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What Makes a Quality Shareholder? A Conversation with Lawrence Cunningham

Lawrence A. Cunningham is the Henry St. George Tucker III Research Professor of Law at George Washington University (GW). At GW, he is Director of the Center for Law, Economics and Finance (C-LEAF), GW's research program in corporate governance, featuring the Quality Shareholders Initiative. Cunningham has written dozens of books on corporate governance, culture and law. His research findings have been published in journals such as Directors & Boards *and featured in media outlets including* The New York Times, The Wall Street Journal *and* MarketWatch, *where he writes a weekly column, "Cunningham's Quality Investing."*

In a conversation with Brandes Institute Advisory Board members, Brandes colleagues and guests, Larry shared evidence of a link between companies with high numbers of "quality shareholders" and outperformance. He also stressed that in the face of rising passive ownership, the voice of the company-specific investor needs to be heard and the extended period of passive outperformance seems unlikely to be sustainable.

EXECUTIVE SUMMARY

- According to Cunningham, "quality shareholders" (QS) are those with meaningful positions in a company and a long-term holding period.

- Studies have linked the types of shareholders a company attracts with its performance. Cunningham and research partners investigated QS and found U.S. companies with a high density of QS had a cumulative return of nearly 500% between 2010 and mid-2020 vs. 181.9% for the S&P 500 Index and 180.73% for the Russell 3000 Index.

- Quality shareholders tend to hold companies with the following traits: a clear philosophy and strong mission statement; open communication, including candid annual letters to shareholders and annual meetings; competitive advantages such as brand strength; and strong return on invested capital and profitability.

- Cunningham said "…a faithful application of ESG principles requires a firm-specific examination. Quality shareholders have understood this long before ESG became popular."

- He added he is working to raise awareness of QS, including its potential effects on proxy voting. He said Glass Lewis & Co. and Institutional Shareholder Services Inc. (ISS) exert tremendous power over big segments of the shareholder base. "These two firms call a lot of shots without giving the relevant company a chance to comment or debate," he added. (He noted that new SEC rules adopted in 2021 would require proxy advisors to share drafts of their recommendations with companies to give them an opportunity to correct errors.)

HISTORY

Warren Buffett stressed finding quality investors in the late 1970s. Referring to *Common Stocks and Uncommon Profits*, a book by Philip Fisher, Buffett compared companies to restaurants offering menus that attract certain shareholders. According to Cunningham, "Buffett [CEO of Berkshire Hathaway since 1970] said he wanted long-term, focused shareholders. Five years ago, I discovered one of the most important reasons for Berkshire's success was having those shareholders that a different shareholder base wouldn't have permitted."

Inspired by his discovery with Berkshire Hathaway, Cunningham wondered about the correlation between a company's shareholders and its success. He said there are various studies on segmenting shareholder bases, but found work by Dr. Brian Bushee, Vice Dean of Teaching and Learning at the University of Pennsylvania's Wharton School, most interesting. Bushee had divided shareholders in terms of concentration levels and holding periods.

Cunningham used those two traits to define "quality shareholders." Dr. Martijn Cremers at Notre Dame University has published similar results matching active share (or how different a portfolio appears relative to a benchmark) with holding periods; Cremers argued such a strategy leads to outperformance.

SHAREHOLDER SEGMENTATION

Cunningham built on Bushee's framework to segment shareholders in 2,070 U.S. companies into four cohorts: indexers; transients; activists; and quality, as shown in Exhibit 1.

Exhibit 1: Shareholder Segmentation

		INVESTMENT CONVICTION	
		Lower	**Higher**
INVESTMENT HORIZON	**Shorter**	Transients	Activists
	Longer	Indexers	Quality

Source: Lawrence A. Cunningham, Initiative on Quality Shareholder Highlights, C-LEAF OCCASIONAL PAPER SERIES (Fall 2020). Available at SSRN: https://ssrn.com/abstract=3697259

"The dominant cohort consists of indexers," Cunningham said. "They own maybe 30-50% of the shares; 30% are transients who tend to hold less than 1-2 years. The activist cohort might command 3-5%. The rest [roughly 15% to 40%] is quality. It's a minority cohort, but it's significant and forceful. These are the discerning stock pickers."

