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Over-Reaction to the CALPERS Focus List?

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The California Public Pension Fund (CalPERS) is one of the large pension funds. Over time it has gained a reputation for being a prudent stevedore. Embracing an activist shareholder role, CalPERS management monitor their investments and on occasion target firms needing improvement. The Focus list is a public prodding to take corrective action. This study examines the reaction of the market to the CalPERS focus list. Results show a statistically significant negative reaction in the short term. Long term portfolio results point to positive returns indicative of improved performance but, these results may be influenced by other events. Overall, it appears that the market over-reacts negatively in the short term.

INTRODUCTION

The California Public Employees Retirement System (CalPERS) has over \$ 200 billion in assets. Over the years it has gained an activist reputation. The size of investment provides it with a strong voice and the incentive to incur monitoring costs. CalPERS nudges the management and the board to act in the best interest of the shareholders. CalPERS regularly examines its portfolio and seeks change in firms that can potentially perform better. Some firms heed to this attention while those that ignore the attention end up on the focus list.

This study examines the reaction of the market to the publishing of the CalPERS focus list. On one hand, an investor could interpret this news positively: A large shareholder is actively pushing management and the board, to improve operations. In the remaining sections, the literature is reviewed, we present our results and the paper ends with a discussion.

RELATED LITERATURE

Investors seek all types of news to trade on. It has been documented that the market can be slow to incorporate new relevant information into prices. For example, Rendleman, Jones, and Latane (1982) document stock price drift in the post-earnings-announcement period. Loughran and Ritter (1995) find under-reaction to seasoned issues of common stock.

Markets also can over-react to announcements. DeBondt and Thaler's (1985) seminal paper argues the market over-reacts to large and unexpected announcements as demonstrated by their winners-losers effect. The market's interpretation of announcements causes excessive price changes and then there is a correction phase over time where the market seems to understand the event.

Interestingly, in some situations the announcements are neither relevant nor "new." For example, Urrutia and Vu (1999) examined what happens to firms that show upon the cover of BusinessWeek, they document an overreaction. Clayman (1987) looks at firms that invest effort in being rewarded with the Baldrige award. She finds no abnormal return when one invests in these firms. Cooper, et. al. (2001) find that firms which added "dot com" to their names experienced positive announcement effects during the 'Dot Com' bubble period, while Cooper, et. al. (2005) find firms which removed "dot com" from their names experienced positive announcement effects during the 'Dot Com' crash period. Evidence of small retail investors over-reacting to "cosmetic" announcements is found by Cooper, Gulen, and Rau, (2005). They find that mutual funds which change their name to reflect the current "hot" investment style experience an abnormal large inflow of money into their funds. Kolodny, Laurence & Ghosh (1989) study the 'excellent firm' (Peters & Waterman) portfolio; shareholders do not benefit from such a listing. Brammer, Brooks & Pavelin (2004) find similar results in *Management Today's* list of the United Kingdom's Most Admired Firms.

While others have examined the CalPERS focus list, these papers typically focus on the impact of CalPERS intervention in the long-run firm performance. For example, Junkins & Toth (2009) shows that firms on the focus list actually improve and that these firms provide a superior return to the S&P 500 Index and the Wilshire 4500 index over a five year period. Barber (2007) also examines the focus list. Crutchley et. al. (1998) obtain similar results. In this paper, we focus on the short-run announcement effect and its statistical significance through the lens of the over-reaction interpretation and how these results may be explained in a behavioral framework.

DATA & METHOD

We collect the CalPERS focus list and the publication date from 1996 till 2010 and subject it to standard event study methodology using EVENTUS. On each announcement date we form an equally weighted portfolio. We then compare the returns of the focus portfolio to the returns of a market portfolio during the same period. We have 98 firms in our sample.

