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Institutional investors, political connections and analyst following in Malaysia

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ABSTRACT

We examine the association between institutional ownership, political connections, and analyst following in Malaysia from 1999 to 2009. Based on 940 firm-year observations, we document a positive relation between institutional ownership, particularly by Employees Provident Fund (EPF), and analyst following, thus supporting the governance role that institutional investors play in promoting corporate transparency. However, there is no evidence that political connections matter to analyst following. The monitoring role of institutional investors, including EPF, does not appear to be any different between politically connected and non-connected firms.

1. Introduction

Financial analysts play an important intermediary role in the capital market by providing information about firms, including estimates of earnings and price forecasts and buy/sell recommendations (Healy and Palepu, 2001). Analysts' services are also demanded by external parties to assist in monitoring (Brown et al., 2011; Jensen and Meckling, 1976) and valuing the firms (Bradshaw, 2011). Bushman and Smith (2001) and Healy and Palepu (2001) find lower information asymmetry for firms with greater analyst following, suggesting that analysts provide an important contribution to the firm's information environment (Bushman et al., 2004).

Studies that examine the determinants of analyst following have centred on firm characteristics, including institutional ownership (Ackert and Athanassakos, 2000, 2003; Fernando et al., 2012; Hussain, 2000; O'Brien and Bhushan, 1990) and corporate governance (Baik et al., 2010; Yu, 2010) as well as the rules and regulations of the capital market (Tan et al., 2011). However, nothing is known about how analyst following is related to political connections. Our first aim in this paper is to fill this void by providing the first evidence on the association between political connections and analyst following in Malaysia.

The intimate ties between the business elites and political leaders are an integral part of many economies, particularly the emerging economies, including Malaysia. In Malaysia, almost one-third of the listed firms are known to be politically connected (Faccio et al., 2006). The extant evidence shows that politically connected firms are highly opaque, and that there is greater information asymmetry between the connected firms and market participants, such as financial analysts. The opacity is due in part to the higher complexity and uncertainty of the income generation process created by the connection (Chen et al., 2011). The protection that government provides to connected firms, e.g., government bailouts (Faccio et al., 2006) and the imposition of tariffs on competitors (Goldman et al., 2013), allows managers of these firms to practise greater discretion on financial disclosure thus further contributing to firm opacity (Bhattacharya et al., 2003). Indeed, Chaney et al. (2011) find that the quality of accounting information is significantly poorer for politically-connected firms, and Lim et al. (2014) report that these firms have a less timely price discovery process. Riahi-Belkaoui (2004) finds managers in connected firms camouflage their performance, increasing earnings opacity. All these studies suggest that connected firms have a poorer information environment. As analysts are attracted to firms with more informative disclosure policies (Lang and Lundholm, 1996), we thus predict that there is a negative relation between political connections and the number of analysts following the firms. Since connected firms receive preferential treatment from governments[2] and are thus less reliant

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[2] These preferential treatment include easy access to cheaper bank loans (Chaney et al., 2011; Claessens et al., 2008; Johnson and Mitton, 2003; Khawaja and Mian, 2005; Leuz and Oberholzer-Gee, 2006); the awarding of profitable government contracts (Bertrand et al., 2007; Goldman et al., 2013; Wu et al., 2012); and lower taxation (Bertrand et al., 2007; Faccio, 2010).

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on external funding (Faccio et al., 2006), analysts also have less incentive to forecast the earnings of these firms.

Our second aim is to examine the association between institutional ownership and analyst following. Institutional investors have substantial market power, influence, and sophistication in gathering and interpreting information about the firm (Abdul Wahab et al., 2007; Grier and Zychowicz, 1994). These attributes provide institutional investors considerable advantage in monitoring corporate activities compared to other investors. Karpoff (2001) finds that institutional investors are successful in shareholder activism, prompting firms to act in accordance with investors' needs. Aggarwal et al. (2011) find a positive relation between institutional ownership and corporate governance in a cross-country study. Some supporting evidence of this in Malaysia is provided by Abdul Wahab et al. (2008).

The effectiveness of institutional investors as a monitoring body has been recognized by governments that incorporate institutional monitoring duties into regulations in order to ensure adequate oversight (Starks, 2000). In Malaysia, the Finance Committee in Corporate Governance (FCCG) highlighted the need for greater involvement by institutional investors in corporate governance after the 1998 Asian financial crisis. This has resulted in the establishment of the Minority Shareholders Watchdog Group (MSWG), which aims to protect the interest of minority shareholders through shareholder activism and acts as an independent research organization to advise and encourage good governance practices amongst publicly listed firms (Mintchik et al., 2010). There are four founding members of MSWG,[3] which collectively dominate the market share of institutional investments in Malaysia (Abdul Wahab et al., 2007). Ammer and Abdul Rahman (2009) investigate the effectiveness of shareholder activism by MSWG, and find that MSWG-targeted firms earn higher stock returns than non-targeted firms in the long run. They note that the two most important issues raised by MSWG during annual meetings are financial reporting and corporate governance. Domestic institutional investors can thus provide effective monitoring of corporate behaviour (Chhaochharia et al., 2012).

