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# Behind the Scenes: The Corporate Governance Preferences of Institutional Investors

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# 1. Introduction

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## Motivation

- Institutional investors influence financial markets through their predominance as buyers and holders of shares
- Understanding the preferences of institutional investors is important for firms, policy makers and researches
- Inferences on institutional investor preferences from previous studies based on indirect evidence
- But: Much of institutional investors preferences, particularly behind-the-scenes activities, are private and thus difficult to observe and measure

# 1. Introduction

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## **This Study**

- Aim: Understanding corporate governance preferences and behind the scenes actions of institutional investors
- Methodology: Comprehensive survey that directly measures preferences of institutional investors with respect to three main areas:
  - Investor protection across countries
  - Firm-level corporate governance
  - Shareholder activism
- Survey: Focuses on preferences for two different financial market regimes
  - The US: Common law & high investor protection & shareholder oriented regime
  - The Netherlands: Civil law & low investor protection & stakeholder oriented regime
- Respondents: Surveys sent to chief investment managers of 1,178 institutional investors with investments in both countries
  - 118 institutional investors responded to our survey, for a response of 10%
  - 90 responses matched to additional investor information (e.g., equity holdings)

# 1. Introduction

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## Main Findings (1)

### Investor Protection and Corporate Governance

- Respondents have definitive and diverse assessments of investor protection in the US and Netherlands
  - Relative differences consistent with anti-director index of LLSV (1998) and the anti-self dealing index of DLLS (2008)
- Most important firm-level corporate governance mechanisms:
  - Equity ownership by management, use of equity-based compensation, board independence, transparency about holdings of large shareholders, and high free float
- Governance preferences vary across investor types
  - E.g. Pension funds care most about high free float, hedge funds most about equity incentives
- Subset of firm-level governance mechanisms (efficient boards, equity incentives, no anti-takeover provisions) considered to be substitute mechanisms for poor country-level investor protection

# 1. Introduction

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## Main Findings (2)

### Shareholder Activism

- Institutional investors are willing to engage in a variety of shareholder activism methods
  - They concentrate their activities on selling shares, voting against management, and discussions with the Executive Board
  - More than 50% of investors are willing to take these actions
- Independent institutional investor are more willing to undertake conflicting corrective actions than grey investors
- Institutional investors are willing to conduct corrective actions/shareholder activism in response to conflicts over corporate goals and strategy, planned acquisitions, and poor performance
- Almost 60% of all institutional investors consider coordinating their corrective actions

# 1. Introduction

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## Main Findings (3)

### Preferences and Portfolio Firm Characteristics

- Assessment of investor protection by institutional investors is related to characteristics of firms in portfolios (e.g. innovation)
- Assessment of whether there exist appropriate legal measures to allow shareholders to influence the strategy of a company is related to firm characteristics
  - Investors which believe mechanisms are in place to influence strategy invest in firms which are in need for a change in strategy
  - These firms have lower Tobin's Q, invest less, and are less innovative (if R&D is used as an ex ante measure of innovative potential)

# Outline

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1. Introduction
2. Data and Methodology
3. Perception of Investor Protection and Corporate Governance
4. Shareholder Activism
5. Governance and Characteristics of Portfolio Firms
6. Conclusion

## 2. Data and Methodology

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### Delivery and Response

- Survey sent by email to chief investment managers of 1,178 institutional investors on November 01, 2007
- Survey recipients selected based on data entry in FactSet/LionShares Database
- Investors required to have at least 5% invested in The Netherlands in 2006
- Confirmed to investors that responses are treated anonymous to obtain frank answers
- 118 surveys returned, response rate of about 10% (for comparison, Graham and Harvey (2001) have 9% for their CFO survey)
- 90 surveys match with data on institutional investor characteristics in FactSet/LionShares
  - Gives us combined data set of almost 8,000 investor-portfolio firm observations

