Institutional Investors: A Literature Review

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Abstract: We survey the related theories and burgeoning literature on the consequences of institutional investors’ holdings and shareholder activism campaigns. Agency theory, monitoring theory, and limited attention theory are widely used in institutional investors studies. About the economic consequences of institutional investors’ holdings, we summarize that institutional holdings could improve corporate disclosure quality and frequency, for both mandatory and voluntary information disclosure. Additionally, higher ownership concentration of institutional investors is related to higher performance sensitivity of management compensation and lower compensation level. Furthermore, we propose that investor holdings could also affect dividend policy, firm performance and firm innovation. Lastly, we further discussed about shareholder activism campaign. We find that shareholder activism has both positive effect on firm performance and corporate governance, and negative side on executives and threats of exit.

Keywords: Institutional investors, agency theory, shareholder activism.

1. Introduction

In this study, we focus on the theories and literature review of institutional investors. The related theories mainly include agency theory, regulatory effects, and limited attention theory. Then, I studied the consequences of institutional investors’ shareholding and found its relation with corporate information disclosure and corporate governance environment. In addition, investor holdings have a positive impact on executive compensation, dividend policy, company performance and innovation. Finally, I found that shareholder activism has a positive impact on company performance and corporate governance, and has a negative impact on executives and exit threats. To sum up, the existing literature mostly focus on U.S. studies and a specific firm. We suggest more research on emerging markets like China, and studies on the contagion effect of institutional investors.

The remaining paper constructs as follows. Section 2 summarizes the related theories. Section 3 reviews the economic consequences of institutional investors’ holdings. Section 4 focuses on a specific institutional investor’s activity, the shareholder activism campaign. Lastly, Section 5 concludes.

2. Related theories

2.1 Agency theory

Agency relationship is defined as a contract that one or more principal(s) engaged another agent to perform liability and duties (Jensen, 1976) [1]. Because the different risk preferences, the principal and agent may trend different actions. Agency theory has developed along two lines. They have positivist and principal-agent. According to the governance mechanism and the object in the agency relationship, positivist prefer former and principal-agent researchers are concerned with the later. Subsequent paragraphs, however, are indented. Bitler et al. (2005) develop a principal-agent model in an entrepreneurial setting, they find that agency costs may help explain why entrepreneurs concentrate large fractions of their wealth in firm equity [2].

2.2 Monitoring effect

This supervision effect of institutional investors can effectively supervise the management of the company and improve company performance. The shareholder rights protection initiated by the joint shareholder meeting represents a new way of supervision (Strickland et al., 1996) [3]. The company’s performance and efficiency can be improved in two ways. On the one hand, institutional investors have a strong motivation to supervise management's behavior due to their huge investment and their fiduciary view. This kind of supervision will improve the company's management efficiency and decision-making quality. On the other hand, institutional investors are more professional than minority shareholders and only need to spend lower supervision costs to improve company performance by reducing agency problems. Similarly, small shareholders can influence the corporate governance of large companies.
On the other hand, some (but not all) institutional groups are effective monitors of their investment companies, and the company has established a reputation bond with large independent institutional investors (Ferreira and Matos, 2008) [4].

2.3 Limited attention theory
When there is too much information and the ability to process information is limited, limited attention will be born. When attention is drawn to the appearance of related targets, or focused on a specific thought or frame, it may cause deviation. To the extent that facts that are more salient or vivid are more available, attentional biases can bias beliefs. For example, a significant clue is easier to get attention than a non-significant clue, but it’s easier to cover things that should be noted or dealt.

Limited attention has implications for non-equivalent disclosures as well (Hirschleifer and Siew, 2003) [5]. Their model is the effects of different presentations on market prices when investors have limited attention and processing power. Limited attention may affect behavior and prices in actual capital markets. Who analysis implicitly allows for limited attention by allowing for the possibility that some investors under react to the public signal (Hirschleifer and Siew, 2003).

It may also appear in the transaction, investors knowing that the current situation will also adopt imperfect adjustments. First, if he is fully concerned, he may not have a transaction. Second, if he is too confident, he will make some wrong decisions. Third, the investor’s understanding and processing capabilities will make it impossible to fully pay attention to the current state.

3. The economic consequences of institutional investors’ holdings
In the process of searching the literature, I found that the literature on the economic consequences of institutional investors’ holdings is mostly, while the literature on the influencing factors of institutional investors is rarely. So in the following text, I will focus on the literature on the economic consequences of institutional investors.

