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Institutional investor stability and crash risk: Monitoring versus short-termism?

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ABSTRACT

This study tests two opposing views of institutional investors—monitoring versus short-termism. We present evidence that institutional investor stability is negatively associated with 1-year-ahead stock price crash risk, consistent with the monitoring theory of institutional investors but not the short-termism theory. Our findings are shown to be robust to alternative empirical specifications, estimation methods and endogeneity concerns. In addition, we find that institutional ownership by public pension funds (bank trusts, investment companies, and independent investment advisors) is significantly negatively (positively) associated with future crash risk, consistent with findings that pension funds more actively monitor management than other types of institutions.

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1. Introduction

One of the important issues emerging from the recent financial crisis is the alleged negative role played by institutional investors leading up to and during the crisis period. Some observers maintain that institutional investors exacerbated the crisis by pressuring financial service entities for short-term profits and increasing the latter's risk-taking behavior.[1] Della Croce et al. (2011) assert that "…long-term institutional investors are also recurrently being labeled as "short-termist", of feeding asset price bubbles with a herd-like mentality." Others claim that the demand for relatively safe debt assets by institutional investors helped drive the excessive US credit and securitization expansion in 2003–2006, ostensibly a primary cause of the crisis.[2] In a recent study, Manconi et al. (2012) provide evidence that contagion spread from securitized bonds to corporate bonds during the crisis thanks to trades by liquidity constrained institutional investors with portfolios exposed to securitized bonds. The European Union has gone so far as to state that the recent financial crisis has undermined the assumption of institutional investors as responsible shareholders (European Parliament, 2010).

The literature provides two essentially opposing views of institutional investors which, for lack of better terminology, we call monitoring and short-termism. Characterizing the monitoring view of institutional investors, Shleifer and Vishny (1986, 1997) argue that institutional shareholders, by virtue of their large shareholdings, have the incentive to collect information and monitor management because they reap greater benefits than smaller investors from monitoring the organization. Similarly, Dobrzynski (1993) and Monks and Minow (1995) argue that sophisticated institutions with large shareholdings tend to monitor and discipline managers to ensure that the firm's investment strategy is consistent with the objective of maximizing long-term value, rather than meeting short term earnings goals. Consistent with this monitoring view of institutional investors, empirical studies provide evidence on a variety of benefits from institutional ownership as it affects firm growth, R&D investment, executive compensation, management (earnings forecast) disclosures, CEO turnover, anti-takeover amendments, and corporate governance generally.[3] The monitoring view is also consistent with some evidence that institutional shareholder activism affects corporate events and enhances corporate value (Gillan and Starks, 2000, 2007; McCahery et al., 2008; Brav et al., 2008a,b; Klein and Zur, 2009; Helwege et al., 2012).

Nevertheless, there are several reasons to expect that institutional investors behave less benignly as the crisis experience seems

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[1] See Cheng et al. (2010), for example.

[2] See Holmstrom (2008), for example.

[3] See Jarrell and Poulsen (1987), Brickley et al. (1988), Agrawal and Mandelker (1990, 1992), McConnell and Servaes (1990), Bushee (1998), Wahal and McConnell (2000), Hartzell and Starks (2003), Parrino et al. (2003), Ajinkya et al. (2005), Bushee et al. (2008), Janakiraman et al. (2010), Aggarwal et al. (2010, 2011) and Chung and Zhang (2011).

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to imply. First, if monitoring is costly and/or time consuming, institutional investors may just sell off their stocks and bonds in response to unfavourable performance rather than influencing corrective action (Coffee, 1991; Manconi et al., 2012). Second, the strategy of many institutional investors in US equity markets (e.g., Vanguard) is to invest in a large number of different equities in order to diversify risk and maintain liquidity. The latter are likely indifferent regarding the governance of individual corporations. In fact, the activism literature cited above also provides some evidence that institutional investors are indifferent to and "walk away" from influencing corporate activities. Third, and more crucially, many critics claim that, by acting as traders, institutional investors themselves place excessive emphasis on short-term performance, causing management to be overly concerned that near-term earnings disappointments will induce heavy stock selling by institutional investors and the undervaluation of stock price (Graves and Waddock, 1990; Jacobs, 1991; Porter, 1992; Bushee, 1998, 2001).[4] Indeed, prior research provides empirical evidence of this "short-termism" view. This evidence suggests that institutional investors trade heavily based on current earnings news, place excessive emphasis on short-term performance, and fail to serve as monitors in correcting CEO overcompensation. (Graves and Waddock, 1990; Jacobs, 1991; Porter, 1992; Lang and McNichols, 1997; Bushee, 1998, 2001; Yan and Zhang, 2009; Yudan, 2010; Cheng et al., 2010; Cella et al., 2011; Manconi et al., 2012).