## 2. Data and Methodology

### Institutional Investor Characteristics

#### Panel A: Overview Institutional Investor Characteristics

	Mean	Median	STD	5%	95%	Obs.
<b>Investor Characteristic</b>						
Assets under Management (in 1000 USD)	623,000	140,000	1,260,000	9,540	3,550,000	90
Fraction of Assets invested in NL (in %)	10.38%	6.85%	13.96%	0.00%	33.38%	90
Fraction of Assets invested in US (in %)	9.21%	0.00%	18.93%	0.00%	48.23%	90
Share Turnover	0.16	0.13	0.13	0.04	0.32	87
Number of Firms in Portfolio	89	60	135	20	292	89
<b>Ownership Position in Portfolio Firms</b>						
Percentage Ownership Stake (in %)	0.131	0.006	0.573	0	0.534	7919
Value of Ownership Stake (in 1000 USD)	6,103	841	20,100	44	29,400	7919

## 2. Data and Methodology

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### Evaluation of Response Bias

- Respondents do not have significantly different...
  - ...assets under management
  - ...share turnover
- Respondents have significantly...
  - ...more assets invested in The Netherlands (by construction)
  - ...less assets invested in US (by construction)
- Sample exhibits an overweighting of investors from NL and LU, and underweighting of investors from the UK and the US
- Our investors are likely to be more governance sensitive than the average investor

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### 3. Investor Protection and Corporate Governance

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#### **Hypotheses and Predictions**

- We hypothesize that institutional investors have distinct preferences on country level investor protection which are consistent with the measures used in the literature
- We hypothesize that investors have preferences for firm-level mechanisms that reduced agency conflicts between shareholders and managers but also between large and small shareholders when making investment decisions
  - We expect these to be in line with the mechanisms document to be relevant in the literature
- We hypothesize that certain firm-level mechanisms are considered as partial substitutes for poor country-level investor protection

### 3. Investor Protection and Corporate Governance

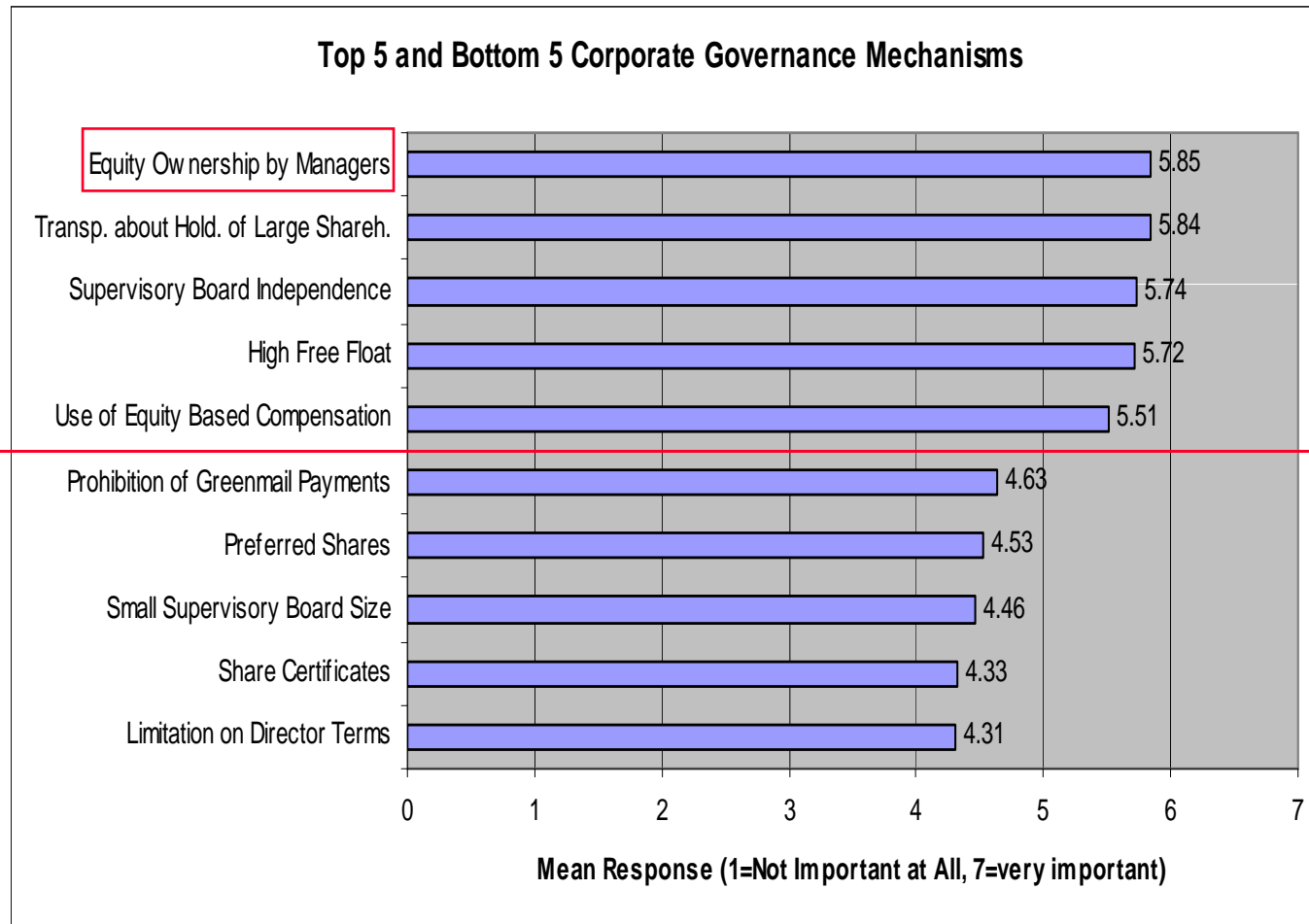
#### Importance of Country-Level Investor Protection

