



The effect of institutional ownership on firm transparency and information production [☆]

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ABSTRACT

We examine the effects of institutional ownership on firms' information and trading environments using the annual Russell 1000/2000 index reconstitution. Characteristics of firms near the index cutoffs are similar, except that firms in the top of the Russell 2000 have discontinuously higher proportional institutional ownership than firms in the bottom of the Russell 1000 primarily due to indexing and benchmarking strategies. We find that higher institutional ownership is associated with greater management disclosure, analyst following, and liquidity, resulting in lower information asymmetry. Overall, indexing institutions' predilection for lower information asymmetries facilitates information production, which enhances monitoring and decreases trading costs.

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1. Introduction

Institutional investors, who own and manage a large portion of US equities, are viewed by managers, directors, and regulators as among the most important market participants (Parrino, Sias, and Starks, 2003; Graham,

Harvey, and Rajgopal, 2005).¹ Though institutional investors exhibit heterogeneous investment and trading strategies (Gillan and Starks, 2000; Bushee and Noe, 2000), little is known about how their varying preferences for information impact firms' public information production and the trading environment. Given that a firm's information environment affects investment, liquidity, and risk, understanding institutional investor influence on this environment has important capital market implications (e.g., Grossman and Stiglitz, 1980; Verrecchia, 1983; Myers and Majluf, 1984).

Prior research shows a link between institutional ownership and the information environment (e.g., Healy,

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¹ For example, Commissioner Luis A. Aguilar of the US Securities and Exchange Commission gave a speech on April 19, 2013 outlining how disclosure and institutional investors' impact on corporate governance are important considerations for regulators. See <https://www.sec.gov/News/Speech/Detail/Speech/1365171515808#P35>.

Hutton, and Palepu, 1999; Bushee and Noe, 2000; Ajinkya, Bhojraj, and Sengupta, 2005), yet drawing causal inferences is confounded by their endogenous relationship. It is not clear whether institutional investors induce changes in the information environment or instead migrate toward firms with particular informational qualities (Healy and Palepu, 2001; Roberts et al., 2012). To overcome this hurdle, we use the annual reconstitution of the Russell 1000 and 2000 indexes to study how institutional ownership can influence a firm's information environment.

Our identification strategy is based on two salient characteristics of firms around the Russell 1000/2000 cutoff. First, firms on either side of the threshold exhibit similar characteristics that extant literature identifies as determinants of cross-sectional differences in the information environment. Second, due to the value-weighted construction of each index, firms near the top of the Russell 2000 have significantly higher index portfolio weights compared with firms near the bottom of the Russell 1000.

The index-weighting mechanism creates variation in institutional ownership around the Russell 1000/2000 threshold that is plausibly exogenous to a firm's information environment, but the ownership effect is unlikely to be homogenous across all types of institutions. Index weighting should principally impact ownership by indexing and benchmarking institutions that mechanically hold proportionately more shares in firms near the top of the indexes and fewer shares in firms near the bottom of the indexes. To examine the differential effect, we delineate institutional investors into three categories: quasi-indexers, transient, or dedicated, based on portfolio turnover, diversification, and expected investment horizon as detailed in Bushee (2001). Our findings reveal that institutional investors constitute higher proportional ownership in firms at the top of the Russell 2000 index versus the bottom of the Russell 1000. As expected, this result is primarily driven by quasi-indexers, but we also find that transient investors gravitate toward these same firms. Dedicated investors, in contrast, do not exhibit distinctly different holdings around the index threshold.

Differences in investment and trading strategies suggest that each type of institutional investor has varying preferences for, and influence over, public versus private information production. Dedicated investors hold large positions in a select set of firms for long periods of time, providing the ability to directly interact with management (Admati and Pfleiderer, 2009; Edmans and Manso, 2011). We, therefore, expect dedicated investors to have less influence on public information production because they likely rely more on private information (Bushee and Noe, 2000).

Transient investors, who tend to hold small positions for short periods, could benefit from either private or public information. On the one hand, gathering private information enables them to trade ahead of firm-specific news and gain from short-term price movements (Ke, Petroni, and Yu, 2008). On the other hand, greater public information generates more opportunities to trade and can lessen the price impact of those trades. Transient investors' short investment horizon likely reduces their ability to

influence either managerial or analyst public information production. Moreover, managers associate short-term investors with undesirable effects on stock price volatility and are, therefore, unlikely to alter policies to cater to this clientele (Beyer, Larcker, and Tayan, 2014). Instead, if transient investors' trading strategy benefits from public (private) information, they would gravitate toward (away from) more transparent firms.

Quasi-indexer investors include both passive index funds and those that are actively managed, but closely mimic a particular index. Their diverse holdings make gathering private information on their portfolio firms more costly, and their tracking strategies largely attenuate their ability to strategically trade on private information (Gillan and Starks, 2000; Parrino, Sias, and Starks, 2003). Nevertheless, these institutions are not indifferent to the information environment because higher information asymmetries increase both their transaction and monitoring costs.² We posit, therefore, that quasi-indexers demand greater firm transparency and enhanced public information production to minimize these costs.

These preferences germinate from two primary points. First, quasi-indexers (e.g., open-end or pension funds) must respond to continued flows throughout the year via ongoing buying and selling of shares of the index portfolio. Indexers, who often compete by minimizing costs, derive benefits from greater transparency because it lessens information asymmetries and enhances liquidity (Diamond and Verrecchia, 1991), reducing their overall transaction costs (Keim, 1999; Frino and Gallagher, 2001).

Second, greater disclosure by firm management reduces the costs of information gathering (Easley and O'hara, 2004), which augments the ability to assess managerial strategies and lowers monitoring costs. Consistent with this notion, investment management corporation BlackRock claims it engages with firms or uses its vote to encourage better disclosure when it believes reporting or transparency is inadequate (BlackRock, 2014). Many mid-size to smaller indexers rely on proxy advisory services, rather than in-house investigations. Hence, we further note that Institutional Shareholder Services (ISS), one of the largest such entities, states that it bases its voting research solely on publicly available information (ISS, 2014). Generating more information through forecasts and disclosures helps these services better comprehend the nuances of managerial choices.

There are compelling reasons that managers would respond to quasi-indexers' informational preferences. Both purely passive index funds and those active funds that closely benchmark against indexes account for a significant portion of total equity funds (Cremers and Petajisto, 2009). Recent academic evidence also finds that quasi-indexers are active voters (Lu, 2013; Crane, Michenaud, and Weston, 2014), lending further credence to their sway over managers. However, Vanguard notes that while voting patterns are visible, they do not fully reflect Vanguard's level of manager engagement (Noked, 2013). Vanguard argues that active engagement

² Passive funds are likely to rely predominately on hard information (Chen, Hong, Huang, and Kubik, 2004).

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