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Institutional investors in Australia: Do they play a homogenous monitoring role?

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ABSTRACT

This paper examines whether the presence of institutional investors in Australian publicly listed firms has an impact on firm performance. Our findings provide evidence that institutional investors are not a homogenous group of investors and that it is important to distinguish them by investment objective and their monitoring ability to exert influence. Results show that while institutional investors taken as a homogenous group appear to play an important governance role in terms of future firm performance, our analyses of the three broad typologies of institutional investors and by their respective sub-categories reveal differing conclusions. While pressure-resistant institutional investors (i.e., independent and having only investment relationship) significantly improve the short-term performance of Australian listed firms, they do not show any long-term monitoring ability. The impact of pressure-sensitive institutional investors is less clear, which is consistent with the view that these investors have some existing and potential business ties with the investee firms. More interestingly, we find that "faceless" investors via nominee and trustee institutions play an important monitoring role in creating a long-term firm value. Results have policy implications on the monitoring abilities of institutional investors in Australia.

1. Introduction

Institutional investors have a notable presence and a growing influence in capital markets across the globe, with the extant literature reporting that institutional investors can wield their influence in numerous ways, resulting in divergent effects on firm performance. Not only do institutional investors exert power by influencing trading activities in the capital market (Chaganti and Damanpour, 1991), but they also change existing power distributions within companies (Sacristán-Navarro et al., 2011), and they play an effective monitoring role by exerting pressure on corporations on specific issues such as excessive executive remuneration (Almazan et al., 2005; Khan et al., 2005; Gillan and Starks, 2003; Gomez-Mejia et al., 2003)[1].

Although institutional investors influence the governance of firms both directly and indirectly, leading to improved firm performance (e.g., Hutchinson et al., 2015), there is contrasting evidence in the literature suggesting that some institutional investors have limited incentives to actively and effectively monitor firms, resulting in no improvement (e.g., Pham et al., 2011; Schultz et al., 2010) or even having an adverse effect on firm performance. This evidence suggests that different types of institutional

Abbreviations: SG superannuation guarantee; Top twenty Top 20.

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[1] An article published in The Telegraph dated 4th May 2012, states that BlackRock (the world's biggest money manager) has initiated a wave of shareholder's revolts in the UK, particularly punishing companies which have been found to be guilty of excesses, especially executive pay.

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investors have divergent monitoring incentives, which are determined by various factors such as their risk preferences, objectives, and ownership control. As these divergent monitoring incentives have different agency cost outcomes, it is important to adequately identify and classify institutional investors into different types based on these factors rather than treating them holistically as a homogenous group. Accordingly, this study examines the effect that different types (or classes) of institutional investors have on firm performance, since different investors have varying capacities to ameliorate or exacerbate agency costs.

The extant literature documents that the increased presence of institutional investors in corporations provides three types of monitoring situations, each having differing performance outcomes (Pound, 1988). Their presence leads to active monitoring of management (Bushee, 1998; Han and Suk, 1998; McConnell and Servaes, 1990), conflict with management (Agarwal and Ann Elston, 2001), or aligned interest with other shareholders (Lehmann and Weigand, 2000). Indeed agency theory suggests that outside shareholders' interests are protected when power exists to challenge corporate managements' actions (Anderson and Reeb, 2004), hence institutional investors with large stakes in the firm rely on monitoring management to shield their ownership interests (Lasfer, 2006; David and Kochhar, 1996; Jensen, 1993). Thus institutional investors who have an increased presence in firms via their ownership interests will have differing monitoring incentives compared with institutional investors who have a limited presence or no control or only have a short-term relationship with the firm.

For example, institutional investors with substantial control can influence the governance of firms by using the threat of exit[2] and voice[3] to execute their specific objectives by either buying or threatening to sell their shares (Aggarwal et al., 2011; Del Guercio et al., 2008). The recent expansion of proxy advisory firms such as CGI-Glass Lewis and Institutional Shareholder Services provides these institutional investors with the means to influence management by transmitting voting instructions easily and quickly (Stapledon, 2011). These institutional investors have access to research and other information not available to other types of investors (Gillan, 2006), enabling them to act decisively with these decisions being quickly reflected in their trading activities (Sias et al., 2006).