	United States				The Netherlands				Diff Sign p-value
	Mean	Median	STD	Obs.	Mean	Median	STD	Obs.	
<b>Survey Responses</b>									
Minority Shareholders Protected?	4.38	4.00	1.53	72	3.79	4.00	1.38	72	0.0028
Easy to Exercise Rights?	4.49	5.00	1.43	72	4.00	4.00	1.45	72	0.0180
Public Information Sufficient?	5.07	6.00	1.49	72	4.65	5.00	1.48	72	0.0091
Legal Rights in Place?	4.01	4.00	1.43	72	3.53	4.00	1.37	72	0.0042
Anti-Directors Index (LLSV (1998) rev.)	3.00				2.50				
Ant-Selfdealing Index (DLLS (2007))	0.65				0.20				

Note: Range from 1=Strongly disagree to 7=Strongly Agree

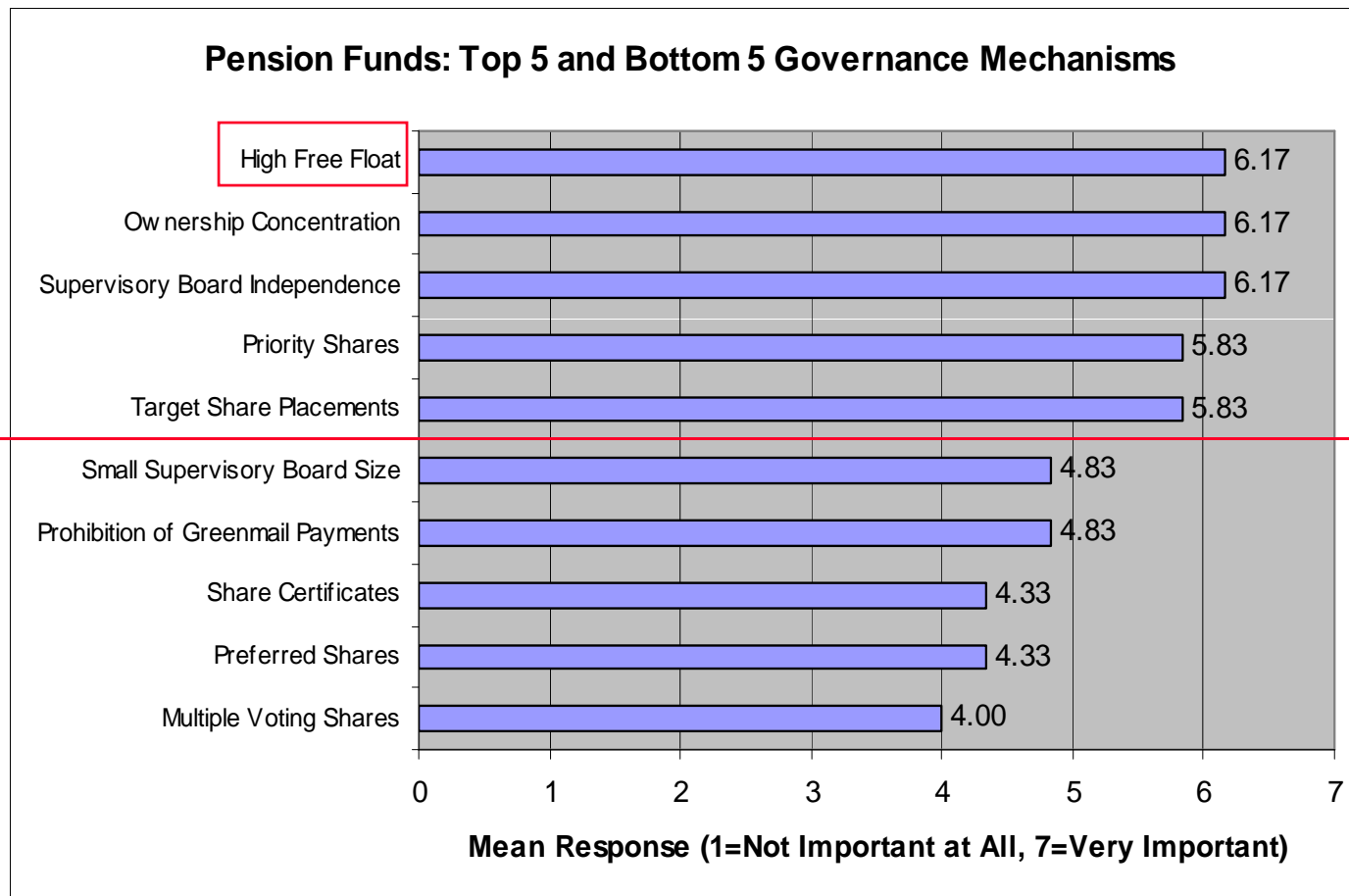
### 3. Investor Protection and Corporate Governance

