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Institutional investor monitoring motivation and the marginal value of cash☆

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ABSTRACT

This paper examines whether the motivation of institutional investors in monitoring a firm is positively related to the relative importance of the firm's stock in their portfolios. We find that greater motivated monitoring institutional ownership is associated with a higher marginal value of corporate cash holdings, which cannot be explained by other corporate governance measures and institution types. Further, we find that the economic effect of institutional monitoring on the marginal value of cash falls with decreasing institutions' monitoring motivation. Based on these findings, we construct a monitoring motivation-weighted institutional ownership measure and document a positive relation between it and the marginal value of cash. Our results are robust after controlling for the endogeneity of institutional ownership, three cash regimes, firm size, and changes in US public firms over time.

1. Introduction

By the end of the fiscal year 2015, the aggregate cash holdings reported by non-financial and non-utility firms listed on the New York Stock Exchange (NYSE), NASDAQ, and the American Stock Exchange (AMEX) had reached \$2.3 trillion, representing 22.4% of total firm assets and equivalent to 12.5% of annual US GDP. Firms may hold more cash or other liquid assets for the precautionary motive should they face higher cash flow uncertainty, market competition, or credit constraints (e.g., Haushalter et al., 2007; Bates et al., 2009; Harford et al., 2014). However, the use of cash is mainly at the managers' discretion. Firm managers may either directly take the cash in the form of perks or excessive salaries, or invest it in projects that do not maximize shareholders' profits. Therefore, the managerial agency problems may reduce the value of corporate cash holdings.

This paper studies how institutional investor attention affects their governance role in monitoring corporate cash holdings. With the growth of institutional investors in the US stock market, large shareholders are likely to be active in firm governance.[1]

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[1] Edmans and Holderness (2016) provide a detailed survey of previous studies on the role of large shareholders in corporate governance.

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Previous studies have usually measured institutional monitoring by total institutional ownership or the ownership of institutional investors with similar characteristics, such as institution types, investment horizon, activeness in the engagement with firms, and a certain ownership threshold (e.g., Bushee, 1998; Chen et al., 2007; Cremers and Petajisto, 2009; Cronqvist and Fahlenbrach, 2009). However, institutional investors hold a large number of stocks in their portfolio.[2] Recent theoretical and empirical studies support the view that institutional investor attention is a scarce resource (Sims, 2003; Kacperczyk et al., 2016; Kempf et al., 2017). If the optimal level of monitoring attention to a holding firm is determined by the trade-off between monitoring benefits and costs, it may not be optimal for institutional investors to distribute their monitoring attention evenly to all the stocks in their portfolios. Fich et al. (2015) show that in mergers and acquisitions (M&A), the monitoring attention of institutional investors to a target firm is positively associated with the relative importance of the firm's stock in their portfolios. Following Fich et al. (2015), we define a firm's most motivated monitoring institutional investors as those whose holding values in the firm account for the top 10% of their portfolios.[3] If motivated monitoring institutional investors are indeed more actively engaging in firm governance than other institutional investors, then the market perceived value of cash should be higher for firms with greater motivated monitoring institutional ownership (IO).

To test the institutional investor limited attention hypothesis, we examine the following three research questions. First, is there a negative relation between institutional monitoring attention and the relative importance of firms in their portfolios? Second, does our measure of monitoring motivation vary across different institution types? Third, does motivated monitoring IO differ from other traditional corporate governance measures? There are several advantages of using the marginal value of cash as an empirical setting to answer these questions. First, the effect of motivated monitoring IO on the marginal value of cash can be measured by a dollar value perceived by stock market participants. Second, the pecuniary numbers documented in our panel sample not only contain time-varying and cross-section-varying information on the value of institutional monitoring, but also provide us with an empirical framework to examine how institutional investors allocate their monitoring attention to all firms in their portfolios. Lastly, conflicts of interest between shareholders and managers may cause firms to invest cash inefficiently (e.g., Jensen, 1986; Harford et al., 2008), so it is naturally to study whether and to what extent motivated monitoring institutional investors impinge on the value of corporate cash holdings.

Our sample includes 67,404 firm-year observations from the Centre for Research in Security (CRSP)/Compustat Merged dataset over the period 1995–2015. To quantify the effect of motivated monitoring institutional investors on firm cash holdings, we adopt Faulkender and Wang's (2006) specification and estimate the change in firm market value associated with a change of one dollar in cash holdings.[4] We find strong evidence that the marginal value of cash increases with most motivated monitoring IO. Controlling for other factors, a one standard deviation increase in most motivated monitoring IO is associated with a 9.2 cents higher marginal value of cash. This economic effect is even stronger if we replace most motivated monitoring IO by either the ratio of the numbers of the most motivated monitoring institutional investors to the numbers of total institutional investors (23.7 cents), or the natural log of one plus the numbers of the most motivated monitoring institutional investors (19.9 cents).

We next examine whether the positive effect of most motivated monitoring IO on the marginal value of cash can be explained by other traditional firm governance measures. We use four proxies following the previous literature: Gompers et al.'s (2003) *G-index*, Bebchuk et al.'s (2009) *E-index*, total institutional ownership, and blockholder ownership. The positive relation between the most motivated monitoring IO and the marginal value of cash remains statistically and economically significant after controlling for both anti-takeover indexes and other institutional ownership measures. More importantly, total institutional ownership and blockholder ownership do not have a significantly positive effect on the marginal value of cash in addition to the most motivated monitoring IO. This suggests that the motivation of an institutional investor to monitor a firm is more related to how important the firm is to the investor than how important the investor is to the firm. Our findings show that the role of the most motivated institutional investors in monitoring firm cash holdings is unlikely to be driven by the traditional firm governance measures.

We also try to determine whether our measure of institutional monitoring motivation may only be applied to a particular type of institution. According to Brickley et al.'s (1988) classification, we find that both independent and grey most motivated institutional investors have a positive association with the marginal value of cash. We further use Bushee's (1998) classification and show that all three types of most motivated monitoring IO have a positive effect on the marginal value of cash, while the effect is only statistically significant for transient and quasi-indexer institutions. Our findings indicate that institutions, whose monitoring role is believed to be ineffective due to the potential business ties (grey) and short investment horizon (transient), still have a positive contribution in monitoring firms that are relatively important in their portfolios.

To explore how an institutional investor's monitoring attention to a firm changes with the firm's market value weight in the portfolio, we sort all firms in an institutional investor's portfolio into ten decile groups by their descending market value weight in the portfolio. We extend Fich et al.'s (2015) 10% threshold and examine the allocation of monitoring attention to all the stocks in institutional portfolios. The institutional investor's monitoring attention should be higher for firms in the top decile group than for those in the bottom decile group. If firm i is assigned in the decile group j of an institutional investor's

[2] On average, an institutional investor's portfolio included 219 stocks during 1980–2010 (Zeng, 2016).

[3] Later in the paper, we extend the top 10% cutoff and construct a general monitoring motivation-weighted institutional ownership measure. Therefore, we append "most" to motivated monitoring institutional investors.

[4] In this paper, we use "the marginal value of cash" and "the change in firm market value associated with a change of one dollar in cash holdings" interchangeably.