He added that each cohort plays a role—everything from providing liquidity to generating reliable estimates of value to efficiently allocating capital. "Quality shareholders can offer some validation to incumbent management in the face of activists whose views may focus on the shorter term," he said. "Quality shareholders may produce more rational pricing. Transient trading tends to create volatility and the indexers are a bit odd in that they tend to buy as prices rise."

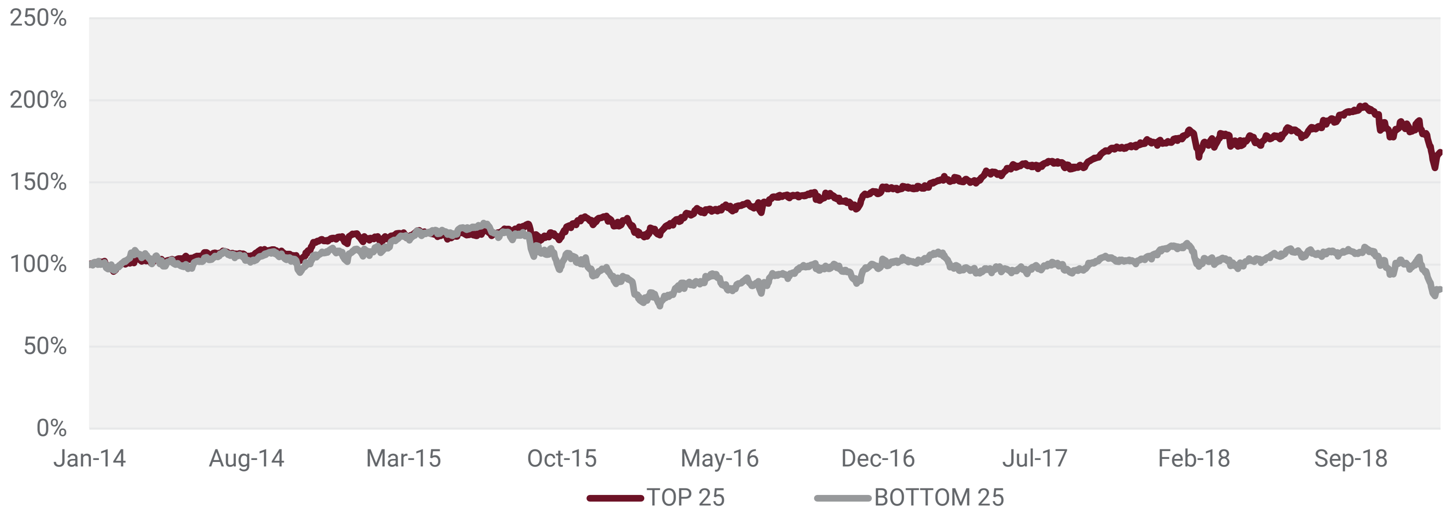
Another benefit of quality shareholders? Insights. "They may serve as a brain trust," Cunningham said. "It's often desirable for a CEO and board to have shareholders to consult on tricky problems—maybe the optimal hurdle rate or compensation for management and others. Also, it's a great place to look when companies seek directors. Companies with a high level of director ownership attract a high level of quality shareholders."

QUALITY SHAREHOLDERS AND THE COMPANIES THEY HOLD

So, what traits tend to *attract* quality shareholders? Cunningham said QS companies have:

1. Moats: "Companies that attract a high density of quality shareholders tend to boast competitive advantages that protect business performance against a variety of threats," he said. "Brand strength appears to be a particular magnet."
2. Clear philosophy and strong mission statements.
3. Communication: candid annual letters to shareholders and annual meetings. "Quality shareholders appear to appreciate clear, consistent and useful financial information," he added.
4. Economic Profit: "They seem to value concepts such as return on invested capital and economic profit," Cunningham noted.
5. Capital Allocation. Cunningham cited a study by Prof. George Athanassakos at Western University's Ivey Business School in Canada: "His study ranked companies by capital allocation success and then compared portfolios comprised of those at the top versus the bottom," Cunningham said. "On average, the superior allocator portfolio outperformed the inferior one by 33% in terms of cumulative three-year returns, over several recent decades." More details about the study here.

