three groups based on payout ratio (below 10%; between 10 and 30%; and above 30%). We choose the particular cutoffs to ensure that a meaningful number of firms are identified as payers and, at the same time, their payments are not trivial. As shown in [Table 1](#) (Panel A), approximately a quarter of the sample firms are identified as payers. The later robustness check, however, uses the original data with finer categorization.

Table 1

Firm characteristics comprising governance index.

Panel A. Firm characteristics comprising governance index								
Governance characteristics								# of firms (%)
1. Non-staggered board								204 (31.9%)
2. Directors elected by minority shareholders/directors with an opposing or different view								29 (4.5%)
3. More outside directors than required								185 (29.0%)
4. Foreign directors								68 (10.6%)
5. Compliance with international accounting standards/corporate disclosure in English								51 (8.0%)
6. Governance evaluation results publicly available								32 (5.0%)
7. Dividend yield greater than 3 percent%								165 (25.8%)
8. Payout ratio greater than 30%								156 (24.4%)
9. Paying interim dividends								18 (2.8%)
Panel B. Correlation coefficient between governance characteristics								
	1	2	3	4	5	6	7	8
2	−0.020 (0.609)							
3	−0.008 (0.843)	0.292 (0.000)						
4	0.003 (0.936)	0.120 (0.002)	0.104 (0.008)					
5	0.021 (0.591)	0.407 (0.000)	0.309 (0.000)	0.179 (0.000)				
6	−0.065 (0.101)	0.501 (0.000)	0.265 (0.000)	0.130 (0.001)	0.303 (0.000)			
7	−0.013 (0.746)	0.009 (0.825)	−0.022 (0.582)	0.052 (0.194)	0.011 (0.782)	−0.037 (0.349)		
8	−0.038 (0.344)	0.034 (0.396)	0.007 (0.866)	0.170 (0.000)	0.088 (0.026)	0.070 (0.077)	0.297 (0.000)	
9	0.025 (0.521)	0.190 (0.000)	0.100 (0.012)	0.187 (0.000)	0.159 (0.000)	0.091 (0.021)	0.137 (0.001)	0.079 (0.045)
Panel C. Frequency of governance characteristics								
Incidences	# of firms				% of sample			
0	177				27.70%			
1	193				30.20%			
2	163				25.51%			
3	66				10.33%			
4	25				3.91%			
5	7				1.10%			
6	3				0.47%			
7	3				0.47%			
8	1				0.16%			
9	1				0.16%			
3–9	106				16.59%			

This table reports firm characteristics comprising the governance index and their frequency in the sample. Their information is obtained from Korea Corporate Governance Services (KCGS; 2005 edition).

We also stress that the paucity of companies with more than three or four provisions is not an indication of the irrelevance of our nine provisions. Rather, the observed frequency distribution of those provisions is consistent with the limited investment by Korean companies in their internal, firm-level governance, which is the very reason for the spillover effects. To ensure the robustness of our results, however, later robustness checks employ four alternative indices, two of which are based on all nine provisions (either using their original scores assigned by KCGS in log transformation, or not winsorizing their incidences at three), and the other two on a subset of three provisions that are ex ante considered to be more important. Our view is that, as long as our governance indices represent some—if not all—aspects of a firm's governance, the finding of a negative relationship between those indices and the abnormal return constitutes evidence that more poorly governed companies, at least in some dimensions, experience a more positive stock price reaction to the Fund target announcement.

3.3. Control variables

Table 2 also provides the summary statistics of the firm characteristics that we use as control variables. In terms of the market capitalization as of August 22, 2006 (i.e., immediately before the event window), the sample is broad-based, covering both small companies whose market capitalizations are below 10 billion Korean won and large companies with market capitalization greater than 10 trillion Korean won. We also note that most variables contain extreme values (e.g., a market-to-book ratio of 38). The

Table 2

Summary statistics of control variables and correlation with governance index.

	<i>n</i>	Mean	Std	Min	<i>p</i> 1	<i>q</i> 1	Med	<i>q</i> 3	<i>p</i> 99	Max
<i>Mcap</i> (1)	639	977	4989	8	9	36	86	318	15,836	108,260
<i>MBR</i> (2)	639	1.3	2.0	0.1	0.2	0.5	0.8	1.5	6.8	38.0
<i>Leverage</i> (3)	639	47.2	20.8	1.7	7.4	31.5	46.9	62.3	94.3	99.3
<i>CashFlow</i> (4)	639	3.8	21.3	−460.3	−38.2	1.8	5.2	9.7	26.1	43.2
<i>ForOwn</i> (5)	639	12.7	17.0	0.0	0.0	0.4	5.1	20.1	69.2	87.1
<i>LiqAsset</i> (6)	587	5.9	6.7	0.0	0.1	1.4	3.8	8.0	31.4	52.9
Correlations between control variables and governance index										
	(1)*	(2)*,**	(3)**	(4)**	(5)**	(6)**				
<i>Gidx</i> [0,3]	0.412 (0.000)	0.080 (0.044)	0.022 (0.576)	0.164 (0.000)	0.371 (0.000)	−0.018 (0.667)				

This table reports summary statistics of the control variables used in the empirical analysis. *Mcap* is the market capitalization in billions of Korean Won as of August 22, 2006 (immediately before the event window). *MBR* is the market-to-book rate as of the end of the second quarter of year 2006. *Leverage* is the percentage of total debt in total asset for fiscal year 2006. *CashFlow* is the percentage of the sum of (earnings before interests and taxes and depreciation) in total asset for fiscal year 2006. *ForOwn* is the percentage of foreign ownership as of the end of the second quarter of year 2006. *LiqAsset* is the percentage of cash and cash equivalents in total assets for fiscal year 2006. All data are from *FnGuide*. *Gidx*[0,3] is the governance index composed of 9 provisions (# of incidences and winsorized at 3). The original data for the individual governance provisions are from the Korea Corporate Governance Services (KCGS).

