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Does institutional ownership influence firm performance? Evidence from China

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ABSTRACT

In recent decades, institutional investors have played an increasingly important role in China's stock markets, following a series of market-liberalizing reforms. This study uses a simultaneous equations model with a generalized method of moments estimator to investigate the effects of institutional ownership on firm performance in a new large sample of Chinese listed firms from 2004 to 2014. The results generally suggest that institutional ownership positively affects firm performance and are robust to accounting for deregulation, contemporaneous market conditions, and different stock market boards. However, not all institutional investors are active monitors and improve firm performance. In particular, the results indicate that pressure-insensitive, foreign and large institutional shareholders have greater positive effects on firm performance than pressure-sensitive, domestic, and small institutional shareholders. The results further suggest that institutional investors enhance shareholder value by attracting more analysts and reducing insider ownership (among other reasons), and these findings are robust to a series of sensitivity analyses.

1. Introduction

In recent decades, the Chinese government has undertaken a series of important reforms to liberalize Chinese stock markets and incentivize the development of institutional investors, including opening Chinese stock exchanges to qualified foreign institutional investors (QFIIs), social security funds, and insurance companies in 2002, 2003, and 2004, respectively.[1] In addition, from 2005 to 2006, policymakers implemented a split share structural reform that transformed approximately two-thirds of previously non-tradable shares into tradable shares.[2] As a consequence, the number of shares of Chinese listed companies that are owned by institutional investors (including mutual funds, social security funds, insurance companies, broker dealers, and QFIIs, among others) grew dramatically over the 2004–2014 period—from 3.04% of the total number of outstanding shares in 2004 to 32.65% in 2014. This trend has raised an interesting question: Do these institutional investors positively influence firm performance in China?

According to the “active monitoring” view, institutional investors (as large shareholders) should be able to supervise and monitor investee firms, reduce information asymmetries, lower agency problems and maximize shareholder value by virtue of their superior

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[1] Based on the approved investment quota, a QFII can invest in A shares and bonds listed on China's stock exchanges and other financial instruments approved by the China Securities Regulatory Commission (CSRC). A social security fund can invest up to 40% of its total assets in funds and stocks. An insurance company can invest in capital markets through two approaches: a) directly purchasing stocks, with such purchases equaling no more than 5% of its total assets, and b) buying securities investment funds, with such purchases equaling no more than 15% of its total assets (CSRC, 2007).

[2] By the end of 2006, the majority of listed companies had joined the share split reform.

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managerial skills and substantial resources. In addition, these institutional investors can use their ownership rights to pressure managers to improve corporate governance (Shleifer & Vishny, 1986).[3] Alternatively, the "passive monitoring" view suggests that institutional investors act only as passive monitors and do not intervene in management, trading shares to earn speculative short-term trading profits based on informational advantages (David & Kochhar, 1996) or to satisfy idiosyncratic portfolio needs (Elyasiani & Jia, 2010).[4] According to the "exploitation" view, institutional investors cooperate with firm managers to exploit dispersed small shareholders. In particular, they may choose to overlook management fraud if they can benefit from its consequences.[5] As Elyasiani and Jia (2010) indicate, these three views are not "mutually exclusive" (p. 606), but one may play the dominant role in explaining the relationship between firm performance and institutional ownership.

The previous literature notes that institutions are masters at influencing firm performance but presents mixed results. Brickley et al. (1988) examine a sample of 201 US firms with 308 antitakeover amendments in 1984 and find that there is a significant difference between pressure-insensitive and pressure-sensitive institutions in terms of voting for or against antitakeover amendments. Their results suggest that pressure-insensitive institutions are more likely to actively monitor and oppose management than are pressure-sensitive institutions. Cornett, Marcus, Saunders, and Tehranian (2007) investigate the effects of institutional ownership on corporate operating performance in the US from 1993 to 2000 and find that only pressure-insensitive institutional investors (e.g., mutual funds) have a positive impact on firm performance. Ferreira and Matos (2008) provide international evidence regarding the role of institutional ownership in 27 countries over the 2000–2005 period and suggest that foreign and independent (insensitive) institutions improve firm value (as measured by Tobin's Q) and operating performance (as measured by ROA and net profit margin), whereas the applicable coefficients for domestic and non-independent (sensitive) institutions are either insignificant or negative. Elyasiani and Jia (2010) investigate a large sample of 1532 US firms over the 1992–2004 period and find a positive relationship between firm performance and the stability of institutional ownership. These authors also suggest that insensitive institutional investors and investors owning 5% or more of shares have a greater positive impact on firm performance (as measured by industry-adjusted ROA) than sensitive institutional investors and institutional investors owning less than 5% of the outstanding shares, respectively. In addition, these authors find that the channels of such influence include decreased information asymmetry and increased incentive-based compensation.