Exhibit 2: Top 25 QS Companies vs. Bottom 25, Cumulative Performance (1/2/14 to 12/31/18)



Source: Lawrence A. Cunningham, *Initiative on Quality Shareholder Highlights*, C-LEAF OCCASIONAL PAPER SERIES (Fall 2020). Yahoo! Finance market data based on Quality Shareholders Initiative (QSI) data set, as of 12/31/18. Past performance is not a guarantee of future results.

6. Corporate Governance: "The index funds tend to adopt broad guidelines on director independence, staggered boards and other matters," Cunningham said. "Quality shareholders are more firm specific. This is an illustration of something important. Indexers cannot make individual decisions; they can only afford to reach broad conclusions about what is most likely best. Quality shareholders are about particular arrangements and performance of particular firms."

7. Shareholder Voting: "While corporate tradition provides shareholders with one-vote-per-share, alternative shareholder voting rules abound. Examples include dual class structures giving different votes-per-share to different classes, as well as time-weighted voting—more votes to longer-held shares."

QUALITY SHAREHOLDERS AND COMPANY PERFORMANCE

So, Cunningham summarized briefly how he and co-researchers created a universe of 2,070 large-cap U.S. companies. The details are laid out in Appendix A of his book, *Quality Shareholders*, at pages 168-170, excerpts of which are included below. The lead-in paragraph notes the data set consists of all listed U.S. companies with market caps exceeding $1.1 billion and with at least nine quarters of data as of the study date, July 2019. They ranked the companies using a multi-factor model that incorporated a variety of different metrics to capture investor horizons and concentrations, including share turnover and average investor concentration.

Each company was ranked in terms of its "density" of quality shareholders (QS). By density, they mean the companies that scored highest in the combined multi-rank for attracting quality shareholders. Then, they took roughly the top and bottom 1% of companies (25 for both top and bottom) ranked by their density of quality shareholders and tracked their performance between 2014 and 2018.

They measured performance as cumulative return or the total change in the price of the investment expressed as a percentage using daily, unadjusted historical closing prices from 1/2/2014 (the first trading day of the year) through 12/31/18. Exhibit 2 shows the Top 25 QS companies outperformed the Bottom 25.

Exhibit 3 shows the Top 25 also outperformed the Bottom 25 during each calendar year between 2014 and 2018.