*in the second panel indicates that the variable is in log, while ** indicates that the variable is winsorized at 1st and 99th percentiles.

subsequent analysis thus uses their winsorized values at the 1 and 99 percentiles. In an unreported result, we found that the sample companies are distributed over 23 industries including the banking sector. There are 81 chemical companies (largest proportion), 65 electronics companies (second largest), and so forth. The later regression analysis controls for an industry effect by using a 0/1 dummy variable for each of those 23 industries. As mentioned earlier, we also examine a sub-sample from which financial firms are excluded.

4. Empirical results

4.1. Abnormal stock return of non-targets around the Fund's first target announcement

For each of our sample stocks, we estimate the abnormal return surrounding the Fund's first target announcement by estimating the OLS market model. Specifically, the abnormal return of a stock on an event day *t* is the difference between its day-*t* return minus $(\hat{\alpha} + \hat{\beta} \times R_{mkt,t})$, where $\hat{\alpha}$ and $\hat{\beta}$ are the estimated coefficients of the market model and $R_{mkt,t}$ is the day-*t* return on the market index (KOSPI). The estimation period is from January 1, 2005 to August 22, 2006, and we use the first newspaper day, namely, August 24, 2006, as day zero to construct the event windows.

The first panel of Table 3 reports the summary statistics of the daily returns of the sample stocks and the market index. For individual stock returns, we report both the cross-sectional averages of the individual summary statistics and the time-series averages of the cross-sectional summary statistics. We report both in order to facilitate the comparisons with the market index return and with the abnormal returns of individual stocks. Compared with the daily market index returns that are distributed between −3.5 and +3.5% during the estimation period, the daily individual returns have a much wider range from −11.5 to +13.7%. In cross-section, they are similarly distributed with a slightly larger dispersion between −13.4 and +15.4% with an average return of 0.18%.

These cross-sectional summary statistics put into perspective the daily abnormal returns whose summary statistics are reported in the second panel (from August 23, 2006 to August 31, 2006). Both on the filing day (*D* − 1) and on the first newspaper day (*D* = 0), the cross-sectional average of the daily abnormal returns is above 0.5% and is therefore much larger than the typical daily stock return (0.18%). This impact appears to stabilize the next day (*D* + 1) towards the end of the month, although the abnormal returns later pick up at times. It thus seems natural to focus on three trading days over the [−1, +1] window for the main analysis.¹⁷

The cumulative abnormal return over this three-day window is as large as 1.12% on average with a standard deviation of 4.22%, which is consistent with the overall positive impact of the Fund's announcement on non-target companies. Note, however, that this implication is based on an equally weighted average of individual abnormal returns. In an unreported result, we found no meaningful changes in the value-weighted market index, indicating that most of the impact is concentrated on small stocks. It also suggests that the larger abnormal return accruing to small stocks is not attributable to their greater sensitivity to some market-wide shocks, since such shocks would be observable in a value-weighted market index.¹⁸

¹⁷ As a robustness check, we explore two more event windows, namely, the [−1, +5] and [−1, +26] windows. As mentioned earlier, the latter window ends in September 2006 due to a market-destabilizing political event in early October (i.e., the nuclear missile tests of North Korea).

¹⁸ We also confirmed that no global shocks occurred around our event days, as we found no unexpected changes in the market indices of neighboring countries such as China, Japan, or Hong Kong.

Table 3

Summary statistics of daily stock returns and abnormal stock returns around the Fund's first target announcement.

	<i>n</i>	Mean	Std	Min	<i>p</i> 1	<i>q</i> 1	Med	<i>q</i> 3	<i>p</i> 99	Max
Market index return	408 (days)	0.10	1.16	−3.45	−2.82	−0.47	0.19	0.81	2.60	3.51
Individual stock return	408 (days)	0.18	3.20	−11.48	−7.56	−1.49	0.00	1.55	10.21	13.74
	639 (stocks)	0.18	3.12	−13.43	−7.05	−1.40	−0.08	1.37	12.13	15.43
AR [D − 1]	639	0.52	2.60	−14.77	−5.00	−0.72	0.18	1.39	10.44	15.41
AR [D − 0]	639	0.57	2.52	−11.20	−4.44	−0.64	0.28	1.31	9.85	16.02
AR [D + 1]	639	0.03	2.29	−8.22	−4.76	−1.22	−0.20	0.90	6.77	14.50
AR [D + 2]	639	0.20	2.49	−9.24	−5.58	−0.98	−0.02	0.89	8.90	14.77
AR [D + 3]	639	0.10	2.95	−16.05	−7.08	−1.28	−0.40	1.09	13.37	13.98
AR [D + 4]	639	0.62	2.70	−14.74	−4.72	−0.78	0.25	1.64	8.52	14.85
AR [D + 5]	639	0.56	2.53	−7.93	−4.35	−0.84	0.14	1.51	10.61	14.57
CAR [−1, +1]	639	1.12	4.22	−14.05	−7.61	−1.10	0.60	2.59	15.49	28.09