3.1 Corporate disclosure
Mandatory Financial Reporting quality. In previous studies, it has been shown that the quality of financial reporting is directly proportional to the efficiency of capital investment. Higher quality of financial reporting is associated with lower over- and under-investment. And this quality depends on what kind of investment environment the company is in. Biddle et al. (2009) define financial reporting quality as the precision with which financial reporting conveys information about the firms’ operations, and one objective of financial reporting is to inform present and potential investors in making rational investment decisions and in assessing the expected firm cash flows [6]. Previous research has shown that higher financial reporting quality can improve investment efficiency by reducing information asymmetry that leads to frictions such as moral hazard and adverse selection. The collective decision to disclose price information also helps reduce conflicts between brokers and clients, thereby reducing the need for clear contracts and signals (Garbade and Silver, 1982) [7].

Voluntary Disclosure Strategy. One of the methods used by management when presenting the company’s operating status and performance to external agencies is company’s voluntary disclosure. In the effective allocation of resources in the capital market economy, company disclosure has effectively alleviated information and incentive problems. Healy and Palepu (2001) put forward the corporate disclosure has encountered two problems: one is the information problem, and the other is the agency problem [8]. Managers voluntarily disclose bad news, this method may make the company escape bankruptcy. From another perspective, managers may conceal some forward-looking information disclosures in order to avoid shareholder lawsuits that may occur in the future (Bourbeau et al., 2017) [9].

In addition, the connection between climate risk disclosure and shareholder activism is rarely mentioned in the academic field. Flammer et al. (2020) proposed that under environmental shareholder activism, companies that voluntarily disclose climate change risks get higher valuations, and shareholder activism triggers greater disclosure of climate risks, and this has improved the corporate governance of its investment portfolio.

3.2 Executive compensation
The higher the ownership concentration of institutional investors, the higher the performance sensitivity of management compensation and the lower the compensation level. In addition, there is no opposite relationship between changes in institutional concentration and subsequent changes in incentive compensation. These results support the hypothesis that institutional investors influence executive compensation (Hartzell and Starks, 2003) [10].

3.3 Dividend policy
In order to effectively protect the rights and interests of shareholders, dividends were born (Bae et al., 2020) [11]. Under rational conditions, the company’s dividends can not only reflect the company’s source, but also infer the company’s current earnings. This kind of inference can also estimate the expected return. However, if a company uses information asymmetry to raise its stock price by paying higher dividends, it will cause non-sale shareholders to suffer such deceptive harm. When the standard full-information model of the company’s dividend investment decision-making process incorporates both transaction and asymmetric information, the full-information optimal investment and dividend policy will not ensure consistency (Miller and Rock, 1985) [12].

On the other hand, when the company’s board of directors has strong governance and a strong external governance mechanism, then the company will normally pay dividends under the supervision of the board of directors.
(Bae et al., 2020). In the research of Bae (2020), it is found that board reform will have a good impact on dividend payment. When the board of directors' supervision becomes more effective, external shareholders can force internal personnel to spit out cash.

3.4 Firm performance
In previous studies, company performance and the board of directors as a whole have almost no correlation. However, in the research of Klein (2003) [13], it is found that if we study the internal operation of the board of directors, we will find that there is a correlation between company performance and the board of directors. One of the main roles of the board of directors is to supervise the company's long-term investment strategy. The board of directors can also ease agency restrictions between shareholders and executives. There is a positive horizontal correlation between the percentage of internal personnel on the Finance and Investment Committee of the Board of Directors and the company’s performance indicators.

3.5 Innovation
Innovation is an important part of enterprise competitiveness. If a company wants to survive the fierce competition, innovation is an indispensable part, which can enable the company to gain a certain advantage in the competition. Innovation in the company can better promote employee cooperation, and make the work arrangements between the management become coordinated. Innovation in the market can meet a wider range of customer needs, make the company full of vitality, and directly affect the increase in the company's market share. Of course, under conservative conditions, failed innovations can also motivate the company to learn from the pain and examine the problem. The key reason for innovation is also that companies want to have higher operating performance. Gunday (2011) concluded that managers need to pay more attention to organizational innovation, and organizational innovation has a great effect on innovation capabilities [14]. At the same time, innovation can prompt managers to improve operational performance. Rong Zhong (2018) stated that corporate transparency directly increases managers' R&D investment and improves the efficiency of R&D into patents. In addition, the implicit contract of corporate transparency eases the suppression of managerial innovation motives by occupational risks to a certain extent [15].

4. Shareholder activism campaign

4.1 Background
**Definition.** Strickland (1996) proposed that shareholder activism improves shareholder value. Shareholder activism is the behavior of external investors actively intervening and participating in major business decisions of the company in order to maximize it. The role of institutional shareholder activism is caused by the conflict of interest between managers and shareholders (Gillian and Starks, 2000) [16].

**Objectives.** Activism goals consist of corporate governance, financial matters, legal matters, mergers and acquisitions matters, meeting matters and strategic matters. Among them, corporate governance, mergers and acquisitions and strategic issues are very important parts of activism goals.