Exhibit 3: Calendar Year Returns for Top 25 QS Companies vs. Bottom 25

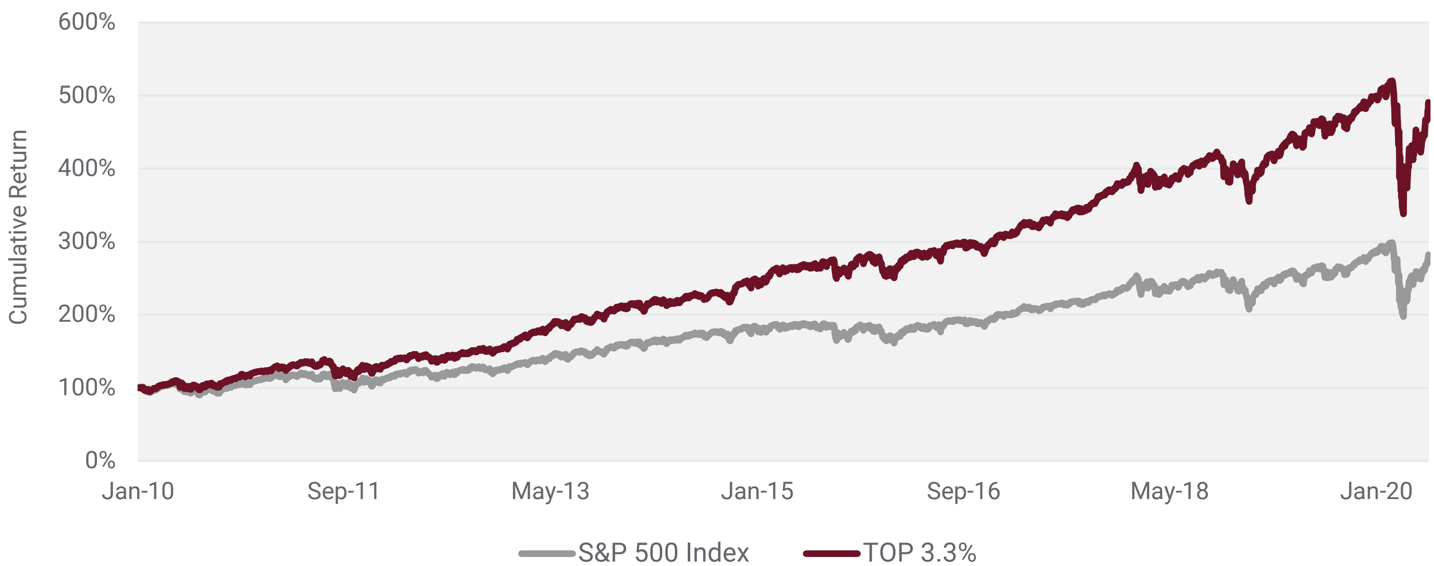
Year	Top 25	Bottom 25
2014	17%	9%
2015	8%	-16%
2016	18%	13%
2017	19%	8%
2018	-3%	-24%

Source: Lawrence A. Cunningham, *Initiative on Quality Shareholder Highlights*, C-LEAF OCCASIONAL PAPER SERIES (Fall 2020). Yahoo! Finance market data based on QSI data set.

Expanding the top and bottom groups to reflect 3.33% of the universe (69 companies in both the top and bottom groups), they analyzed performance between 1/1/10 and 6/5/20. Exhibit 4 shows the cumulative return of the Top 69 QS companies vs. the S&P 500 Index during that period.

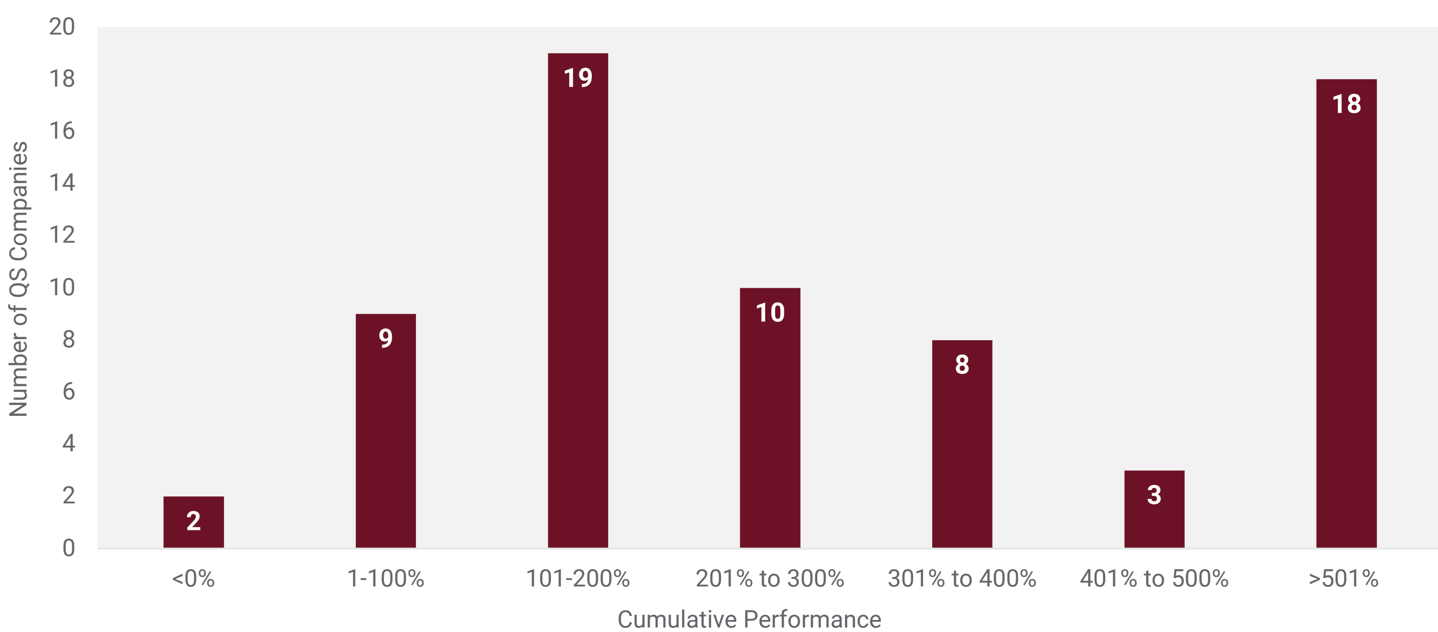
The cumulative return for the Top 3.3% of QS companies was nearly 500% during the period vs. 181.9% for the S&P 500 Index and 180.73% for the Russell 3000 Index. Exhibit 5 breaks down returns for the 69 constituents in the top 3.3% of QS companies.