This table reports summary statistics of daily returns of our sample stocks and the market index (KOSPI) during the estimation period (from January 1, 2005 to August 22, 2006; 408 days). The summary statistics of the daily returns of the sample stocks are either first estimated for an individual stock and then averaged across all the 639 sample stocks (second line), or first estimated cross-sectionally and then averaged over the 408 trading days (third line). This table also reports the summary statistics of the daily abnormal stock return from August 23, 2006 to August 31, 2006, and the 3-day cumulative abnormal stock return over the [−1, +1] window surrounding August 24, 2006 (the first newspaper day). The abnormal return of a stock on day *t* is the difference between its day-*t* return minus ($\hat{\alpha} + \hat{\beta} \times R_{mkt,t}$), where $\hat{\alpha}$ and $\hat{\beta}$ are the estimated coefficients of the OLS market model during the estimation period, and $R_{mkt,t}$ is the day-*t* return on the market index (KOSPI).

4.2. Cross-section of non-targets' abnormal returns — univariate test of the first hypothesis

We begin our tests by examining the three-day cumulative abnormal return (CAR) by the governance index values. Of course, it is necessary to control for other firm characteristics before we attribute the abnormal stock return to governance. However, given that most firm characteristics are highly correlated with each other, it is instructive to begin with the univariate relation between the two.

Table 4 (Panel A) reports the three-day CAR for each of the governance index-sorted sub-samples. Consistent with our hypothesis, the abnormal return is the greatest for companies with the lowest governance index value. The three-day CAR is on average 1.92% for this sub-sample, and decreases with index value, albeit not strictly monotonically. More precisely, the two sub-samples in the middle have the statistically significant three-day CARs of 1.00 and 1.18%, respectively, whereas the fourth sub-sample with the highest governance index value has an insignificant CAR of −0.08%. To prevent a few extreme values from affecting our inferences, we exclude the CARs with absolute values in excess of 10% and then redo the analysis. As shown in Panel B, the inverse relationship between the abnormal return of non-target companies and their governance quality remains robust.

4.3. Cross-section of non-targets' abnormal returns — multivariate test of the first hypothesis

To correctly isolate the effect of governance on the abnormal stock return, we estimate the following cross-sectional regression:

$$CAR_i = \sum_{j=1}^J \alpha_j + \beta_1 Mcap_i + \beta_2 MBR_i + \beta_3 Gidx_i + \sum_{k=1}^K \gamma_k X_k + \varepsilon_i, \quad (1)$$

where **CAR** is the cumulative abnormal return during the event window of [−1, +1] around the first newspaper day (August 24, 2006), **Mcap** is the natural log of the market capitalization as of August 22, 2006 (i.e., immediately before the event window), **MBR** is the natural log of the market-to-book ratio (which is winsorized at the 1st and 99th percentiles) as of the end of the most recent quarter prior to the event, **Gidx** is one of our governance indices, and **X** includes other control variables such as: **BGroup** or the 0/1

Table 4

Cumulative abnormal returns over [−1, +1] by governance index value.

<i>Gidx</i> [0,3]	<i>n</i>	Mean	Std	[<i>t</i> -stat]	Min	Max
Panel A. Using the full sample of 639 CARs						
0	177	1.92	5.38	[4.74]	−12.56	28.09
1	193	1.00	4.08	[3.41]	−14.05	20.99
2	163	1.18	3.45	[4.36]	−6.95	14.22
3	106	−0.08	2.86	[−0.27]	−7.80	12.16
Panel B. Excluding CARs greater than 10% or smaller than −10%						
0	165	1.31	3.44	[4.89]	−9.89	9.48
1	184	0.54	2.94	[2.47]	−7.61	9.08
2	157	0.78	2.83	[3.47]	−6.95	8.65
3	105	−0.19	2.61	[−0.75]	−7.80	9.00

This table reports the cumulative abnormal stock return over the [−1, +1] window around August 24, 2006 (the first newspaper day) by governance index value.

Table 5Cross-sectional regression of CAR $[-1, +1]$ on firm characteristics.

