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Local ownership as private information: Evidence on the monitoring-liquidity trade-off☆

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Abstract

We investigate how ownership patterns affect the way the firm is monitored, the liquidity of its shares, and its stock price. We show that informed ownership improves governance and induces value-enhancing decisions (less over-investment and fewer but better acquisitions). At the same time, it increases the adverse selection discount required by less informed investors to trade, reducing the firm's liquidity. Both effects are impounded in the stock price. This explains why ownership seems to be unrelated to performance. Informed investors affect prices in opposite directions: monitoring would raise prices, but the lower liquidity induced by their presence would reduce them.

JEL classification: G30; G23; G32

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1. Introduction

Recent corporate events have reignited the debate on both the role of corporate governance and the best way to enhance it. Central to this debate is the modern

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corporation's separation between ownership and control. The idea is that at least some monitoring by informed shareholders is necessary to prevent self-interested managers from undertaking suboptimal decisions, which implies that there should be a relation between a firm's shareholding composition (i.e., ownership structure) and its performance. This implication has been extensively investigated in the literature (e.g., Morck, Shleifer, and Vishny, 1988; McConnell and Servaes, 1990; Holderness, Kroszner, and Sheenan, 1999; Himmelberg, Hubbard, and Palia, 1999).

Unfortunately, the endogenous nature of ownership structure (Demsetz, 1983; Demsetz and Lehn, 1985) complicates the analysis of this issue. Equilibrium ownership patterns depend on their relative costs and benefits. Given the lack of a suitable identifying restriction, however, the literature has been unable to produce conclusive evidence on this issue. Thus, while the current view argues that no relation exists between ownership and performance (Demsetz and Villalonga, 2001), it falls short of analyzing the underlying economic story that describes the costs and benefits of ownership.

Central to any such story is the role of information. In an important contribution, Kahn and Winton (1998) show that there is a trade-off for an informed institution between profitably trading on its private information ("speculation") and using that same information to monitor the firm ("intervention"). The choice between these two actions depends on the size of the informed shareholder's stake. For instance, high stakes provide an incentive to monitor the firm; however, they make uninformed shareholders require an adverse selection premium to trade in the firm's shares. The presence of such stakes therefore has observable implications for both the way the firm is run and the liquidity of the firm's shares.

Our paper uses a proxy of informed investment to study the relations among the existence of informed shareholders, corporate governance, and stock liquidity, as well as their implications for stock prices. Specifically, we measure the degree of informed investment in a particular stock as the fraction of a mutual fund's investors that are headquartered nearby. This metric comes from Coval and Moskowitz (2001), who find that US mutual funds earn substantial abnormal returns in their nearby equity holdings and that the amount of local investment in a stock is positively correlated with the stock's expected return. Indeed, Coval and Moskowitz argue that local mutual fund ownership may "offer a unique method of identifying... perhaps the first set of seemingly informed investors."[1] More recent research is consistent with this conclusion,[2] and shows that local fund managers, who are both informed and more proximate to the company headquarters, are in a better position to influence the firm's management in governance-related issues.

The important feature of the above measure is that the main determinant of proximity, namely the place where the investor is located, is reasonably exogenous. We can therefore generate a set of instruments to address any potential residual endogeneity. In summary, by using local ownership as an explanatory variable we obtain an identifying restriction that enables us to study the economic implications of informed investment.

[1] Coval and Moskowitz (2001, p. 839).

[2] Hau (2001) finds that German traders located near the headquarters of firms in which they trade exhibit higher trading profits. Using a representative panel of Swedish investors, Massa and Simonov (2005) show that familiarity-driven investment is information- as opposed to a behavior-based. Butler (2003) finds that local investment banks seem to display informational advantages on the municipal bond market. Malloy (2003) finds that geographically-proximate equity analysts make more accurate forecasts than other analysts, and also that their recommendations have a higher price impact.