Although China is the second-largest economy in the world, its stock market remains far from mature, similar to many other transitional and emerging economies. This mismatch has greatly hampered the efficient allocation of resources and, consequently, the sustainable development of the economy. To address this critical issue, the Chinese government has, since 2002, gone to great lengths to encourage the development of institutional investors because such investors are expected to stabilize the stock market by improving corporate governance, lowering information asymmetries, and helping investee firms respond to both external and internal shocks.[6] The China Securities Regulatory Commission (CSRC) even included "continuously promoting the development of institutional investors" as one of the key development strategies for China's capital markets for the period between 2008 and 2020 (CSRC, 2008, p. 137). As mentioned previously, however, different types of institutional investors can influence firm performance in quite different (or even opposite) ways. Therefore, another interesting question is which types of institutional investors contribute to improved investee performance in China? Moreover, the transmission mechanism between institutional ownership and firm performance is a critical issue, not only to policy makers but also managers and investors, because investigating it enables us to identify the key success factors concerning this value-enhancement mechanism.

Surprisingly, to date, only a handful of studies have empirically investigated this important issue in the Chinese context.[7] Yuan, Xiao, and Zou (2008) find that mutual fund stock ownership has a positive effect on firm performance in a sample of 1211 firms between 2001 and 2005. Chen, Du, Li, and Ouyang (2013) note that institutional ownership (both foreign and domestic) increases return volatility in a sample of 1458 Chinese firms for the 1998–2008 period. Examining Chinese listed firms from 2003 to 2008, Chan, Ding, and Hou (2014) indicate that better external governance through sources such as mutual funds could improve financial reporting quality and, in turn, strengthen investors' confidence and enhance financial market liquidity. Using data from 102 local Chinese banks between 2006 and 2011, Wu, Shen, and Lu (2015) demonstrate that having more foreign strategic investors (FSIs) enhances the earnings smoothing of local banks, and such effects become stronger for banks with more FSIs and more FSI directors. Employing data from over 1000 Chinese listed firms with institutional ownership from 2003 to 2011, Firth, Gao, Shen, and Zhang (2016) show that pressure-insensitive institutional ownership has a significantly positive effect on firm performance, whereas pressure-sensitive institutional ownership does not seem to generate such an effect. However, a comprehensive investigation of whether different types of institutions have differential effects on firm performance has yet to be undertaken, and no analysis has been performed of the channels through which institutional investors might affect firm performance.

To fill this gap, the aim of this study is to investigate the effects of institutional ownership on firm performance using a new and large sample of Chinese listed firms from 2004 to 2014. In particular, this study seeks to extend the previous empirical literature in

[3] For example, improvements might include the quality of information disclosure and transparency of firm operations.

[4] For example, fund managers adopt "prudent" investing behavior, treating their portfolio returns the same as index returns and buying stocks that represent the components of an index (e.g., S & P 500) (Elyasiani & Jia, 2010).

[5] For example, investment firms may side with management at the expense of other shareholders with the aim of obtaining more investment banking business (Brickley, Lease, & Smith, 1988).

[6] In 2002, the China Securities Regulatory Commission (CSRC) proposed simplifying the approval process and reducing government control to initiate market reforms in the mutual fund industry. In the same year, the CSRC also issued the *Notification on Relevant Issues Concerning the Examination and Approval of Securities Investment Funds* to stimulate the development of institutional investors.

[7] Several commentators (e.g., Gen, 2002; Tenev, Zhang, & Brevort, 2002) suggest that financial institutions—as short-term traders—play no monitoring role in the Chinese stock market because they represent such a small market share.