**Tactics.** When conducting research on the strategy of radical shareholders, we will find that radical shareholders generally take legal proceedings, non-confrontational communication, request for board representation, shareholder proposals, proxy fight, takeover bid, threat to launch lawsuits, threat to launch proxy fight, and Vote No/Withhold Votes. Among them, the two strategies of non-confrontational communication and threats to launch proxy fight accounted for the majority. Gantchev (2013) proposed that in shareholder activism, when radical shareholders put forward demands but could not meet them, he would use board to make demands. But when that fails, activist shareholders may choose for more adversarial tactics, such as proxy threats or even proxy fights [17].

4.2 The positive effect of shareholder activism
Admati and Pfleiderer (2015) show that public forms of shareholder activism include: proxy fight, strategic voting, company acquisitions and investor proposals, etc.[18]. Shareholder activism directly or indirectly affects the decision-making of the company's management, allowing the company's operating status to be what the radical shareholders want to see. This positive way promotes the improvement of company performance. For example, non-confrontational communication and the use of shareholder voice to interfere with the company’s management can play a big role.

4.3 The negative effect of shareholder activism
Institutional investors indirectly influence the adoption of better governance practices by international companies by directly influencing management and using voting rights, or by purchasing or threatening to exit decisions (Aggawal et al., 2011) [19].

**Executive compensation and career concerns.** Ertimer et al. (2013) show that the effectiveness of activism related to compensation needs to be re-examined [20]. They studied the Vote-no campaigns and proposals related to executive compensation between 1997 and 2007 in the literature, and union pension funds dominated the sample. Types of activism can be divided into shareholder proposals and Vote-no campaigns. Evidence shows: shareholder proposals will affect corporate governance practices. Vote-no is a symbolic event that can express an attitude and may become a catalyst for change. Shareholders vote to determine executive compensation.

**Exit threats.** Rights defenders usually do not initiate disputes over agency rights, but respond in the form of threats to the infringement of interests or the inadequate supervision and decision-making of the company’s management (Klein and Zur, 2009) [21]. The threat of exit can reduce agency costs, and the exit of major
shareholders may bring about a decline in stock prices, so as to achieve the purpose of prompting the company to make correct decisions. Admati and Pfleiderer (2015) put forward four questions about exit threats: Is the threat credible? Will it interfere with other rules? Will the situation of corporate governance be further improved? Can it effectively restrain managers? In the context of preventing bad behaviors and encouraging good behaviors, the conclusions of Model B and Model G were made. These two conclusions are exactly opposite.

4.4 An anecdotal evidence
Rent-A-Center shares soared on the acquisition. The furniture and equipment rental company rejected Vintage Capital's $800 million offer, calling it "inadequate and opportunistic" [22]. When Rent-A-Center was in trouble before, an "inadequate and opportunistic" $800 million take over offer from private equity firm Vintage Capital Management was rejected by Rent-A-Center's board. However, Rent-A-Center's stock soared after the company was reported to be being acquired. And engage capital, an activist hedge fund, launched a campaign for major changes, which led to a comprehensive power of attorney dispute. The shareholders of Rent-A-Center dismissed three board members. Three directors nominated by engage capital succeeded the dismissed directors. But judging from the facts, Vintage Capital already had a majority stake in Buddy's Home Furnishings at the time, a self-owned leasing company located in Rent-A-Center.

According to this case, shareholder activism is reflected in the company’s acquisition and external investors forcing the replacement of three company directors as capital directors. When the radical shareholders and the company’s executives conflicted, in this case, the method of competing for agency rights was adopted. The three directors of the company were replaced by those on the capital side. This method stabilized the company’s internal supervision and control activities, and also played a role in spurring executives. In this way, the performance of executives is improved and the operation of the company remains stable. Therefore, when the company was reported to be acquired, the company's stock price rose sharply.

5. Conclusion
In this paper, I focus on the related theories and literature review of institutional investors. The related theories mainly include agency theory, monitoring effect and limited attention theory. And then, I research the consequences of institutional investors’ holdings. It proved that corporate disclosure can influence governance environment of corporate. Additionally, investor holdings have positive impact on executive compensation, dividend policy, firm performance and innovation. Lastly, I found that shareholder activism campaign has positive effect on firm performance and corporate governance, and negative effect on executives and threats of exit. According to existing literature, I put forward two suggestions for future studies. First, the data of United States dominates the empirical literature. As an important and largest emerging economy, China stories should be more considered based on its unique institutional setting. Second, most of the prior studies have conducted a direct relation between a firm’s characteristics and related economic consequences. Therefore, I suggest more research on the contagion (or spillover) effect of institutional holdings, which brings about little endogeneity concerns and new prospects.

References