Preference for Firm-Level Corporate Governance Mechanisms when Investing in a Country with Low Investor Protection (NL): All Investors



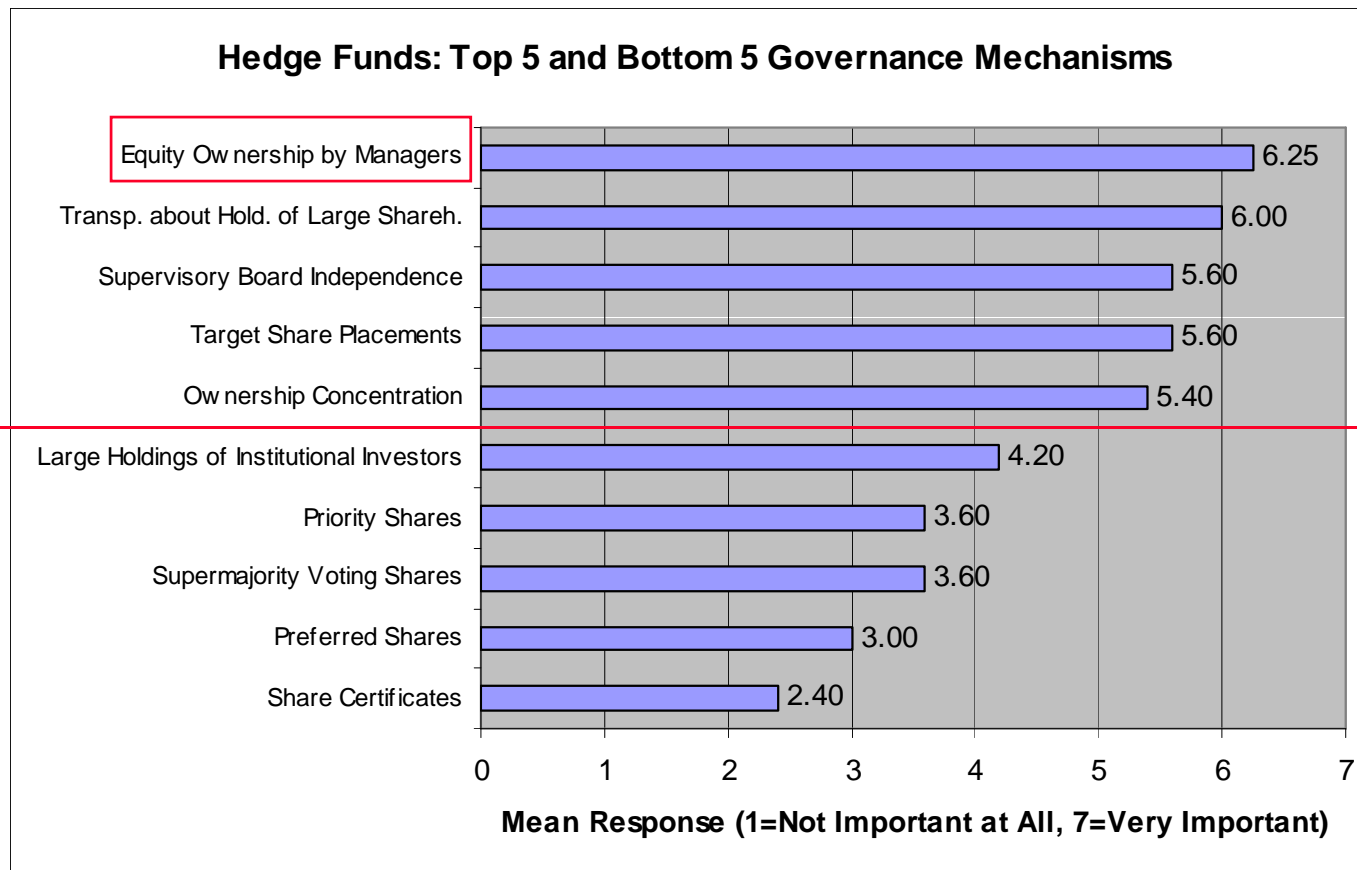
### 3. Investor Protection and Corporate Governance