The purpose of this study is to evaluate the monitoring versus short-termism views of institutional investors by reference to stock price crash risk. Recent studies maintain that managers withhold bad news from investors because of career and short-term compensation concerns and that when a sufficiently long-run of bad news accumulates and reaches a critical threshold level, managers tend to give up. At that point, all of the negative firm-specific shocks become public at once leading to a crash—a large negative outlier in the distribution of returns (Jin and Myers, 2006; Kothari et al., 2009; Hutton et al., 2009). The empirical evidence supports the hypothesis that managerial bad news hoarding behavior results in stock crashes by showing that financial reporting opaqueness, corporate tax avoidance, and CFO's equity incentives act to increase future firm-specific crash risk (Jin and Myers, 2006; Hutton et al., 2009; Kim et al., 2011a, 2011b).

We test these two views of institutional investors by examining the role of institutional investor stability on future stock price crash risk. Prior studies document empirical evidence linking institutional investor stability to various economic outcomes, including R&D investments, domestic and foreign acquisition decisions and debt financing costs (Bushee, 1998; Gaspar et al., 2005; Callen et al., 2005; Chen et al., 2007; Elyasiani et al., 2010). In this study, we hypothesize that if institutional investors act as monitors then more stable institutional investor holdings should reduce future stock price crash risk by curbing managerial bad news hoarding activities. Contrariwise, if institutional investors are fixated on current performance (short-termism), then more stable institutional investors will increase future stock price crash risk by exacerbating the tendency of managers to engage in bad news hoarding in order to satisfy their stable institutional investor base.

Using a large sample of US public firms for the years 1981–2008, we provide evidence that institutional investor stability is significantly negatively associated with 1-year-ahead stock price crash risk. The effect is economically as well as statistically significant. These results are consistent with the theory that institutional investors act to monitor management and reject the theory that institutional investors induce short-termism. These results are shown to be robust to potential endogeneity of institutional holdings and alternative model specifications and estimation techniques. Our findings also show that institutional investor stability can forecast crash risk as far as 3 years ahead and that (first and second) differences in institutional investor stability also help to predict future crash risk.

Hutton et al. (2009) find that firms with opaque financial reporting are more prone to stock price crashes, suggesting that opaque financial reporting facilitates managerial bad news hoarding activities. We further examine whether this result depends upon institutional investor stability. Monitoring by more stable institutional investors should mitigate the impact of opacity on future crash risk by reducing opportunities for managers to engage in bad news hoarding activities. We find that transient institutional holdings, one of our instability measures, is strongly positively related to future stock price crash risk and the relation increases significantly with financial statement opacity. Opacity alone is no longer significant. These results do not obtain when institutional instability is measured by the other two metrics in that the interaction effect is not significant, although the separate instability and opacity effects are significant and consistent with monitoring by institutional investors.

We further divide our institutional investors into functional-legal categories. We find that institutional ownership by public pension funds (bank trusts, investment companies, and independent investment advisors) is significantly negatively (positively) associated with future stock price crash risk. This is consistent with the findings in Brickley et al. (1988) and Bushee (2001) that pension funds tend to invest for the long-term and monitor management actively relative to other types of institutions.

Our study contributes to the literature in several ways. First, to our knowledge, this is the first study to assess the relation between institutional investor stability and future price crash risk. By focusing on a unique perspective—the extreme moment of the stock return distribution—this study provides new firm-level evidence concerning the economic consequences of institutional investing. In particular, our findings contribute to the ongoing debate about the monitoring versus short-termism roles of institutional investors. Do stable institutional investors monitor and mitigate firm agency costs or do they exacerbate these costs? In particular, our findings identify significant benefits (costs) that stable (unstable) institutional investing brings to firms and their shareholders. Xing et al. (2010) and Yan (2011) suggest that extreme outcomes in the equity market have a material impact on the welfare of investors and that investors are concerned about the occurrence of these extreme outcomes. Thus, our empirical evidence is useful for understanding the role that institutional investor stability plays in influencing both corporate behavior and overall shareholder welfare.

Second, this study extends research on the bad news hoarding theory of stock price crash risk. In particular, the implication of institutional investor stability for future crash risk yields valuable insights into the external-governance role of institutional investors in mitigating managerial manipulation of information. Recent studies on crash risk find that managerial bad new hoarding activities are related to corporate financial opacity, tax avoidance and CFO's equity incentives (Hutton et al., 2009; Kim et al., 2011a, 2011b).[5] However, the role that external governance factors play

[4] Short-termism has theoretical support as well. Bolton et al. (2006) present a multi-period agency model showing that incumbent investors use compensation contracts as an incentive to induce managers to engage in short term behavior which increase the short-term speculative component of the share price. In particular, they show that long-term-oriented shareholders may encourage managers to pursue some short-termism strategies in order to reduce the firm's cost of capital.

[5] Kim et al. (2011a) examine the association between corporate tax avoidance and future stock price crash risk. They further condition this association on external monitoring mechanisms, e.g., institutional shareholding. However, their study does not address the issue of institutional investor *stability* which the focus of this study.

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