RESULTS

Table 1 shows the results of the focus portfolio when compared to the market index without adjustment for risk. The Standard & Poor's (S&P) 500 is the proxy for the market portfolio. The market adjusted returns are computed by subtracting the observed return on the S&P index for the day from the return on the stock for the day.

$$\text{MAR}(jt) = R(jt) - R(mt)$$

Markets react negatively, which indicates that the portfolio loses value for the eleven day and sixty one day windows. Interestingly, for the larger window (-30,+250) the returns are positive. While these results may be spurious in that over time many other events could affect the share prices; these results are also consistent with a negative over-reaction in the short run followed by a correction. Again the market

adjusted returns show that windows (-5,+5) and (-30,+30) indicate that the markets react to the publishing of the CalPERS focus list.

**TABLE 1
MARKET ADJUSTED ABNORMAL RETURNS**

Days	N	Mean Cumulative Abnormal return	Precision Weighted CAAR	Positive/Negative
(+1,+30)	98	1.44%	1.38%	50/48)
(-5,+5)	98	-1.50%	-0.43%	50/48)
(-1,+1)	98	0.19%	0.56%	51/47)
(-30,+30)	98	-1.00%	-2.26%	52/46>
(-1,+250)	98	-10.23%	-12.73%	47/51
(-30,+250)	98	-12.83%	-16.74%	46/52
(0,+250)	98	-10.22%	-13.01%	46/52

Symbols), > show direction and test of significance at 0.10 and 0.05 level.

Table 2 presents the market model using the equally weighted index. We show the eleven day window (-5,+5) show a negative return for the focus portfolio after adjusting for the returns on the market. The larger window (-30,+30) shows a change, the negative returns turn positive. Results using the Scholes-Williams model for adjusted betas are similar to the Market Model results.

**TABLE 2
MARKET MODEL USING THE EQUALLY WEIGHTED INDEX**

Days	N	Mean Cumulative Abnormal return	Precision Weighted CAAR
(+1,+30)	98	5.06%	3.98%
(-5,+5)	98	-0.41%	0.63%
(-1,+1)	98	0.60%	0.69%
(-30,+30)	98	6.82%	4.33%

Symbols), >> show direction and test of significance at 0.10 and 0.01 level.

**TABLE 3
MARKET MODEL BUY AND HOLD RESULTS**

Days	N	Mean Compound Abnormal Return	Precision Weighted CAAR	Positive/Negative	Patell Z	p-value
(+1,+30)	98	4.18%	3.98%	54/44)	3.388	0.0004
(-5,+5)	98	-0.50%	0.63%	51/47	0.878	0.1901
(-1,+1)	98	0.55%	0.69%	54/44)	1.855	0.0318
(-30,+30)	98	5.20%	4.33%	55/43 >	2.585	0.0049

Symbols), > show direction and test of significance at 0.10 and 0.05 level.

Table 3 presents results for the buy and hold strategy and in Table 4 we use the Scholes-Williams (Table 4) beta.

TABLE 4
BUY AND HOLD RESULTS WITH USING THE SCHOLES WILLIAMS MODEL

Days	N	Mean Compound Abnormal Return	Precision Weighted CAAR	Positive/Negative	Patell Z	p-value
(+1,+30)	98	4.52%	3.88%	56/42 >	3.285	0.0005
(-5,+5)	98	-0.19%	0.82%	51/47	1.141	0.1269
(-1,+1)	98	0.56%	0.72%	55/43 >	1.928	0.0269
(-30,+30)	98	5.88%	4.29%	55/43 >	2.553	0.0054

Symbol > shows direction and test of significance at 0.10 level.

TABLE 5
RESULTS WITH MARKET MODEL FOR LONG PERIODS

Days	N	Mean Compound Abnormal Return	Precision Weighted CAAR	Positive/Negative
(-1,+250)	98	24.67%	17.03%	64/34 >>>
(-30,+250)	98	25.98%	16.92%	65/33 >>>
(0,+250)	98	24.53%	16.72%	66/32 >>>

Symbol >>> shows direction and test of significance at 0.001 level

Returns over long horizons are striking (Table 6). One could infer that the firms on the Focus list do change. Caution must be applied when examining these results. The reason is when we estimate (forecast) the market model the chances of errors are greater and thus the estimates are influenced by other confounding events which increase the possibility of error.