Independent variables	Model 1	Model 2	Model 3	Model 4
<i>Mcap</i>		0.133 (0.307)		0.146 (0.307)
<i>MBR</i>		−0.693 (0.012)		−0.664 (0.020)
<i>Gidx</i> [0,3]	−0.498 (0.000)	−0.455 (0.002)	−0.495 (0.001)	−0.433 (0.006)
<i>BGroup</i>		−0.382 (0.338)		−0.532 (0.220)
<i>Leverage</i>		−0.009 (0.327)		−0.009 (0.344)
<i>CashFlow</i>		0.013 (0.554)		0.011 (0.635)
<i>ForOwn</i>		−0.006 (0.543)		−0.004 (0.695)
<i>LiqAsset</i>				−0.018 (0.509)
Industry fixed effects are in the regressions but not reported here.				
Adj. R-squares	15.8%	16.8%	16.4%	17.2%
# of obs.	639	639	587	587

This table reports the coefficients from the regressions of the 3-day cumulative abnormal return of non-target firms around August 24, 2006 (the first newspaper day) on their firm characteristics. *Mcap* is the natural log of the market capitalization as of August 22, 2006 (i.e., immediately before the event window), *MBR* is the natural log of the market-to-book ratio (which is winsorized at the 1st and 99th percentiles) as of the end of the second quarter 2006, *Gidx*[0,3] is the governance index that is composed of 9 provisions and winsorized at 3. *BGroup* is the 0/1 dummy variable for companies belonging to the 30 largest business groups, *Leverage* is the winsorized percentage of total debt to total asset, *CashFlow* is the winsorized percentage of (earnings before interests and taxes and depreciation) to total asset; *ForOwn* is the winsorized foreign ownership, and *LiqAsset* is the percentage of cash or cash equivalents to total asset, which is not available for financial firms. The weighted least squares method is used with the residual variance from the abnormal return estimation as the weight.

dummy variable for companies belonging to the 30 largest business groups, *Leverage* or the winsorized percentage of total debt to total assets, *CashFlow* or the winsorized percentage of the sum of (earnings before interests and taxes and depreciation) to total assets, and *ForeignOwn* or the winsorized foreign ownership. We at times add *LiqAsset* or the percentage of cash and cash equivalents to total asset; this variable is not available for financial services companies such as banks. We also control for industry fixed effects (α_i 's). Inclusion of the industry dummies makes all the variables de-measured within the same industry, and thus helps control for the growth opportunities that tend to be common among same-industry firms. To account for heteroscedasticity, the weighted least square method is used with the residual variance from the abnormal return estimation as the weight.¹⁹

After briefly confirming the results in Table 4 by further controlling for industry effects (Models 1 and 3), Table 5 reports the regression results for Eq. (1). Either using the full sample (Model 2) or the sub-sample of non-financial firms (Model 4), we find a significant and negative coefficient for the governance index. This result supports the hypothesis that more poorly governed companies experience a more positive stock price reaction to the Fund's target announcement. Note that this negative coefficient for the governance index is obtained after controlling for the initial valuation level, as measured by the market-to-book ratio. The valuation ratio itself enters the regression significantly with a negative coefficient, meaning that stocks with a low valuation experience a more positive stock price reaction to the announcement.

4.4. Sub-sample analysis – test of the second hypothesis

Given that small firms have more severe governance problems in Korea (e.g., Black et al., 2005a, 2006), we expect firm size to be instructive in identifying candidates for future activism. Similarly, since activist investors make profits by restoring the stock prices of the targets, the hypothesized relationship between the abnormal stock return of non-target companies and their governance characteristics should be more pronounced among companies with undervalued stocks.

To test this second hypothesis, we estimate Eq. (1) separately for each of the two sub-samples sorted by market capitalization or market-to-book ratio. Only Models 2 and 4 are adopted for this sub-sample analysis.²⁰ Consistent with the second hypothesis,

¹⁹ Since we examine a single event common to non-target companies, their abnormal returns are likely to be highly correlated. However, Karafiath (1994) shows that this bias does not cause a serious problem in the cross-sectional analysis if the sample is sufficiently large and heteroscedasticity is taken into consideration.

²⁰ We do not use the dummy-interactive term method for the sub-sample analysis, because this method makes it difficult to reconstruct the coefficients for each sub-sample. In general, this reconstruction can be easily done by reading the coefficient for the variable in question for one sub-sample and adding it to the coefficient for the interactive term for the other sub-sample, which is represented by the dummy variable; the difference between the two sub-samples is then captured by the coefficient for the interactive term alone. The resulting coefficients for the two sub-samples should be exactly the same as those from the separate estimation for each sub-sample, as long as all other explanatory variables in the regression are also allowed to have different coefficients across sub-samples (i.e., one interactive term for each of the explanatory variables). In our dataset, the sub-samples have slightly different sets of industries, so this task becomes non-trivial. In addition, since we are interested in the statistical significance of the governance coefficient in each sub-sample as well as in the difference across sub-samples, the dummy-interactive term method, which focuses on the difference, is not utilized. However, we confirmed that our results are robust to using this method.

Table 6

Sub-sample analysis – by size or market-to-book ratio.

