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Liquidity risk and institutional ownership[☆]

Charles Cao^{a,b,c}, Lubomir Petrasek^{d,*}



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^a Smeal College of Business, Pennsylvania State University, USA

^b PBC School of Finance, Tsinghua University, China

^c The China Center for Financial Research (CCFR), Tsinghua University, China

^d Board of Governors of the Federal Reserve System, USA

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ABSTRACT

Institutional ownership affects the sensitivity of stock returns to changes in market liquidity (liquidity risk). Overall, institutional ownership lowers the liquidity risk of stocks. However, different types of institutions affect liquidity risk in opposite ways. Stocks held by hedge funds, especially levered hedge funds, as marginal investors are more sensitive to changes in market liquidity than comparable stocks held by other types of institutions or by individuals. In contrast, stocks held by banks are less sensitive to changes in aggregate liquidity. These findings are robust to alternative specifications that control for institutional preferences for different stock characteristics and risk.

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* Corresponding author. Tel.: +1 202 912 7810.

E-mail addresses: qxc2@psu.edu (C. Cao), lubomir.petrasek@frb.gov (L. Petrasek).

1. Introduction

Although institutional ownership has long been regarded as a stabilizing factor in financial markets, questions have been raised about the impact of institutional investors on stock market stability during liquidity crises. Among institutional managers, hedge funds, in particular, have come under increased public scrutiny in the aftermath of the recent financial crisis because of their use of leverage and reliance on short-term funding. Policy makers, practitioners, and academic researchers have expressed concerns that hedge fund ownership may increase the exposure of stocks to fluctuations in market liquidity (liquidity risk).

Researchers have proposed potential channels through which institutional ownership can affect the liquidity risk of stocks. [Baker and Stein \(2004\)](#) argue that institutional ownership decreases the sensitivity of stock returns to fluctuations in market liquidity because institutional trades are less likely to be motivated by sentiment than individual trades. In their model, high liquidity is a symptom of the fact that the market is dominated by irrational investors, who underreact to information contained in order flow, thereby boosting liquidity. To the degree that investor sentiment affects the trading of individual investors more than the trading of institutional investors (e.g., [Lee, Shleifer, and Thaler, 1991](#)), [Baker and Stein \(2004\)](#) predict that institutional ownership should reduce the liquidity risk of stocks.

Others argue that different types of institutional investors affect liquidity risk in opposite ways. For example, [Brunnermeier and Pedersen \(2009\)](#) propose a model that relates liquidity risk to ownership by levered speculators such as hedge funds. The hedge fund sector makes extensive use of leverage, which is typically obtained through short-term funding (e.g., [Lo, 2008](#); [Ang, Gorovyy, and Inwegen, 2011](#)). In the model of [Brunnermeier and Pedersen \(2009\)](#), low market liquidity increases margins and decreases the amount of leverage available to speculators. Faced with higher margin requirements and increased funding costs, speculators are forced to sell their assets, leading to declines in the prices of assets held by speculators. An important implication of their model is that assets held by levered speculators such as hedge funds are likely to be sold off when market liquidity dries up and should therefore have high liquidity risk. An alternative view is that restrictions on fund withdrawal allow hedge funds to have long-term investment horizons and act as suppliers of capital during liquidity crises. According to this view, hedge fund ownership should have no adverse effect on liquidity risk and may even reduce the liquidity risk of stocks.

Ownership by other types of investors, such as mutual funds or commercial banks, could also affect liquidity risk. Although mutual funds do not typically use leverage, their trading behavior could amplify liquidity risk. In particular, [Grinblatt, Titman, and Wermers \(1995\)](#), [Nofsinger and Sias \(1999\)](#), [Wermers \(1999\)](#), and [Sias \(2004\)](#) show that mutual funds tend to herd, that is, buy into or out of the same stocks at the same time. [Chordia, Roll, and Subrahmanyam \(2000\)](#) and [Koch, Ruenzi, and Starks \(2012\)](#) hypothesize that correlated trading and herding among mutual funds can lead to commonality in the performance of assets held by mutual funds. An implication of this argument is that stocks in mutual fund portfolios should have high liquidity risk. [Gatev and Strahan \(2006\)](#) argue that, in contrast to other institutions, banks have a unique ability to trade against market-wide liquidity shocks because they experience funding flows and costs that covary negatively with market liquidity. This gives banks the unique ability to hedge against market-wide liquidity shocks. Therefore, ownership by banks could decrease the liquidity risk of stocks.

To test these hypotheses, we examine the effects of institutional ownership on liquidity risk in the cross-section of stocks. Specifically, we investigate whether stocks with higher institutional ownership exhibit greater or lower liquidity risk than comparable stocks held by individual investors. Furthermore, we distinguish between the holdings by different types of institutional investors, such as hedge funds, mutual funds, and banks.

In particular, we use a unique, hand-collected data set of hedge fund holdings to examine whether stocks held by hedge funds as marginal investors have returns that covary more strongly with changes in aggregate liquidity than otherwise identical stocks held by other types of institutional investors, and whether the effect of hedge fund ownership on liquidity risk is related to hedge funds' use of leverage. Such evidence would support the hypothesis that ownership by levered traders of the type discussed by [Brunnermeier and Pedersen \(2009\)](#) affects liquidity risk more than ownership by other types of institutional investors, such as mutual funds, commercial banks, and insurance companies.

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