GOVERNANCE BY INSTITUTIONAL INVESTORS AND FINANCIAL ANALYSTS

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Abstract

This study examines how two governance mechanisms, monitoring by financial analysts and institutional investors, interact with each other. I find that after stocks experience a reduction of analysts' coverage, the firms' governance measures drop. In addition, long-horizon institutional investors increase their holdings, and short-horizon institutional investors decrease their holdings of those stocks. However, even though long-horizon institutional investors increase their holdings, the drop in the firms' governance measures is not mitigated. I argue that financial analysts' monitoring role through information production cannot be substituted by the institutional investors' monitoring role, which is usually through the channel of voice and exit.

Keywords: corporate governance, financial analyst, institutional investors, investor horizon

INTRODUCTION

The agency problem is one of the most important issues in corporate finance. It is well documented in many finance studies that agency costs matter for a firm's value, such as Jensen and Meckling (1976) and Morck, Shleifer, and Vishny (1988). Different corporate governance mechanisms are developed to ensure that managers are behaving in the best interests of shareholders. Such governance mechanisms include the board of directors, blockholders' voice and the threat of exit (Edmans, 2013), legal protection of shareholders (Shleifer and Vishny, 1997), and financial analysts' voice and disclosure of firms' information (Chen, Harford, and Lin, 2015). Literature has documented that the above governance mechanisms all play a role in reducing agency costs. However, very little can be gleaned from the finance literature about whether these governance mechanisms work jointly or independently.

In this study, I address whether the monitoring role by institutional investors of different investment horizons is a substitute or complement of the monitoring role by financial analysts. Long-term institutional investors focus on the long-run value of a firm and are expected to fill in the gap of excess demand of monitoring when the stocks they hold experience a reduction in analysts' coverage. Therefore, long-term institutional investors' monitoring should be a substitute for analysts' monitoring. On the other hand, short-term institutional investors do not have much incentive to exert efforts to monitor the firm and are expected to rely on the monitoring role played by financial analysts. Therefore, they are expected to flee away when a stock loses analysts' coverage. In other words, I hypothesize that the monitoring by long-term institutional investors is substitute and the monitoring by short-term institutional investors is complement of the monitoring by financial analysts.

I use brokerage firm closures and mergers events during the year 2001-2010 as plausibly exogenous shocks to a firm's stock financial analyst coverage and study whether institutional investors of different horizons change their ownership of stocks that experience a reduction in analyst coverage and further how the corporate governance of the treated firms are affected.

First, by implementing a difference-in-difference methodology, I find that long-term institutional investors increase their holdings if their stocks experience a reduction in analyst coverage. This is consistent with the substitution hypothesis. Short-term institutional investors decrease their holdings after their stocks experience a reduction in analyst coverage.

To further examine whether the change in institutional ownership mitigates or aggravates the already reduced corporate governance caused by a reduction in analyst coverage, I study the ex-post corporate governance by implementing a triple-difference methodology. I find insignificant evidence to support these hypotheses. In other words, the change in long-term institutional investors or short-term institutional investors does not affect the magnitude of the effect of a reduction in analysts' monitoring on a firm's corporate governance.

The main findings in this study indicate that even though institutional investors are known to play a monitoring role on the firm as an outside governance mechanism, they do not seem to substitute the monitoring role played by financial analysts. This is partially due to the fact that analysts' monitoring is usually through information production while institutional investors' monitoring is usually through voice and exit.

This study contributes to the finance literature in several ways. First, this study is the first one to answer the question of whether outside governance mechanisms, particularly financial analysts and institutional investors, substitute each other. Second, this study uses a quasi-experiment setting to identify the causal substitution and complementary effect of the monitoring between institutional investors and analysts without much endogeneity concern. Corporate governance studies are constrained by endogeneity problems, and this study provides a plausible analysis to address an important corporate governance question.

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