	Model 2				Model 4			
	Small	Large	LowMB	HighMB	Small	Large	LowMB	HighMB
<i>Mcap</i>	0.478 (0.251)	−0.041 (0.821)	0.243 (0.311)	0.156 (0.345)	0.470 (0.263)	−0.026 (0.901)	0.300 (0.228)	0.145 (0.436)
<i>MBR</i>	−0.902 (0.015)	−0.800 (0.065)	−0.653 (0.373)	−0.442 (0.347)	−0.852 (0.023)	−0.756 (0.105)	−0.782 (0.295)	−0.346 (0.482)
<i>Gidx</i> [0,3]	−0.697 (0.003)	−0.295 (0.157)	−0.717 (0.001)	−0.157 (0.483)	−0.718 (0.002)	−0.167 (0.473)	−0.655 (0.004)	−0.123 (0.614)
<i>BGroup</i>	−0.230 (0.777)	−0.680 (0.176)	0.463 (0.472)	−1.030 (0.053)	−0.095 (0.910)	−0.986 (0.076)	0.287 (0.666)	−1.288 (0.034)
<i>Leverage</i>	−0.014 (0.282)	−0.001 (0.964)	−0.007 (0.604)	−0.010 (0.494)	−0.016 (0.225)	−0.002 (0.924)	−0.005 (0.732)	−0.010 (0.536)
<i>CashFlow</i>	−0.023 (0.388)	0.050 (0.202)	0.024 (0.532)	0.026 (0.362)	−0.023 (0.392)	0.048 (0.249)	0.022 (0.576)	0.027 (0.363)
<i>ForOwn</i>	0.028 (0.130)	−0.021 (0.120)	0.020 (0.244)	−0.027 (0.049)	0.029 (0.118)	−0.022 (0.158)	0.019 (0.294)	−0.027 (0.094)
<i>LiqAsset</i>					−0.041 (0.290)	−0.007 (0.860)	−0.011 (0.789)	−0.033 (0.399)
Industry fixed effects are in the regressions but not reported here.								
<i>Adj.R</i> ²	13.8%	21.0%	20.3%	13.1%	14.0%	21.4%	20.5%	12.4%
# of obs.	319	320	319	320	311	276	303	284
<i>Gidx</i> coefficient difference [<i>t</i> -stat]	−0.401 [−1.29]		−0.560 [−1.81]		−0.551 [−1.68]		−0.532 [−1.61]	

This table reports the coefficients from the regressions of the 3-day (−1, +1] window) cumulative abnormal return of non-target firms around August 24, 2006 (the first newspaper day) on their firm characteristics. Regressions are estimated separately for size- or market-to-book-ratio-sorted sub-samples. The variables in the regressions are defined in Table 5. The weighted least squares method is used with the residual variance from the abnormal return estimation as the weight.

Table 6 shows that a significantly negative coefficient for the governance index is found only in the “Small” and “LowMB” sub-samples. In the other two sub-samples, the governance index enters the regression insignificantly, although the coefficient sign is negative. The magnitudes of the governance index coefficients are also strikingly different, with the coefficients for the “Small” and “LowMB” sub-samples being several times greater than those for the counterparty sub-sample. As reported in the last two lines of the table, however, the cross-subsample differences are not statistically significant. It is because the governance index coefficients for the “Large” and “HighMB” sub-samples are estimated imprecisely.²¹ Taken together, the results confirm that the negative relation between the abnormal returns of non-target companies and their governance characteristics arises because investors anticipate the increased level of activism in those companies and capitalize the resultant benefits into stock prices.

4.5. Robustness checks

4.5.1. Alternative governance indices

We have thus far used nine governance provisions to characterize a firm's governance structure. A natural question arises as to whether the negative relation between the abnormal stock return and the governance index is found only with those provisions and our particular index construction method. To address this question, we consider four alternative governance indices. First, we utilize the KCGS-assigned scores of the nine provisions by first adding up their scores within the company and then taking the log transformation (after adding one, to avoid taking log of zero). In cases that two characteristics make one provision, we use their average score. The resultant index is denoted as *AGidx1*. Another alternative index, *AGidx2*, is the same as the original four-value index except that it is not winsorized.

The third and fourth alternative indices are based only on three provisions. Specifically, the third one, *AGidx3*, consists of the three provisions that appear most frequently in the sample, namely, non-staggered board (204 firms), more outside directors than required (in 185 firms), and dividend yield greater than 3% (in 165 firms). This index is winsorized at two. Finally, the fourth index, *AGidx4*, is based on three provisions that are ex ante more important than others. Those provisions include the existence of a director who was elected by minority shareholders or who expressed an opposing or different view during the board meetings, the compliance with the international accounting standards or the corporate disclosure in English, and a dividend yield greater than 3%. This index is winsorized at one.

Table 7 shows that all these alternative governance indices enter the regression significantly with a negative coefficient and that their negative relation to the abnormal return of non-target firms is more pronounced among small firms and low market-to-book ratio stocks. The message from this analysis is straightforward. As long as our governance indices represent some, if not all, aspects of a firm's governance, our results clearly show that more poorly governed companies, at least in some dimensions, experience a

²¹ We use an asymptotic *t*-ratio measured by $(\hat{\beta}_a - \hat{\beta}_b) / \sqrt{(\text{stderr}_a^2 + \text{stderr}_b^2)}$, where $\hat{\beta}_s$ and stderr_s are, respectively, the coefficient estimate for the governance index in sub-sample *s* and its standard error. Consequently, a large standard error from one sub-sample increases the denominator and reduces the overall *t*-ratio.

Table 7

Cross-sectional regressions using alternative governance indices.