Exhibit 4: Hypothetical Portfolio Performance of QS Attractors: Top 3.3% of QS Companies Outperformed the S&P 500 Index from 1/1/2010 to 6/5/2020



Source: Lawrence A. Cunningham, *Initiative on Quality Shareholder Highlights*, C-LEAF OCCASIONAL PAPER SERIES (Fall 2020). Yahoo! Finance market data based on QSI data set, as of 6/5/20. Hypothetical illustration. Does not represent the performance of any particular investment. Actual results will vary. One cannot invest directly in an index.

Exhibit 5: Breakdown of Cumulative Performance: Top 3.3% of Highest QS Companies, 1/1/10 to 6/5/20



Source: Lawrence A. Cunningham, *Initiative on Quality Shareholder Highlights*, C-LEAF OCCASIONAL PAPER SERIES (Fall 2020).Yahoo! Finance market data based on QSI data set, as of 6/5/20.

Question and Answer Session
After his comments, Cunningham opened the virtual meeting to questions:

Q: What specific guidance are you giving to corporations in terms of outreach to QS?

LC: I'm trying to educate managers and boards in terms of what appeals to this cohort and help them develop their own menus to attract more, similar investors. At the general level, I'm explaining the existing cohorts. I try to tell them why having high quality shareholders is an advantage.

Q: What doesn't every company do this?

LC: Indifference. Not every CEO cares. The average tenure for CEOs is about seven years. Some don't care about their shareholders. Some probably fear having quality shareholders who are intelligent and may know a lot about their business.

Q: My question is on the time horizon of the research. Anything in the works to add more time horizons and see more cycles?

LC: The performance is fairly limited, I agree. And the rankings are static. The practices and policies we're looking at are historic. My strategy for research going forward is a partnership with EQx[1] and its proprietary long-term enhanced equity securities. They have way more funding than I have and they're crunching data in real time. I'll have access to that database as it's updated regularly. As we work with fresh data, we'll be able to work with more cycles.

Q: What is the overlap between quality shareholders and ESG?

LC: I looked at the highest-ranked ESG (environmental, social, corporate governance) companies—and that can be defined a lot of different ways. I selected two that seemed to be mainstream: *Investor's Business Daily* and *Barron's* rankings. I compared the top ESG companies with my quality shareholder density ranking and there was a positive correlation.

My theory is to look at the idea of sustainability; these are the types of things that quality shareholders have been interested in for decades. In general, a faithful application of ESG principles requires a firm-specific examination. Quality shareholders have understood this long before ESG became popular. Quality shareholders and ESG go hand in hand. [More details available here at Cunningham's MarketWatch column.]

