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The colors of investors' money: The role of institutional investors around the world ☆

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Abstract

We study the role of institutional investors around the world using a comprehensive data set of equity holdings from 27 countries. We find that all institutional investors have a strong preference for the stock of large firms and firms with good governance, while foreign institutions tend to overweight firms that are cross-listed in the U.S. and members of the Morgan Stanley Capital International World Index. Firms with higher ownership by foreign and independent institutions have higher firm valuations, better operating performance, and lower capital expenditures. Our results indicate that foreign and independent institutions, with potentially fewer business ties to firms, are involved in monitoring corporations worldwide.

JEL classification: G15; G24; G32; G34

Keywords: Institutional investors; Firm value; International capital markets; Monitoring

1. Introduction

A key factor in global capital markets is the fast growing importance of institutional investors. According to the International Monetary Fund (2005) (IMF), these professional investors manage financial assets exceeding US$45 trillion (including over US$20 trillion in equities). Assets under management of institutions have tripled since the early 1990s. Further, institutional investors are major players not just in developed markets; their role is rapidly growing in emerging market countries (see Khorana, Servaes, and Tufano, 2005).

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In this paper we examine what drives institutional investors to firms and what role these investors play. Gillan and Starks (2003) posit that the rise of professional money managers as a large shareholder group in corporations worldwide offers the potential for increased monitoring of firm management. Institutions' involvement can range from threatening the sale of shares to the active use of corporate voting rights or meetings with management.[1] We are interested in whether these large investors are effective in influencing corporate management and boards towards creating shareholder value. But there are reasons to expect that not all money managers are equally equipped or motivated to be active monitors. Foreign and more independent institutions are many times credited with taking a more active stance, while other institutions that have business relations with local corporations may feel compelled to be loyal to management. For example, Fidelity is reported to be more aggressive on governance issues in Europe, but it is relatively acquiescent in the U.S. where it manages several corporate pension accounts (Business Week, 2006; Davis and Kim, 2006). Further, several empirical studies suggest that independent investment advisers and mutual funds are active monitors (Brickley, Lease, and Smith, 1988; Almazan, Hartzell, and Starks, 2005; Chen, Harford, and Li, 2007).

There is little evidence on the monitoring role of institutional investors outside the U.S., so we offer a first exploration of this issue. Toward this end, we use a new comprehensive database of institutional stock holdings worldwide. The data set contains holdings at the stock-investor level of over 5,300 institutions in 27 countries, with positions totaling US$ 18 trillion as of December 2005. Thus, the institutional ownership data used in this paper represent nearly 40% of the world stock market capitalization.

For a better understanding of the role of institutional investors worldwide, we focus on non-U.S. firms in which institutions hold US$ 5.2 trillion.[2] These institutional investors, depending on their geographic origin, could be a U.S.-based mutual fund manager (like Fidelity), a non-U.S.-based pension or endowment fund (like Norway's State Petroleum Fund), or a domestic bank trust or insurance company (like BNP Paribas and AXA in France). Overall, U.S.-based institutions hold more than US$ 2 trillion overseas in non-U.S. stocks. This is matched by US$ 1.7 trillion held by non-U.S. foreign institutions and US$ 1.5 trillion by domestic institutions. Thus, while most research to date looks at U.S. institutions as the primary source of capital, we find that the three groups of professional investors worldwide have similar pools of capital.

We start by exploring the revealed stock preferences of these three different institutional investor clienteles (U.S., non-U.S. foreign, and domestic money managers), and investigating which firm- and country-level characteristics attract a particular group. Our results reveal preferences when investing at home, much like those that U.S. institutions exhibit in U.S. markets (Gompers and Metrick, 2001), but money managers exhibit specific preferences when investing abroad.

First, we find that all institutional investors, whatever their geographic origin, share a preference for the stock of large and widely held firms (i.e., companies without large controlling blockholders), of firms in countries with strong disclosure standards, and of firms located physically near their home market. Second, foreign and domestic institutional investors diverge in some stock preferences. Foreign institutional investors have a strong bias for firms in the Morgan Stanley Capital International (MSCI) World Index, firms that are cross-listed on a U.S. exchange, and firms that have external visibility through high foreign sales and analyst coverage. Domestic institutions underweight these same stocks. Foreign institutions also tend to avoid high dividend-paying stocks. Third, U.S. institutions diverge from non-U.S. foreign institutions in their preference for value over growth stocks, and a tendency to hold stocks in English-speaking countries and emerging markets. Thus, there is generally substantial diversity in the revealed stock preferences of various groups of institutional investors depending on their geographic origin.

Another dimension of investor diversity is institution type. We can characterize professional money managers as being of different "colors" in terms of their ability to actively monitor managers' decisions. Because of potential business ties with the firms in which they invest, not all money managers act as

[1]For analyses of the effects of selling shares on corporate governance, see Admati and Pfleiderer (2006) and Parrino, Sias, and Starks (2003). For surveys of shareholder activism, see Black (1999), Karpoff (2001), and Gillan and Starks (2007).

[2]We focus on non-U.S. firms for three reasons: (1) most existent institutional investor studies examine only U.S. firms (e.g., Gompers and Metrick, 2001); (2) most international corporate governance studies focus on non-U.S. firms (e.g., Doidge, Karolyi, and Stulz, 2004); and (3) results are not affected by the fact that the number of U.S. firms is much larger than that of any other country. We describe later in the paper some of the results for the sample of U.S. firms.