	Model 2				Model 4			
	AGidx1	AGidx2	AGidx3	AGidx4	AGidx1	AGidx2	AGidx3	AGidx4
All	−0.682 (0.005)	−0.351 (0.002)	−0.396 (0.051)	−0.789 (0.008)	−0.684 (0.009)	−0.346 (0.005)	−0.379 (0.077)	−0.779 (0.014)
Small	−0.769 (0.019)	−0.664 (0.003)	−0.732 (0.018)	−0.893 (0.054)	−0.843 (0.012)	−0.687 (0.002)	−0.754 (0.016)	−0.896 (0.056)
Large	−0.588 (0.139)	−0.199 (0.182)	−0.279 (0.337)	−0.563 (0.171)	−0.378 (0.402)	−0.157 (0.346)	−0.119 (0.709)	−0.479 (0.297)
Diff.	−0.181	−0.466	−0.453	−0.330	−0.465	−0.530	−0.635	−0.417
[t-stat]	[−0.35]	[−1.75]	[−1.07]	[−0.53]	[−0.83]	[−1.91]	[−1.42]	[−0.64]
LowMB	−0.886 (0.011)	−0.656 (0.001)	−0.787 (0.008)	−1.155 (0.006)	−0.804 (0.027)	−0.598 (0.004)	−0.737 (0.017)	−1.043 (0.017)
HighMB	−0.516 (0.166)	−0.092 (0.548)	−0.040 (0.893)	−0.214 (0.633)	−0.606 (0.142)	−0.106 (0.529)	0.008 (0.979)	−0.291 (0.556)
Diff.	−0.371	−0.563	−0.747	−0.941	−0.198	−0.492	−0.745	−0.753
[t-stat]	[−0.73]	[−2.24]	[−1.79]	[−1.54]	[−0.36]	[−1.84]	[−1.68]	[−1.15]

This table reports only the regression coefficient for various governance indices (used one at a time). *AGidx1* is the index based on the score assigned to the 9 governance provision by the KCGS (log of: 1 + sum of their scores). *AGidx2* is the index that counts the incidences of the 9 provisions but is not winsorized. *AGidx3* is the index that counts the incidences of 3 provisions with the highest frequency (#1, #3, and #7 in Table 1) and is winsorized at 2. *AGidx4* is the index that counts the incidences of 3 provisions with the greatest ex ante relevance (#2, #5, and #7 in Table 1) and is winsorized at 1. The same set of control variables are used as in Table 5 but their coefficients are not reported here.

more positive stock price reaction to the Fund target announcement. Conversely, if our indices were a pure noise, then we would not be able to find such robust and consistent results.²²

4.5.2. Alternative event windows

We now employ a longer event window to address the possible under- or overreactions during the three-day event window. Before proceeding further, it should be noted that the long-horizon abnormal stock returns are subject to the bad model problem, since a true asset pricing model is simply unknown (Fama, 1998). Consequently, while a longer event window mitigates the under- or overreaction problem, it opens up another problem of less reliable abnormal return estimates. We attempt to optimize this trade-off by using two alternative windows. One spans four more days following the end of the three-day window (i.e., ending at the close of August 2006), and the other fares further to the end of September 2006. The former seven-day window is motivated by the observation that the announced target firms themselves continue to experience price increases during this window (Fig. 1). The latter 28-day window ending on September 29, 2006 is exogenously determined by a market-destabilizing event that occurred in early October: the North Korean nuclear missile tests.

Table 8 reports the coefficients for the governance index on which the cumulative abnormal return over the seven or 28 trading days is regressed (along with the same set of control variables as shown in Table 5). Although the statistical significance weakens with the 28-day window, the pattern of the earlier results remains remarkably robust to using these two alternative event windows. Especially, the negative relation between the abnormal return of non-target companies and the quality of their governance is stronger among small firms and low market-to-book-ratio firms. Note that the results for the market-to-book-ratio-sorted sub-samples are weaker with the 28-day window. We find this to be sensible, since the valuation ratio is directly related to past stock performance, and thus introduces biases into abnormal stock return estimates, especially the long-horizon ones. (See, e.g., Yermack (1997; p.458) for a more detailed discussion of this issue.)

4.5.3. Analysis of subsequent announcements

Three months after the first announcement, the Fund announced two more target firms with an interval of one week. In general, subsequent announcements are not much of an event, since they are not as fresh a shock as the first announcement. For example, Song and Walking (2000), in their study of the intra-industry effects of takeover announcements, require at least one year between takeover announcements in order for the subsequent one to be defined as an event. In our setting, the subsequent announcements are useful because the revealed target firms turn out to be more of an undervalued company rather than a poorly governed one.²³ Consequently, one can gauge the effectiveness of our setting by examining whether it responds to the subsequent announcements differently compared with the first announcement. More precisely, the valuation ratio should play a larger role in explaining the cross-section of the abnormal stock return of non-target firms, whereas the governance index is expected to be irrelevant.

Fig. 2 is the stock price patterns of the two target firms revealed through the subsequent announcements. The target firm announced earlier (top panel; first appearing on newspapers on November 23, 2006) shows a pattern similar to the one in Fig. 1.

²² See, for example, Aggarwal et al. (in press) for a similar argument.