Q: Has there been any discussion with policy makers on this topic? Is there anything the SEC is contemplating

LC: I'm eager to advance some proposals. I'm trying to get the point across to policy makers that you have to make sure the voice of the firm-specific investor is heard. I've got a couple ideas: in the current shareholder voting process, the indexers vote on guidelines whereas the quality shareholders vote on specifics. We are investigating creating a platform and related software program to show the votes of activist shareholders *ahead* of time, so the indexers can see what others are thinking. They don't have to use it, but it might be helpful to have. [More details available here at Cunningham's MarketWatch column.]

The largest indexers are enormously powerful and own $20 to 30 trillion worth of stock. They are among the largest holders in almost every major company and they tend to rely on ISS (Institutional Shareholder Services Inc.) or Glass Lewis [for voting issues] and have these template approaches. Their business model is systemic; they are not interested in firm-specific returns. They are interested in risk-adjusted returns. They buy without discrimination and vote in most cases without discrimination.

Getting back to Glass Lewis and ISS, they exert tremendous power over big segments of the shareholder base. These two firms call a lot of shots without giving the relevant company a chance to comment or debate. Last July, the SEC passed a rule that requires firms to provide advance notice on how we recommend our clients vote and the company can look at it and make any corrections. It will put more cost into the ISS process, but I think that will help. I'm trying to persuade the new SEC chair to maintain those rules. [Read Cunningham's editorial on the topic, published here at the *Pensions & Investments* website.]

The third idea is to enhance the voting power of quality shareholders on any votes. The prevailing norm is one share equals one vote, but that can be changed by any company. You can have more tenure voting, where shares held for a longer time get larger voting rights.

Look at Jack Bogle and his success; he helped make indexing a force. It's deeply penetrated the culture. For a lot of people, it's the way to go. But now, you also have Reddit and online trading. That whole development is energizing the transient crowd. So, how do you educate the quality shareholder cohort? I do think there are performance cycles and this current period is unlikely to be sustainable. There probably will be windows ahead.

APPENDIX

Excerpts from Appendix A to Cunningham's book, *Quality Shareholders*, describing universe creation criteria for the study:

Company Appeal

Quality: a purely quantitative measure of the relative quarterly rank of the stock to the universe using a weighted sum of four factors: (1) performance—such as risk-adjusted Sharpe and Sortino ratios, return on equity, return on invested capital; (2) riskiness—volatility, downside deviation, ratio of negative returning months and maximum drawdown (one, three and five years); (3) upside capture—the ratio of months with positive returns and percentage of times the stock outperformed its annual expected return; and (4) turnover—trading volume as a multiple of outstanding shares (quarterly and annually).

Institutionality: the stock's institutional ownership structure, ranked based on four factors: (1) institutional breadth—the number of reporting institutional investors owning the stock (to manage the data, with some cost in size skewing, we limited this to those with at least $1 billion AUM); (2) institutional concentration—the average percentage ownership of each institution and the stock's institutional HH Index; (3) institutional attractiveness—the cumulative institutional weight of the outstanding shares and voting percentage of institutional investors; and (4) institutional turnover—the level of institutional trading in the stock and percentage traded by institutions in a given quarter and year.

Analysis. For each metric, stocks were ranked from highest (100) to lowest (1) quarterly. The quarterly rank measures the stock's quarterly position versus the universe, calculated as the average sum of the foregoing eight metric ranks that quarter. The stock's overall rank is the sum of the 20 quarterly ranks. The stock with the highest overall rank leads the list of stocks over the five-year window.

Shareholder Concentration and Conviction Factors

Portfolio Market Share: the percentage weight of the portfolio in its underlying market, computed by dividing the quarterly portfolio AUM by the aggregate market capitalization of all stocks it is invested in. A high market share can mean one of three things: (1) a relatively large AUM for a given number of stocks; (2) a relatively small number of stocks for a given AUM level; or (3) a relatively high concentration in large companies for a given AUM and number of stocks. A higher Portfolio Market Share implies concentration and control on the investees of the portfolio. Higher ranks are assigned to greater Portfolio Market Shares.

