North American Journal of Economics and Finance 37 (2016) 348–373

Contents lists available at ScienceDirect

North American Journal of Economics and Finance

journal homepage: www.elsevier.com/locate/ecofin

Which institutional investors matter for firm survival and performance?

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ARTICLE INFO

Article history:
Received 19 January 2016
Received in revised form 25 May 2016
Accepted 26 May 2016
Available online 1 July 2016

Keywords:
Institutional investors
Corporate governance
Monitoring
Acquisition
Bankruptcy
Distressed firms

ABSTRACT

Using data that spans three decades, we assess the diverse roles of institutional investors in impacting survival and performance of chronically underperforming firms and contrast the results for consistently overperforming firms. We find material differences in investor roles and investment returns between these samples. Differentiating among institutional types, controlling for prior performance and attrition bias provides insights unattainable by examining aggregated holdings. For underperformers, results are negative for activist pension funds and long-term institutions, positive for activist hedge funds and short-term institutions, and mixed for institutional blockholders.

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1. Introduction

Studies of the complex relationships between institutional ownership and firm performance have yielded mixed results. Some find that ownership is positively related to performance, but others do not. Some researchers infer causality, suggesting that monitoring and efforts to influence governance either directly or by implicit threats to sell give rise to improved performance. Others dispute causality. Most studies focus on only one institutional type (e.g., activist institutions). Sample selection varies across studies, as do the performance measures being studied and the intervals over which performance is measured. Generally, the studies have not considered how institutional ownership may affect firm survival. This is surprising considering that survivorship is a potential source of bias and because institutional investors have become major players in the markets for real assets and financial capital. As such, institutions are positioned to influence asset redeployment, including affecting the probabilities of failure and acquisition. For surviving firms, institutions are positioned to foster improvements in financial performance.

We contribute to the literature in several ways. Our approach addresses the concern that the prior mixed findings may arise from differences in research design. We address this issue by assembling a database that spans several decades and contrasting large samples of firms that have either chronically underperformed (underperformers) or consistently overperformed (overperformers). Our methodology takes account of attrition bias, a concern especially for underperforming firms.

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http://dx.doi.org/10.1016/j.najef.2016.05.012
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By focusing on a common set of outcomes and evaluating the results for major institutional types, we addresses the concern that the prior mixed findings may arise from differences in research design.

Because we are interested in institutional influence on firm survival and performance, we focus on how ownership relates to the performance of firms with long histories of poor performance. Firms that have chronically underperformed are the ones most likely to be in need of transformation and where monitoring is most likely to be effective. We contrast these results to those for firms with histories of good performance.

We study seven institutional types that are frequently the focus of institutional ownership in governance research: activist pension funds, activist hedge funds, institutional blockholders, independent versus gray institutions, and institutions with short-term versus long-term holdings. For each, we consider three outcomes and three performance measures. The samples are constructed during a "sample period", and firm performance is tracked during a subsequent "study period" (defined more precisely in the data section). The mutually exclusive outcomes are failure during the study period (failed), acquisition during the study period (acquired), and survival for the study period (survived). The performance measures are abnormal return (AR), average annual return on assets (ROA), market-to-book assets (Tobin's Q or Q).

A complicating factor is that, by all three measures, sample-period underperformance persists into the study period. That is, firms with low sample-period ROA, Q, and even ARs, continue to underperform during the study period.[1] Persistence, which is ignored in most prior studies, is particularly important for assessing institutional influence because it suggests that if institutions exhibit a "flight-to-quality" by selling firms with records of poor performance and buying those with records of even average performance, then an observed positive relationship between holdings and performance can arise from trading, even if institutions have no skill and no influence. The possibility is reinforced because some institutions are compelled by their internally-imposed investment policies to exit positions in response to trigger events such as discontinuation of dividends, negative book equity, or a share price below $5.[2]

Our empirical analysis points to a number of important differences in impact by type of institution:

- For activist pension funds, we find no significant evidence that holdings are positively associated with subsequent financial performance. In fact, the evidence is more indicative of misaligned incentives or hubris on the part of activist public pension fund managers.
- Activist hedge funds, we find, increase holdings of underperforming firms prior to acquisition and their accumulated ownership percentages are significantly related to acquisition probability.
- Performance results for blockholder institutions are mixed. Some blockholders maintain or increase positions in firms that subsequently fail, which is suggestive evidence that blockholdings can entrench the management of underperforming firms. However, suggestive of the potential for fostering economic efficiency, institutional blockholdings are positively related to the acquisition probability of underperformers and negatively related to the acquisition probability of overperforming firms.
- Both long-term and short-term institutional holdings are reduced in underperforming firms that subsequently fail. In contrast, short-term holdings are positively related to improved performance of surviving underperformers.
- Differences between non-independent (gray) and independent institutions are modest in our sample. Both types reduce positions in underperforming firms that later fail. We find weak evidence that independent institutions achieve higher ARs on their investments in surviving underperformers.

Analysis of the overperformer sample points to a more limited governance role of institutional holdings for firms that are performing well. Rather, levels and changes in holdings of activist pension funds, activist hedge funds, blockholders, and independent institutions all precede declines in stock market and accounting performance of overperforming firms.

In Section 2 we review the literature regarding institutional investor influence on firm performance, distinguishing between activist approaches and those that involve an implicit threat to sell ("Wall Street Walk"). We consider how our evidence of persistence complicates interpretation of the evidence in prior studies. To provide context for the empirical work, we contrast our results to those of previous studies that have examined specific institutional types. In Sections 3 and 4, we describe our methodology, testable hypotheses, and data. Results appear in Section 5 and Section 6 concludes.

2. The roles of institutional investors in influencing firm performance

Prior research has explored two primary avenues by which institutional holdings may be correlated with performance. The first is "influence-based," which implies causality, and the second is "non-influence-based", which attributes positive relationships between holdings and performance to statistical features of the data. These features include endogeneity of institutional ownership, herding, and momentum.

[1] Persistence of negative ARs is noteworthy since it implies market inefficiency. Campbell, Hilscher, and Szilagyi (2008) find that returns of distressed firms are less than expected based on a multi-factor asset pricing model.

[2] See Del Guercio (1996), for example, who examines how institutions with fiduciary responsibility tailor investment policies to mitigate the potential for litigation based on their investment selections.

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