Extending your team: Motivated institutional investors and sell-side analysts' activities

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Abstract

Institutional investors have dominated the ownership of public companies. As the largest category of owners in developed markets and the second-largest in many other countries, institutional investors have become a crucial element of corporate governance. Along with the sizeable investment, institutional investors typically have well-diversified portfolios. Given limited attention and resources, institutional investors rationally allocate their monitoring efforts when managing a large number of different stocks in their portfolios. Existing studies argue that the more money an institution invests in a firm, the more motivated the institution is to monitor that firm. These studies mostly focus on the US setting and document that motivated institutional investors impact firm investment, performance, financing decisions and payout choices. However, the impact of motivated institutional investors on a firm's information environment remains underexplored in the literature. Our study fills the existing gap in the existing research by investigating the association between motivated institutional ownership and analysts' activities outside the US.

A growing body of literature on institutional investors in recent years has underscored the importance of information production for various types of institutional investors. Differences in investment and trading strategies suggest that each type of institutional investor has varying preferences for, and influence over, public versus private information production, including financial analyst activities. On the one hand, sell-side analysts are both processors and producers of information, distributing public and private information to institutional investors, thereby reducing the costs of information acquisition and enhancing monitoring of diverse shareholdings. On the other hand, an institution with a more significant stake in a firm is more likely to produce its in-house information (i.e. by buy-side analysts) for the monitoring of the firm's managers (while the cost of gathering and analyzing information decreases with the size

of the holding, the benefit of information increases) and avoid both the cost and moral hazard problems associated with outside analysts. However, because sell-side analysts usually concentrate on covering fewer industries and fewer firms, buy-side analysts supporting portfolio managers may interact with them. Main benefits flowing from sell-to-buy-side analysts include access to industry-specific information independently developed by sell-side analysts and their access to senior management of companies of interest. The main aim of our study is to empirically test whether the presence of motivated institutional investors as shareholders is associated with more or fewer activities by outside financial analysts[1].

Using a sample of non-financial public companies listed on the Warsaw Stock Exchange, where institutional investors typically play the role of the largest minority shareholders, we find a positive relationship between the shareholdings of motivated institutional investors (i.e., institutions that have both the ability and incentives to monitor) and the firm's analyst coverage. We find this relationship to hold mostly for family-controlled companies, as they prefer private channels of communication, and for firms with extensive use of bank debt, as they do not benefit much from public disclosure. Furthermore, it holds mostly for companies suffering from substantial agency problems and thus having greater monitoring needs. We also document that the observed effect is stronger for motivated institutions with higher monitoring effectiveness, i.e. quasi-indexers, foreign institutions, long-term institutional investors and institutions with multiple blockholdings. Additionally, we show that firms with motivated institutional investors tend to have lower analyst disagreement (i.e., lower forecast dispersion) and thus lower information asymmetry, thereby enhancing monitoring.

To address the endogeneity issue and thus strengthen our prediction that institutional investors at least partly trigger this effect, rather than simply tend to invest in firms with certain analyst activities, we employ a 2SLS research design using the Polish pension funds reform as a quasi-natural experiment. The reform changed (among many others) the profile of Polish pension funds (OFEs) from relatively passive balanced funds with a substantial proportion of treasury bonds in their portfolios towards actively managed funds allocating their resources mostly in companies' stocks, not only listed on WSE but abroad as well. The reform forced OFEs to play a more active role as shareholders and to intensify their monitoring. Our analysis shows that companies with substantial shareholdings held by these funds (motivated institutions) tend to rely more on sell-side analysts' services. An additional test using the Market Abuse Regulation of 2016 supports the interpretation of our main findings.

[1] We refer to firms employing buy-side analysts and portfolio managers as institutional investors.

Additionally, we perform regressions based on year-to-year changes in analyst following and motivated institutional ownership. We find the change in analyst following to be significantly positively related with the changes in ownership of institutions holding large stakes. Our results remain unchanged when we use a propensity score matched sample, include additional controlling variables and use alternative measures of our primary explanatory variable.

Last but not least, we complement our analysis for a direct relationship between motivated institutional ownership, analyst following and firm value. In particular, we find that companies with higher stake held by motivated institutional investors and covered by more analysts tend to have higher Tobin's Q.

All in all, we provide evidence that even sophisticated institutions with a significant stake in the firm, having an incentive to produce their in-house information, may demand and benefit from more specialised third-party information concerning their portfolio holdings. Our study indicates that sell-side analysts' activities play an important role in monitoring executed by motivated institutional investors, and that using sell-side analysts' services may be treated as an extension of an in-house team.

Keywords: institutional ownership, information production, analyst following, agency theory, monitoring

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