We argue that financial institutions are able to mitigate information asymmetry by pressuring firms to disclose information. Since institutional investors play an important governance role by promoting corporate transparency, we thus predict that firms with higher institutional ownership have greater analyst following, all else equal. Further, in performing their fiduciary duties (Hawley and Williams, 1997), institutional investors are likely to demand for analyst services to help them assess the potential investee firms (Hussain, 2000; Jennings, 2005; O'Brien and Bhushan, 1990; Shleifer and Vishny, 1997). This suggests that it is more profitable for analysts to follow firms with higher institutional shareholdings. Thus, analyst following is expected to be higher for these firms.

The effectiveness of institutional investors as monitors of politically connected firms is less clear. On the one hand, the presence of institutional investors in connected firms is expected to promote better reporting environment and increase corporate transparency, thus attracting greater analyst following. However, in Malaysia, government proxies sit on the advisory board of MSWG members. Political involvement in firms' decision making suggests that MSWG investment is likely to be dictated by the government. In an attempt to enhance Bumiputera shareholdings in the capital market under the New Economic Policy (NEP),[4] these domestic institutional investors are likely to skew their investment towards connected firms rather than firms with better governance. The presence of institutional investors in connected firms may thus be politically driven rather than for governance purposes. This argument predicts that the relation between analyst following and institutional ownership is attenuated in politically connected firms.

Based on a sample of 940 firm-year observations from 1999 to 2009, we find some evidence of a positive relation between institutional ownership and analyst following. This supports the corporate governance argument that institutional investors demand greater information disclosure, thus attracting more analysts to the firm. We extend the analysis to reflect the heterogeneity in institutional investors in Malaysia, and find that the ownership of Employees Provident Fund (EPF), the largest institutional investor in Malaysia, is an important determinant of analyst following. Specifically, firms with a higher EPF shareholding have significantly greater analyst following. This result is consistent with the significant participatory role played by EPF in corporate governance (Abdul Wahab et al., 2007). However, MSWG shareholdings are not significant in explaining analyst following.

Despite the strong and well-documented presence of political connections in Malaysia (Faccio et al., 2006; Johnson and Mitton, 2003), we find no evidence that political connection is an important determinant of analyst following. The monitoring role of institutional investors, including EPF, does not appear to be any different between politically connected and non-connected firms.

Our paper contributes in the following ways. First, it contributes to the increasing volume of research that has capitalized on the political economy of Malaysia (Abdul Wahab et al., 2007; Adhikari et al., 2006; Bliss and Gul, 2012a, 2012b; Fraser et al., 2006; Gomez and Jomo, 1999; Gul, 2006; Johnson and Mitton, 2003) by showing whether a firm is politically connected matters to analysts' decision to follow the firm. Second, we add to the literature on the heterogeneity in institutional shareholders by showing the type of institutional monitoring in Malaysia that matters to analyst following. Our findings have important implications for other countries in the neighbouring region where strong government intervention is a salient feature of the capital markets, and which can substantially affect the information environment for investors.

The rest of the paper is set as follows. Section 2 provides a background discussion of political connections and institutional investors in Malaysia. Section 3 outlines our research design, and Section 4 describes the data. Results are discussed in Section 5; 6 concludes the paper.

2. Background

2.1. Political connections

Selznick (1949) argues that political connections exist due to uncertainty of government regulations, and lead to firms working together with the government. Theories forwarded by North (1990) and Olson (1993) suggest that the connection provides government with a means of controlling the firms so that they will act in congruence with the government's agenda. Politicians have been known to extract rents generated by these connections (Shleifer and Vishny, 1994), and in return, the connected firms would receive preferential treatment such as precedence over government contracts.

The growth in research interest on political connections in Malaysia has largely spun from the work of Gomez and Jomo (1999). Subsequent studies utilise their data on political connections and provide valuable insights into the various roles of political connections in Malaysia, e.g., Johnson and Mitton (2003) on capital control, Adhikari et al. (2006) on effective tax rates, Gul (2006) on audit fees, Fraser et al. (2006) on leverage, Abdul Wahab et al. (2007) on corporate governance, and Bliss and Gul (2012a, 2012b) on leverage and cost of debt respectively. Cross countries studies such as Bushman et al. (2004) and Faccio et al. (2006) have also examined political connections in

[3] The four founding members of MSWG are the Permodalan Nasional Berhad (PNB), Lembaga Tabung Angkatan Tentera (LTAT), Social Security Organisation (SOCSO), and Pilgrim Fund Board (LUTH).

[4] The New Economic Policy (NEP) was a social re-engineering and affirmative action program formulated by the National Operation Council in the aftermath of the 1969 racial riot in Malaysia. NEP was adopted in 1971 for a period of 20 years and acceded by the National Development Policy (NDP) in 1991. The main objective of NEP (and its successor, NDP) is to achieve national unity by eradicating poverty, irrespective of race, and by restructuring the society to achieve inter-ethnic economic parity between Bumiputera and non-Bumiputera (Gomez and Jomo, 1999). Its second objective is to reduce inter-ethnic economic differences.