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Institutional Investors, Risk/Performance and Corporate Governance

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Abstract

Modern portfolio theory suggests that investors minimize risk for a given level of expected return by carefully choosing the proportions of various assets. This study sets out to determine the role of the institutional investor in monitoring risk and firm performance. Using a sample of Australian firms from 2006 to 2008, our empirical study shows a positive association between firm-specific risk, risk-management policy, and performance for firms with increasing institutional shareholdings. The study also finds that the significance of this association depends on the institutional investor's ability to influence management, which in turn depends on the size of ownership and whether the investee firm does not have potential business dealings with the investor. We also find that when firms are financially distressed, institutional investors engage in promoting short-term performance or exit rather than support long-term value creation. The results are robust while controlling the potential for endogeneity and using sensitivity tests to control for variants of performance and risk. These findings add to the growing body of literature examining institutional ownership and the importance of understanding the role of risk-management in the risk and return relation.

JEL classification: M40; G34
Keywords: Institutional investors; Corporate governance; Risk and performance

1. Introduction

Many researchers and practitioners have identified excessive risk-taking as the major contributor to the global financial crisis (GFC) and highlight the importance of institutional

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investors in this scenario (Callen & Fang, 2013; Gorter & Bikker, 2013). The GFC highlights the importance of an appropriate corporate governance structure for managing risk. The purpose of this study is to determine the role of institutional investors in the risk–return relation in a period of increasing risk-taking, the GFC. The question is whether institutional investors actively engage or seek out information on the risk-management practices of their portfolios or whether they pursue aggressive risk-taking and favor short-term profits.

This question is particularly important in a country such as Australia, where employers in all sectors are required to contribute to a compulsory employee superannuation scheme.[1] This means that Australia has the fourth-largest pension fund pool in the world, creating enormous investment opportunities.[2] In addition, the global financial crisis provides a unique setting to determine the consequences of institutional investors' involvement in, and influence over, corporate management and board behavior in the period leading up to the crisis. The OECD countries that experienced the fastest economic growth in the 15 years prior to the global financial crisis – including the US, the UK, Australia, and Ireland – were also the countries with the greater financial sector deregulation (Pomfret, 2009). However, financial deregulation increases vulnerability to a financial crisis (Pomfret, 2009). When the global financial crisis unfolded, it was regarded as unexpectedly sudden (Sidhu & Tan, 2011).

Although it is generally accepted that the Australian market suffered less of an economic downturn than other economies (Reserve Bank of Australia, RBA, 2010), the downturn increased business risk through, inter alia, its impact on equity and credit markets (Xu, Jiang, Fargher, & Carson, 2011). While we can evaluate the impact of the global financial crisis in hindsight, there was a climate of uncertainty in the investment community from the global effects, and it is in this environment of escalating uncertainty that we examine the risk-return relationship.

In our study, we model firm performance as a function of firm-specific risk, risk-management practices and the size of institutional ownership. While controlling for potential endogeneity, we determine whether the size of institutional investor has any influence over the association between risk and performance, measured as return on assets. The results of the 3SLS regression show that increasing levels of firm-specific risk and a comprehensive risk-management policy is associated with increasing institutional ownership and firm performance. Further investigation reveals that this association is only significant for pressure-resistant institutional investors. Research defines pressure-resistant investors as those who do not have the scope for economic bonds and who are less averse to challenging management. Pressure-sensitive institutional investors have the potential for business relations with investee firms and are therefore less likely to challenge management for fear of losing business (Brickley, Lease, & Smith, 1988).

This study contributes to the literature relating to the influence of institutional investors on the relationship between risk and firm performance in several ways. First, our results demonstrate that firm-specific risk and risk-management practices are an important determinant of the size of institutional investment. Our study helps to explain previous conflicting results on whether institutional investors consider the governance practices of

[1] Employers are required by law to pay an additional amount based on a proportion of an employee's salaries and wages (currently 9.25%) into a complying superannuation fund.

[2] http://www.asx.com.au/documents/research/financial_sector_factsheet.pdf.