Abstract

We analyze dynamic trading in an anonymous market by an activist investor who can expend costly effort to affect firm value. We obtain the equilibrium in closed form for a general activism technology, including both binary and continuous outcomes. The optimal continuous trading strategy is independent of the activism technology. Activism, prices, and liquidity are jointly determined in equilibrium. Variation in noise trading volatility can produce either positive or negative effects on both efficiency and liquidity, depending on the activism technology and model parameters, because future effort depends on the realized amount of noise trading. The ‘lock in’ effect emphasized in previous literature (e.g., Coffee (1991), Bhide (1993) and Maug (1998)) holds only for special forms of the activism technology. Reducing the uncertainty about the activist’s position improves market liquidity, but the effect on efficiency depends on the specification of the effort cost function. Variation in the activist’s productivity produces a negative cross-sectional relation between efficiency and liquidity as the possibility of more activism exacerbates the risk of adverse selection.

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