#### Preference for Firm-Level Corporate Governance Mechanisms: Pension Funds



### 3. Investor Protection and Corporate Governance

#### Preference for Firm-Level Corporate Governance Mechanisms: Hedge Funds



### 3. Investor Protection and Corporate Governance

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#### Implications of Findings

- Investors focus on issues related to reducing agency problems
  - between shareholders and management (e.g., executive stock options and share ownership) and
  - between large and small shareholders (e.g., dispersed ownership, transparency about large shareholders, independent directors)
- In contrast to previous studies, small board size not key variable
- Mechanisms indicated by Bebchuk, Cohen and Farrell (2005) seem important but not as much as some of the other mechanisms
- Different investor types have different preferences

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### 3. Investor Protection and Corporate Governance

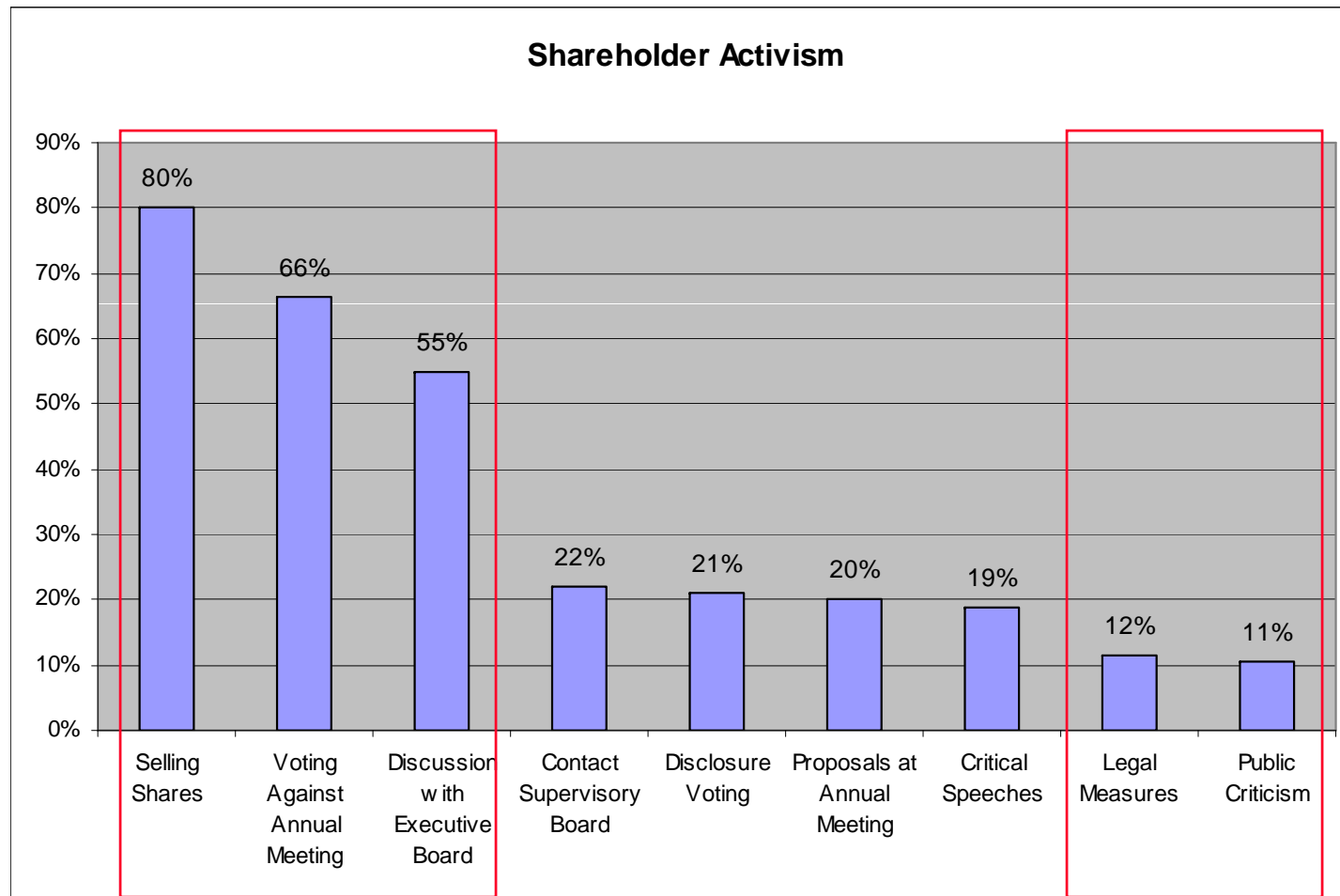
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#### **Hypotheses and Predictions**

- We hypothesize that institutional investors are willing to take corrective actions against poorly performing targets
- We hypothesize that hedge funds are the most activist investors
- We hypothesize that institutional investors that are more independent (from the targeted firms) are more willing to take harsh corrective actions

## 4. Shareholder Activism

Corrective Actions by Institutional Investors: What are they doing?



## 4. Shareholder Activism

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### Implications of Findings

- 80% of investors willing to vote with their feet