²³ Newspaper articles confirm this observation. For example, an article in *The Korea Economic Daily* (A23) on November 23, 2006 reported that the subsequent target is selected on the grounds of its undervalued stock despite the solid asset base and business model. The Fund also stated that the stock of the subsequent target has been neglected due to its location (i.e., being a local company).

Table 8

Cross-sectional regressions using alternative event windows.

	Dependent variable:			
	CAR [−1, +5]		CAR [−1, +26]	
	Model 2	Model 4	Model 2	Model 4
All	−0.522 (0.018)	−0.653 (0.006)	−0.457 (0.350)	−0.696 (0.181)
Small	−0.898 (0.009)	−0.939 (0.007)	−1.898 (0.015)	−1.996 (0.011)
Large	−0.385 (0.217)	−0.496 (0.162)	0.728 (0.283)	0.545 (0.474)
Diff. [t-stat]	−0.513 [−1.11]	−0.442 [−0.89]	−2.626 [−2.56]	−2.540 [−2.34]
LowMB	−1.251 (0.000)	−1.289 (0.000)	−1.165 (0.050)	−1.135 (0.065)
HighMB	0.326 (0.320)	0.199 (0.587)	0.327 (0.699)	0.008 (0.994)
Diff. [t-stat]	−1.577 [−3.48]	−1.488 [−3.04]	−1.492 [−1.45]	−1.142 [−1.02]

This table reports the regression coefficients for the governance index (*Gidx* [0, 3]) when the cumulative abnormal return over an alternative event window is used as the dependent variable. The same set of control variables are used as in Table 5 but their coefficients are not reported here.

The other target (bottom panel) experiences the price run-up several days before its own newspaper appearance (November 30, 2006) probably due to information leaks from the preceding announcement; it also experiences a reversal a few days after the announcement. We thus examine the [−1, +1] windows surrounding each of the first newspaper days.

Table 9 reports the results for the subsequent announcements. Consistent with our prediction, the first two columns of the table show that the abnormal return over the [−1, +1] window surrounding November 23, 2006 is significantly related to the market-to-book ratio. It is also noteworthy that the coefficients for the market-to-book ratio are much larger (in absolute terms) than the case of the first announcement (−0.693 vs. −0.935, and −0.664 vs. −0.888). Also consistent with the prediction, the governance index enters the regression insignificantly, although it continues to carry a negative coefficient. The third and fourth columns of the table are for the regressions using the abnormal return over the [−1, +1] window surrounding November 30, 2006. As suggested by Fig. 2, the information contents of this news appear to have been leaked to the market beforehand and, hence, neither the market-to-book ratio nor the governance index is significantly related to the abnormal return during this window. In a nutshell, our sample shows different reactions to different signals, validating itself as an effective experimental setting.

Table 9

Cross-sectional regression of CAR [−1, +1] around the Fund's subsequent target announcements on firm characteristics.

	Dependent variable:			
	CAR [−1, +1] around 11/23/2006		CAR [−1, +1] around 11/30/2006	
	Model 2	Model 4	Model 2	Model 4
<i>Mcap</i>	−0.142 (0.385)	−0.222 (0.216)	−0.052 (0.721)	−0.044 (0.782)
<i>MBR</i>	−0.935 (0.006)	−0.888 (0.013)	−0.070 (0.817)	−0.096 (0.758)
<i>Gidx</i> [0,3]	−0.181 (0.332)	−0.142 (0.479)	−0.139 (0.401)	−0.166 (0.343)
<i>BGroup</i>	−0.121 (0.809)	−0.109 (0.844)	0.108 (0.808)	0.110 (0.821)
<i>Leverage</i>	0.006 (0.634)	0.006 (0.642)	−0.016 (0.122)	−0.013 (0.229)
<i>CashFlow</i>	−0.040 (0.154)	−0.044 (0.122)	0.028 (0.251)	0.029 (0.251)
<i>ForOwn</i>	0.023 (0.075)	0.029 (0.046)	0.002 (0.890)	0.008 (0.536)
<i>LiqAsset</i>		−0.032 (0.358)		−0.019 (0.546)
Industry fixed effects are in the regressions but not reported here.				
Adj. R-squares	20.6%	21.2%	12.2%	11.3%
# of obs.	631	580	631	580

This table reports the coefficients from the regressions of the 3-day cumulative abnormal return of non-target firms around the Fund's subsequent target announcements (November 23, 2006 and November 30, 2006) on their firm characteristics. The variables in regressions and estimation method are the same as in Table 5.