TABLE 6
SCHOLES WILLIAMS BETA

Days	N	Mean Compound Abnormal Return	Precision Weighted CAAR	Positive/Negative
(-1,+250)	98	24.86%	16.79%	63/35 >>>
(-30,+250)	98	26.22%	16.71%	63/35 >>>
(-1,+250)	98	24.71%	16.44%	63/35 >>>

Symbol >>> shows direction and test of significance at 0.001 level

Symbol < shows direction and test of significance at 0.1 level

We then look at a buy and hold strategy where the investors hold a focus portfolio from the day of publishing to the day of the next publication where the portfolio is changed to the new one.

TABLE 7
RESULTS OF THE TWIN-EVENT WITH THE MARKET MODEL AND SCHOLES
WILLIAMS MODEL.

	Days	Positive/Negative	Patell Z	p-value
Market Model	1st date till 2nd	60/37 >>	4.561	< 0.0001
Scholes Williams	1st date till 2nd	59/38 >>	4.391	< 0.0001

Symbol < and >> show direction and test of significance at 0.1 and 0.05 level

DISCUSSION

CalPERS is known for its activist role. Focusing on the CalPERS focus list has merit. These firms that are on the list ‘react’ to the attention drawn. The initial drop in returns is expected since a large shareholder focuses attention on performance. In the longer term these firms improve performance. This improvement is difficult to attribute to being put on the focus list because other events confound the process.

These results can be examined in an efficient markets framework and that has been done (see: for example: Junkin and Toth (2009); Barber (2007) and Crutchley et. al (1998)). We take a different approach: There is more attention being paid to the frailty of the mind and we explain these results in a *Behavioral Finance* framework.

Some biology Coates (2012) explains such behavior. A winning streak builds confidence. The mind and body are affected. Testosterone and hemoglobin levels rise, muscles tense and a winning trader/investor is goaded into taking added risk. Investors who seek the focus list are similar in that they are aware that firms on this list will change.

Daniel Kahneman (2011) describes the two systems of the brain:

System 1 the mind operates automatically.

System 2 the mind pays attention.

We look at the behavioral finance literature to show the system 1 bias at work in similar situations to explain the phenomenon we document with the focus list.

Barberis and Huang (2006) eloquently describe the plight of an average investor. Rational models of asset pricing do not reflect the dilemma of the investor who becomes aware of an investment under scrutiny. Take for example a firm showing up on the focus list. Does an investor hold on or, should they sell the shares, take the loss and move on? Our results permit the introduction of how individuals look at *losses* and how *framing* affects decision making. Kahneman and Tversky (1979) show that people pay more attention to losses than gains. Thaler (1980) addresses this issue as *Mental Accounting*. Tversky and Kahneman (1981) show how *framing* affects decision making. Framing is essentially how an issue is presented. The fact that a firm is being singled out for poor performance must affect a shareholder.

Barber and Odean (2006) shed light on investor behavior by showing that attention grabbing stock experience abnormal trading volume and extreme one day returns.

Barberis, Shleifer and Vishny (1998), show that investors normally *underreact* to earnings information and they *overreact* to news. Again, a firm in the news for poor performance creates some panic. However, Hong, Lim and Stein (2000) show that negative information spreads slowly and there is evidence of momentum in stock returns. While difficult to separate, one can surmise that the firm reacts and begins to improve with the attention.

Cooper et. al. (2005) show investors reacting to ‘cosmetic’ announcements. A change in the name to reflect the current ‘hot’ investment style experiences an abnormal inflow of money into mutual funds. This is purely conjecture: there is a chance that these events attract the less informed market participant while the firm chooses to change.

CONCLUSION

This paper confirms previous results of the behavior of stock returns of firms that show up on the CalPERS focus list.

We describe in a behavioral framework the decision making of the investor. The market sees a list published by CalPERS focusing on the need to improve. This is an attention grabbing event. Investors choose to reduce investigating (search) time and cost and concentrate on trading. Over time the news is assimilated and maybe the management sees merit in changing some of their ways and the returns improve.

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