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Are foreign investors locusts? The long-term effects of foreign institutional ownership☆

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ABSTRACT

This paper challenges the view that foreign investors lead firms to adopt a short-term orientation and forgo long-term investment. Using a comprehensive sample of publicly listed firms in 30 countries over the period 2001–2010, we find instead that greater foreign institutional ownership fosters long-term investment in tangible, intangible, and human capital. Foreign institutional ownership also leads to significant increases in innovation output. We identify these effects by exploiting the exogenous variation in foreign institutional ownership that follows the addition of a stock to the MSCI indexes. Our results suggest that foreign institutions exert a disciplinary role on entrenched corporate insiders worldwide.

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"We support those companies, who act in interest of their future and in interest of their employees against irresponsible locust swarms, who measure success in quarterly intervals, suck off substance and let companies die once they have eaten them away."

– Franz Müntefering, German Social Democratic Party chairman, 2005

"The effects of the short-termist phenomenon are troubling... In the face of these pressures, more and more corporate leaders have responded with actions that can deliver immediate returns to shareholders, such as buybacks or dividend increases, while underinvesting in innovation, skilled workforces or essential CAPEX necessary to sustain long-term growth."

– Laurence Fink, CEO, BlackRock, 2015

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1. Introduction

How does financial globalization affect long-term corporate investment and productivity? In recent decades, companies have trended away from the stakeholder capitalism model of concentrated ownership historically predominant in continental Europe and Japan, in which long-term relationships with labor, creditors, and other stakeholders are promoted (Tirole, 2001; Carlin and Mayer, 2003; Allen et al., 2015). Instead, many companies are moving toward the Anglo-Saxon shareholder capitalism model, with its dispersed and globalized shareholder structure. Foreign institutional investors are agents in this change, playing an increasingly prominent monitoring role as shareholders worldwide (Aggarwal et al., 2011).

In this paper, we examine two hypotheses. The first hypothesis is that the presence of foreign institutional investors as shareholders can lead managers to cut long-term investment by reducing capital expenditures, research and development (R&D) expenditures, and employment. This view posits that foreign portfolio flows represent “hot money” in search of short-term profits, with little concern for long-term firm prospects.[1] Regulators and policy makers have expressed concerns that the rising importance of activist investors is leading firms toward short-termist strategies, delivering immediate returns to shareholders at the expense of long-term investment (Organisation for Economic Co-Operation and Development, 2015). In one high-profile case, Franz Müntefering, German Social Democratic Party chairman, compared foreign private equity and activist hedge fund investors targeting German companies to an invasion of “locusts” stripping companies bare.[2] The “locust” label has since been used to refer to foreign investors more broadly (Benoit, 2007; The Economist, 2007). Locust foreign capital, it is proposed, could lead companies to strip assets for short-term profits, delocalize production, and adopt unfriendly labor policies, including layoffs. This attitude is part of a more general phenomenon of protectionist sentiment with regard to foreign capital flows.[3]

Foreign institutional investors may create market pressure inducing short-termism if they prompt managers to prioritize short-term earnings over long-term growth. Ferreira et al. (2014) argue that the stock market pressures managers to select projects that they can easily communicate to investors; managers forgo innovation in favor of ready-made technologies, which are more transparent to investors. Foreign institutions, moreover, may be less tolerant of failure, which can place executives at greater risk for career concerns, including termination. These factors may steer risk-averse managers away from pursuing opportunities for innovative growth.

The second hypothesis is that foreign institutional investor monitoring promotes long-term investment in fixed capital, innovation, and human capital. This positive impact derives from the disciplinary effect of the presence of institutions on corporate insiders. Institutional investors may persuade managers, who tend to prefer a quiet life (Hart, 1983; Bertrand and Mullainathan, 2003), to innovate via diplomacy, actively voting their shares, or even confrontational proxy fights. In an international context, other corporate insiders, such as blockholders, may extract private benefits through control and may not be diversified, making them averse to risk.[4]

Foreign institutions may be in a better position than domestic institutional investors to monitor corporate insiders and influence strategic decision making. Domestic institutions, because they are more likely to have business ties with local companies, may have a closer relation with the firms they invest in. They may thus be more accommodating to corporate insiders and less effective as external monitors (Gillan and Starks, 2003; Ferreira and Matos, 2008).[5] In contrast, because they are less encumbered by ties with corporate insiders, foreign institutions can reduce managerial entrenchment and promote investment in riskier opportunities for growth. Foreign institutions may also be better able to tolerate the high-risk/high-return trade-off associated with long-term investment because they can better diversify risks through their international portfolios.[6]

To test our hypotheses, we use a comprehensive data set of portfolio equity holdings by institutional investors covering more than 30,000 publicly listed firms in 30 countries over the period 2001–2010. We find that higher ownership by foreign institutions leads to an increase in long-term investment (proxied by capital and R&D expenditures) and innovation output (proxied by patent counts). We also find that these increases in investment in tangible and intangible capital do not induce unfriendly labor policies. On the contrary, we find that higher foreign institutional ownership leads to increases in employment and measures of human and organization capital.

The endogeneity of foreign institutional ownership makes it difficult to establish a causal effect. In fact, foreign institutions may choose to invest in firms with better long-term growth prospects or in firms for which they anticipate a surge in innovation. We address the omitted

[1] Brennan and Cao (1997) argue that foreign investors, less informed about the prospects of local stocks, may rebalance portfolios disproportionally and amplify the stock reaction to negative public news. Borensztein and Gelos (2003) suggest that international capital flows are more “panic-prone” in emerging markets.

[2] A prominent example is the bathroom hardware maker Grohe, which the U.S. private equity group TPG Capital took over in 2004. TPG Capital’s original plans called for job cuts. However, Grohe subsequently invested in R&D, improved profitability, and reduced its labor force less than expected (Milne, 2008). Another case is Children’s Investment Fund, a UK hedge fund, which helped block Deutsche Börse’s attempt to buy the London Stock Exchange, arguing that buying back shares would be a better use of its cash (The Economist, 2005).

[3] Dinc and Erel (2013) find evidence of economic nationalism in mergers and acquisitions in Europe, in that governments prefer to see target companies remaining in domestic hands.

[4] In an alternative to the voice channel, institutional investors can threaten to exit (e.g., selling and depressing stock prices). Our identification strategy using stock additions to the MSCI All Country World Index (MSCI ACWI) emphasizes the voice channel.

[5] Domestic institutional investors are often affiliated with banks that act as creditors, underwriters, advisors or hold seats on boards (Ferreira and Matos, 2012; Ferreira, Matos, and Pires, 2016).

[6] There are some markets that have witnessed the development of independent domestic institutions. For example, Giannetti and Laeven (2009) show that the reform of the pension system in Sweden increased investor monitoring, but only by independent private pension funds.

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