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Effect of ownership, governance, and transparency on liquidity – Chilean evidence

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ABSTRACT

Companies with relatively thin trading, a high concentration of insider ownership, and a privatized pension system characterize Chile's Santiago Stock Exchange. Within this setting, we study the relationship between ownership concentration, corporate governance, and stock market liquidity. Our results suggest that board independence, corporate disclosure and outside monitoring by institutions help moderate the effects that insiders have on trading costs and liquidity. We also find that market makers with inventory reduce the informational component of trading costs. Finally, the trades of insiders provide price guidance to market makers, while traders employ a follow-the-insider strategy when transparency is low.

1. Introduction

Chile's Santiago Stock Exchange (CSE) provides an interesting setting to test the emerging theory of the relationship between ownership concentration, corporate governance, and stock market liquidity. Two defining features of Chile's equity market are its highly concentrated ownership structure and its private pension funds. Chile's equity market has a long tradition of family ownership. Insiders control approximately 66% of outstanding shares, while institutional investors, which we divide as consisting of pension funds and mutual funds, control less than 5% of outstanding shares in each company.

Pension funds play an important role in Chile's equity market. In 1980, seven pension funds were granted the responsibility of managing the government-mandated payroll deductions of seven million workers[1] as part of Chile's privatized pension system. A World Bank and IMF Study (WBIMF, 2004) notes that the liquidity problem in the CSE is compounded by these seven private pension funds (known as the Administradoras de Fondos de Pensiones, also referred to as AFPs), which are mainly "buy and hold" investors. The ability of these pension fund managers to accumulate sizeable positions in companies introduces a possible avenue for fund managers to influence corporate governance. The positions they take in stocks are public knowledge, with the potential for sending valuation signals to the market. Hence, individual traders may prefer to follow the lead of pension funds, rather than do their own due diligence, particularly when the quality of the fundamental information is low.

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[1] *Source:* U.S. Department of State.

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Additionally, WBIMF (2004) finds that the average proportion of free-floating shares in Chilean companies is approximately 30%, with 80% of IPSA shares held by the 10 largest shareholders.[2] The top 10 shareholders in our sample own 73% of outstanding equity shares.[3] This highly concentrated ownership structure is conducive for an analysis of relationships among liquidity, ownership concentration, and trading costs that arise from potential informational differences between informed insiders and uninformed outsiders.

Informational asymmetries related to ownership concentration and associated transaction costs are among the key reasons for lack of liquidity in Chile's equity markets (see Hernandez and Parro, 2004). Similarly, institutional and insider blockholdings, defined as holdings of 5% or more of outstanding shares, are a key reason for the lack of liquidity in the U.S. capital markets (Rubin, 2007; Brockman et al., 2009). However, ownership is much more highly concentrated in Chile relative to the U.S. For example, the average percentage of ownership of the largest shareholder in the companies included in the IPSA is 41% of outstanding shares. Comparatively, in a random sample of 100 companies from among the Standard & Poor's 500 Index, the largest shareholder owns only 9% of outstanding shares (Coloma, 2010). In 2009, the market value of the Chilean equity market was 121% of GDP, with a turnover ratio of 22%. In contrast, the market value of the U.S. equity market was 109% of GDP, with a turnover ratio of 350%.[4]

A majority of trades on the CSE are handled in similar fashion to the NASDAQ's electronic order system. There are no specialists to maintain an orderly equity market. Instead, three types of intermediaries facilitate trades within an electronic order system. Intermediaries consist of pension funds, which manage their own trading desks; brokers, who passively match buyers and sellers; and market makers (MMs) with inventory, who manage their own portfolios and serve as liquidity providers.[5] MMs with inventory account for 62% of the total market value of trades in our data set during the years 2009 and 2010, and account for at least some trades in every company we study.

To the best of our knowledge, this study is the first to analyze the behavior of MMs with inventory in a capital market where insiders control nearly two-thirds of outstanding shares. This feature of the CSE exposes traders and MMs to adverse selection costs if insiders, or other blockholders, trade with an informational advantage. In this setting, corporate disclosure and transparency become important issues for market participants and regulators, even though Chile's capital market and corporate governance regulations are considered exemplars for Latin American countries (OECD, 2003).

Our study makes several contributions. First, we show that board independence, corporate disclosures, and outside monitoring help moderate the informational and non-informational effects that insiders have on trading costs and liquidity. We find that regardless of the degree of insider ownership concentration, regulations to improve disclosure levels at companies with low to moderate levels of transparency will increase turnover and reduce the informational component of trading costs.

Second, our study adds the impact of MMs with inventory to the ownership–liquidity–disclosure–governance literature, and extends recent ownership–liquidity-informational studies, based on thick markets, to relatively thin markets with highly concentrated ownership. A key finding for policymakers and regulators is that market makers with inventory improve liquidity by reducing the informational component of trading costs. An implication is that policymakers can reduce trading costs if they can devise incentives that increase the number of trades executed by market makers with inventory, relative to brokers who passively match buyers and sellers.

Third, our results suggest that in relatively thin markets with highly concentrated ownership, insiders play an important role in price discovery. Their trades appear to provide guidance to market makers who are able to reduce informational trading costs by reducing the difference between quote midpoint prices and the true value of a security. Traders also appear to follow the lead of insiders when voluntary disclosure levels are low. If traders place more weight on insider trades relative to fundamentals when transparency is low, then they effectively employ a "follow-the-leader" trading strategy by following the lead of insiders. As the disclosure level increases, traders shift weight to fundamentals and away from the trades of insiders. Fourth, the study establishes benchmarks for future studies of the CSE.

The remainder of the paper is organized as follows. Section 2 presents a brief literature review. Section 3 describes the data and methodology used to test our propositions. Section 4 describes empirical results, and Section 5 contains the conclusion.

2. Literature review

The central theme in this strand of the literature is the interactions among liquidity, trading activity, informational costs, ownership, governance, and corporate transparency. We extend recent studies in this area by including the impact of MMs in facilitating liquidity on the CSE. Our study is also the first to undertake an analysis of CSE-listed firms using tick-by-tick data.

Stoll (2000) divides the literature on spreads into three branches and builds a general model to ascertain which components of the branches explain variation in spreads. The first branch of the literature described in Stoll (2000) defines the size

[2] IPSA refers to the Chilean stock market index that is made up of the 40 largest companies traded on the CSE.

[3] In Chile, the listed company shares are regulated by Act 18.046, issued originally on October 22, 1981. Subsequent modifications to this Act ensure that all common/equity shares have the same right to dividends and one vote per share.

[4] *Source:* The World Bank. Market Cap – http://data.worldbank.org/indicator/CM.MKT.LCAP.GD.ZS?order=wbapi_data_value_2009+wbapi_data_value&sort=asc. Turnover – http://data.worldbank.org/indicator/CM.MKT.TRNR.

[5] The security dealers do not know the identity of the investor buying or selling equity, and dealers are required to fulfill their client orders before trading on their own account. Further, the CSE has only one order book; hence, all orders come to the same place for execution.