  - Parrino, Sias and Starks (2003) show that it can have a governance effect
- Remarkable number of 55% are willing to engage in discussion with executives
  - Comparison with study by Brav, Jiang, Partnoy and Thomas (2008) on hedge funds (HF) suggests that discussions with executive board by far not limited to HFs but a more general phenomenon
- Numbers on legal actions even exceed those of Brav et al (2008) for hedge funds
- Additional results in paper:
  - Distinguish between gray and independent investors
    - Find that independent investors are more willing to engage
  - Willingness to engage is unrelated to investment horizon of investors (measured by share turnover)

## 4. Shareholder Activism

### Triggers of Shareholder Activism : When do they get active?

Trigger	Target in United States				Target in The Netherlands				Diff. Sign?
	Mean	Median	STD	Obs.	Mean	Median	STD	Obs.	p-value
Poor accounting performance	5.28	6.00	1.63	67	5.30	6.00	1.61	67	0.709
Poor stock price performance (absolute performance)	4.60	5.00	1.67	68	4.63	5.00	1.68	68	0.418
Poor stock price performance relative to peers	4.99	5.00	1.62	68	5.03	5.00	1.60	68	0.182
Excessive compensation packages	5.09	5.00	1.51	68	5.10	5.00	1.51	68	0.568
Low payments to shareholders despite high cash hold.	5.07	5.00	1.34	68	5.04	5.00	1.35	68	0.418
Suboptimal capital structure	5.24	5.00	1.16	68	5.24	5.00	1.16	68	1.000
Poor corporate strategy	5.59	6.00	1.21	68	5.59	6.00	1.22	68	1.000
Rights issues	4.90	5.00	1.25	68	4.93	5.00	1.24	68	0.159
Significant asset sales	5.13	5.00	1.12	68	5.18	5.00	1.12	68	0.182
Planned acquisitions	5.61	6.00	1.09	67	5.63	6.00	1.07	67	0.321
Goals & strategy	6.00	6.00	1.16	68	6.04	6.00	1.11	68	0.260