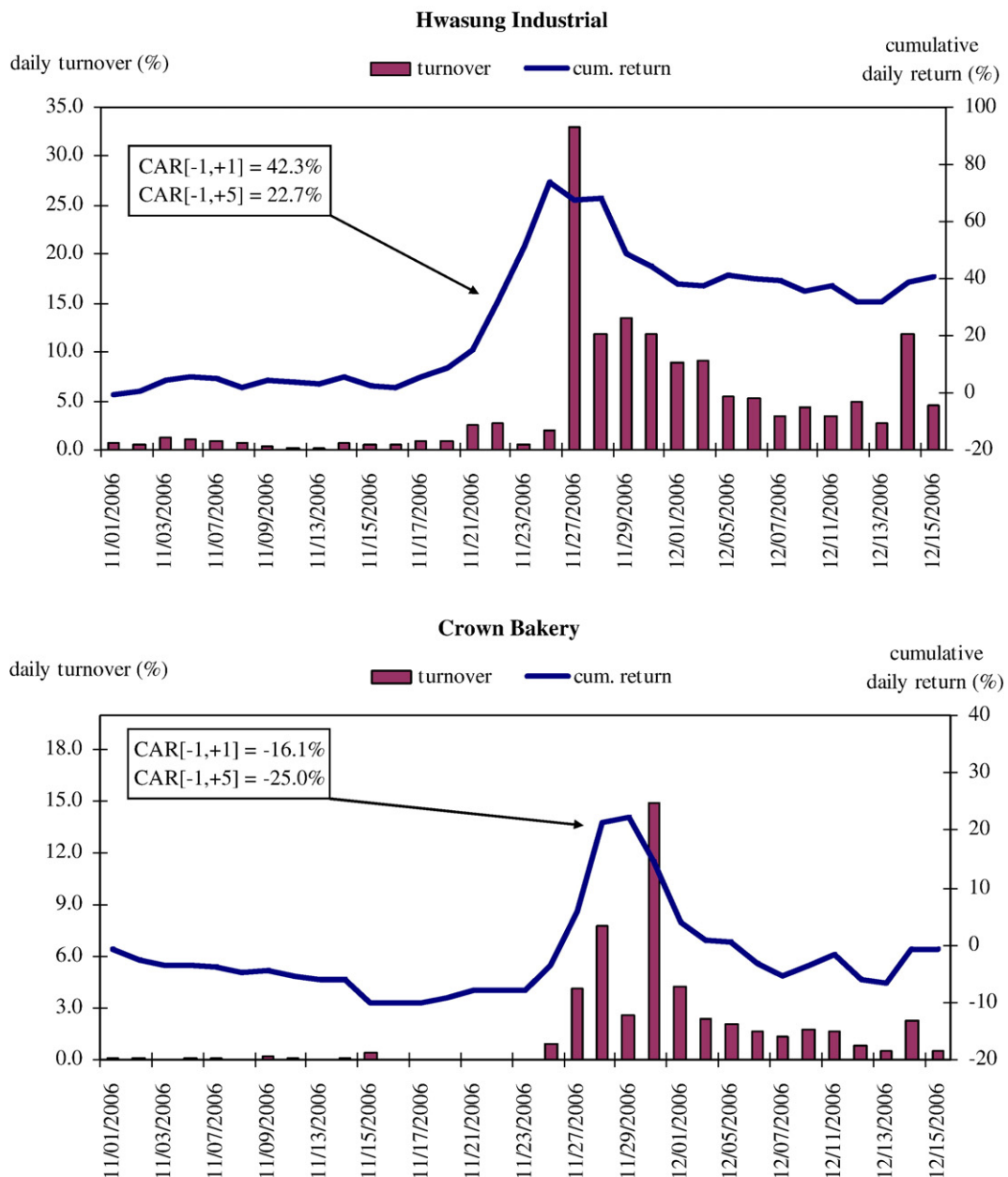


Fig. 2. Daily turnover and compounded stock returns of two firms that are subsequently (with a lag of one week) announced to be the target of Korea Corporate Governance Fund.

4.5.4. Additional robustness checks

Finally, we briefly mention two more robustness checks without tabulating the results.²⁴ The first check is on the role of trading volume. This is motivated by the notion that over a short horizon like our event window, a sudden change in trading volume can create a price impact. Given that the Fund's target announcement was a huge event in the market and was therefore likely to have increased trading volume significantly, it is necessary to examine the extent to which the abnormal return of poorly governed non-target companies is attributable to their increased trading volume. After employing abnormal trading volume as another control variable, we found that the governance index is still significantly and negatively related to the abnormal stock return of non-target companies. The second check is to ensure that our results are not driven by a general pattern between governance and stock returns. To this end, we examined their relation during non-event windows using the bootstrap method. We found that a negative

²⁴ The previous version of the paper includes these results. They are available from the authors upon request.

relation between stock returns of a company and its governance quality over short horizons like our event windows is extremely rare.

5. Conclusions

In this paper, we provide evidence of the shareholder wealth effect of institutional activism using its spillovers on non-target companies. Given the weak evidence in existing studies focusing on target companies, we note that spillovers on non-target companies, if any, can potentially be instructive. It is because they allow for a cleaner event study by creating a random sample of companies that are not pre-selected by any firm conditions or characteristics. Such spillovers uniquely arise from the first target announcement of the Korea Corporate Governance Fund. It is the very first institutional activism effort in a country in which various country-level governance provisions have been put in place but have not been properly utilized at the individual firm level. Consequently, this announcement signals the beginning of more serious investment in firm-level governance across the market, thereby creating the anticipation of increased activism even in non-target firms.

We find that, among non-targets, those companies that grant fewer rights to outside shareholders experience a more positive stock price reaction. We also show that this finding survives a number of robustness checks. Since fewer rights in the hands of the outside shareholders at the present time imply greater room for activism in the future, our findings lend strong support to the positive wealth effect of institutional activism.

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