In contrast, institutional investors exhibiting a limited relationship with the firm such as fund managers who utilize index-type investment strategies that promote overall stock portfolio performance rather than individual stock performance will have limited incentives to actively monitor firms (Del Guercio and Hawkins, 1999). “Free-riding” among some institutional investors can also create problems with initiating collective action, thus hindering governance reforms, and leading to a sell-off in shares when the firm experiences a decline in performance, as this is sometimes an easier option (Admati and Pfleiderer, 2009).

Although the literature has examined the monitoring characteristics of institutional investors in relation to R&D[4] (Brossard et al., 2013; Bushee, 1998; David et al., 2001), executive remuneration[5] (Almazan et al., 2005; Hartzell and Starks, 2003), earnings management[6] (Hsu and Koh, 2005; Koh, 2003; Chung et al., 2002), and corporate performance (Hutchinson et al., 2015; Pham et al., 2011; Schultz et al., 2010), studies in relation to corporate performance have yielded mixed results, depending on the typology used to classify institutional investors. For example, Australian studies by Pham et al. (2011) and Schultz et al. (2010) examined the monitoring effects of institutional investors on firm value, but they found no evidence of improvements in firm value. This could be because both studies assumed that institutional investors are homogenous, using a broad-based typology of institutional investors, which is possibly why these studies yielded no results. More recently, Hutchinson et al. (2015) segregated institutional investors into pressure-resistant and pressure-sensitive categories and found that large institutional investors (with substantial control) who are pressure-resistant are better able to coerce firms to monitor risk, thus increasing both short-term performance and firm value. However, Hutchinson et al.'s sample is limited to the Global Financial Crisis (GFC) period from 2006 to 2008 when Australia coped relatively better than other developed markets such as the US and the UK, making it difficult to generalize their results to other economic conditions.

Our study contributes to the literature in three important ways. As the extant literature documents that “identity of owners may play a crucial role” since investors are driven by differing investment objectives (Lehmann and Weigand, 2000; Kang and Sorensen, 1999), we use more finely granulated typologies of institutional investors to better understand the impact that different types of investors have on firm performance. We extend Hutchinson et al. (2015) and Brickley et al. (1988) classifications of institutional investors and provide more refined sub-classifications within the *pressure-resistant* and *pressure-sensitive* groups to better understand variations in firm performance. In addition, we segregate out *nominee & trustee investors* into a distinctive group to examine their unique contribution to firm performance as not all of these investors represent institutional shareholders. The underlying premise of our paper is that divergent investment objectives by different types of investors will result in differing levels of agency cost, leading to varying impacts on firm performance. In this manner we also extend Pham et al. (2011) and Schultz et al. (2010), who only examined the impact of institutional investors as a homogenous group.

Second, we provide empirical insights on the monitoring effects of institutional investors on firm performance utilizing ownership data of all Australian listed firms from 2000 to 2012. This period encompasses varying economic conditions and legislative changes which have altered the ownership landscape in Australia. By employing a dynamic Generalized Method of Moments (GMM) modeling technique, we not only capture changes in firm performance, but also changes in institutional and large block-holder ownership,

[2] Gina Rinehart, a substantial shareholder of Fairfax Media, sold down her stake from 18.7% to 15% following her refusal to sign the company's charter of editorial independence in return for a board seat.

[3] An example of institutional investors revolt is when Rupert Murdoch was coerced into resigning as director of News International in 2012 after facing allegations of bribery and corruptions by both the US and UK governments in July 2011.

[4] R&D leads to myopic investment behaviour by corporate managers which results in meeting short term earnings targets (Bushee, 1998).

[5] As institutional investment monitoring influence is a difficult measure, a factor that is used as an observable proxy is executive compensation (frequent subject of activism by shareholders) (Almazan et al., 2005).

[6] Frequency in trading and fragmented ownership by institutional investors deters involvement in the governance of firms opting for the exit option instead (Bushee, 1998). This in turn encourages managers to manage reported profits by resorting to discretionary accruals (Chung et al., 2002).

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