#### Top 4 Triggers:

1. Goals & Strategy
2. Planned Acquisition
3. Poor Corporate Strategy
4. Poor Accounting Performance

#### Bottom 4 Triggers:

1. Poor absolute stock price perf.
2. Rights issues
3. Poor relative stock price perf.
4. Low payments to shareholders

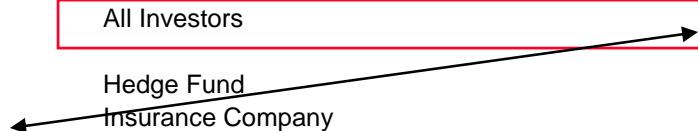
Note: Range from 1=Not Important at All to 7=Very Important

# 4. Shareholder Activism

## Coordination of Shareholder Activism: Do investors coordinate behind the scenes?

Type of Investor	No	Yes	Obs
All Investors	41%	59%	91
Hedge Fund	25%	75%	4
Insurance Company	40%	60%	5
Mutual Fund	41%	59%	59
Pension Fund	17%	83%	6
Other Investors	53%	47%	17
Large Investor ( $\geq$ Median)	32%	68%	38
Small Investor ( $>$ Median)	55%	45%	33
Large US Holdings ( $\geq$ Median)	50%	50%	32
Small US Holdings ( $<$ Median)	36%	64%	39
Large NL Holdings ( $\geq$ Median)	47%	53%	34
Small NL Holdings ( $<$ Median)	38%	62%	37
Long Horizon (Share Turnover $>$ Median)	50%	50%	36
Short Horizon (Share Turnover $\leq$ Median)	35%	65%	34
Origins:			
The Netherlands (NL)	29%	71%	7
UK	33%	67%	3
US	20%	80%	5
Germany (DE)	100%	0%	3
France (FR)	0%	100%	4
Luxembourg (LU)	50%	50%	22

Why not?  
60% of these  
say because  
of Legal Risks



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## 5. Governance and Characteristics of Portfolio Firms

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- Have shown that institutional investors have definitive and diverse views regarding investor protection and corporate governance
- But: Are there links between the considerations of investor protection and the characteristics of the portfolio holdings (e.g., the R&D expenditures of the portfolio firms)?
- We run the following specifications:
  - $Firm\ Characteristic_{ci} = Investor\ Protection_i + \mathbf{X}_c + \mathbf{y}_i + \varepsilon_{ci}$ 
    - $ci$  stands company  $c$  held by investor  $i$ ,  $\mathbf{X}$  are a vector of firm controls,  $\mathbf{y}$  a vector of investor controls
- Run cross-sectional regressions for 2007
- Standard errors clustered at the institutional investor level

## 5. Governance and Characteristics of Portfolio Firms

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### Main Findings

- Assessment of investor protection by institutional investors is related to characteristics of firms in portfolios (e.g. innovation)
- Assessment of whether there exist appropriate legal measures to allow shareholders to influence the strategy of a company is related to firm characteristics
  - Investors which believe mechanisms are in place to influence strategy invest in firms which are in need for a change in strategy
  - These firms have lower Tobin's Q, invest less, and are less innovative
  - We proxy for innovative potential by looking at R&D expenditures

## 6. Conclusion

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- Respondents have definitive and diverse assessments of investor protection in the US and Netherlands
- Relative differences consistent with anti-director index of LLSV (1998) and the anti-self dealing index of DLLS (2008)
- Most important firm-level corporate governance mechanisms:
  - Equity ownership by management, use of equity-based compensation, board independence, transparency about holdings of large shareholders, and high free float
- Some firm-level governance mechanisms could act as substitutes for poor country-level investor protection

## 6. Conclusion

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- When investors undertake corrective actions, they concentrate their activities on selling shares, voting against the AGM, and discussions with the Executive Board
- Willingness to conduct shareholder activism seems very widespread across different investor types
- Independent institutional investors are more willing to undertake conflicting corrective actions than grey investors
- Almost 60% of all institutional investors consider coordinating their corrective actions
- Find relationship between innovation of portfolio firms and investor protection assessment of investors