Portfolio Conviction: a compound equation drawing on three sub-metrices: (1) the average voting power of the portfolio in the companies of the stocks it holds; (2) number of stocks in the portfolio with significant ownership (0.1% or more of market cap); and (3) the total number of stocks in the portfolio. Portfolio Conviction measures the portfolio manager's belief in and dedication to its underlying holdings, computed as the product of (1) the portfolio's average voting power and the percentage of stocks held with significant ownership [(2) / (3)]. Higher ranks are assigned to greater Portfolio Conviction.

Portfolio Concentration: the relative concentration levels of the portfolio versus the universe of managers, computed as the product of the portfolio market share, average AUM per stock, and percentage of stocks held with significant ownership. The higher the value, the higher the Portfolio Concentration rank.

Portfolio Impact: the potential power the portfolio can exert on the companies whose stock it owns or broader market, computed as the product of the Portfolio Market Share, AUM per stock, and voting percentage. In relative terms, the higher the product of these three standardized measures the greater the Portfolio Impact. Portfolio Impact is constructed as two separate matrices, whose average provides the Portfolio Impact rank.

Portfolio Holdings Quality: Using the ranked list of stocks produced in our stock analysis step (described below), this measures the portfolio's concentration in the top quintile of stocks. Portfolio Holdings Quality is the product of the percentage weight of the portfolio's top quintile stocks and the average ownership percentage of the portfolio in those stocks. The greater the Portfolio Holdings Quality, the higher the portfolio rank.

Shareholder Patience and Longevity Factors

Trade Noise: the ratio of the portfolio gross traded dollar-value to its absolute net traded dollar-value. A ratio of 1.00 is the minimum attainable, indicating that the net and gross traded values were identical. A ratio greater than 1.00 implies a less objective trading strategy. To refine the measurement, we multiply it by the number of portfolio trades in the quarter. A long-term oriented portfolio would have a lower turnover and fewer trades per quarter. A higher inverse rank indicates a more stable portfolio.

Portfolio Turnover: the ratio of the portfolio gross traded value dollar-value to its AUM. Leveraged and trade-oriented portfolios have higher Portfolio Turnover, indicating a weaker quality-investing approach, and vice versa. Those with low Portfolio Turnovers receive higher rankings.

Turnover Impact: a measure of the impact of a portfolio's trading activity on its market, this is computed as the product of Portfolio Market Share and Portfolio Turnover. A significant Portfolio Market Share combined with high Portfolio Turnover could disrupt the overall investees' market and hence lower the quality of portfolio holdings, whereas a large Portfolio Market Share with low Portfolio Turnover suggests a more stable market. Turnover Impact identifies portfolios with large Portfolio Market Share plus low Portfolio Turnover; by taking the inverse of this metric, the higher the rank the more stable and impactful the portfolio is.

Portfolio Volatility: the rate of change and change magnitude of a portfolio's constituents, calculated by taking the periodic standard deviation and the overall standard deviation of stocks in the portfolio. Frequent changes indicate high trading activity and less-focused approach. Lower Portfolio Volatility values are ranked higher.

[1] The Foundation for Value Creation (FVC) is committed to improving the state of value creation in nations and organizations. The Foundation develops and supports The Elite Quality Index (EQx) has been developed and supported by the Foundation for Value Creation, an organization "committed to improving the state of value creation in nations and organizations," according to its website. prospects

References

Lawrence A. Cunningham, *Initiative on Quality Shareholder Highlights*, C-LEAF OCCASIONAL PAPER SERIES (Fall 2020). Available at SSRN: https://ssrn.com/abstract=3697259

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Disclosures

S&P 500 Index: The S&P 500 Index with gross dividends measures equity performance of 500 of the top companies in leading industries of the U.S. economy.

Russell 3000 Index: The Russell 3000 Index with gross dividends measures the performance of the largest 3,000 U.S. companies.

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