Corporate Governance and Institutional Investors: Why are They Important?

Ivana Djundjek Kokotec, Ph.D.
University of Zagreb, Faculty of Organization and Informatics, Pavlinska 2, Varaždin, Croatia
idjundjek@foi.unizg.hr

ABSTRACT
The goal of this paper is to analyze the involvement of institutional investors in the corporate governance of companies in their portfolio by analyzing characteristics of institutional investors concerning the type of investment, investment time horizon, and degree of involvement in the process of managing a company. Starting from the deductive approach, the method of description, compilation, and classification is applied in this review paper, which describes and groups the previous theoretical and empirical research. Main findings indicate that institutional investors are involved in the corporate governance of their portfolio companies and that control mechanisms they use include voting rights at general assembly meetings, direct communication with the management to discuss strategies for future development, and collaboration with other institutional investors in the ownership structure. The theoretical contribution of this paper is an extensive, critical, and systematic review of existing theoretical and empirical findings from the domain dealing with the impact of institutional investors on the corporate governance of companies, and identifying key future opportunities to advance knowledge in this field.

Keywords: Corporate Governance, Corporate Governance Mechanisms, Institutional Investors

1. INTRODUCTION
Agency theory represents a useful tool for understanding the crucial issue of corporate governance – the issue of the relationship between owners, i.e. the principal and firm management, i.e. the agent. Jensen and Meckling (1976) argue that the basic goal of agency theory principles is resolving issues and formalizing the relationship between the owner and the manager, to whom the owner delegates his authority to act in his interest. The basic assumption of this theory is that the agent’s behavior is egoistic and driven by self-interest, which leads managers to neglect the owner’s initial interests and this consequently results in agency costs (Arrow, 1985). The principal (owner) aims to minimize these costs by implementing various management control mechanisms. To reduce agency costs, the monitoring role in the firm is often attributed to institutional investors (Hartzell, Starks, 2003). Ferreira and Matos (2008) emphasize that institutional investors may increase firm value using not only direct but also indirect control, i.e. by conducting continuous performance analyses. According to the authors, direct control involves expressing opinions in direct communication with the board of directors and exercising voting rights, to which investors as shareholders are entitled (Ferreira and Matos, 2008).

2. CHARACTERISTICS OF INSTITUTIONAL INVESTORS
According to the investment time horizon, institutional investors can be grouped into two classes: passive investors and active investors. Actively managed institutional investors adopt investment and management strategies procuring returns that outperform the market, which is necessarily accompanied by higher management expenses and transaction costs (Orsag, 2015). In contrast, passively managed institutional investors hold a diversified portfolio to make a profit based on long-term economic, i.e. market growth and development (Orsag, 2015). According to Cornett et al. (2007), active institutional investors have their representatives on supervisory boards when it comes to the Continental model of corporate governance. On
the other hand, Maug (1998) asserts that institutional investors that do not have their representatives on the supervisory boards of firms do not possess enough power to control firm management, hence the term passive investors. This thesis has been confirmed by many other authors such as Parrino, Sias, and Starks (2003), Gaspar, Massa, and Matos (2005). Due to their lack of control, investors of this type have no choice but to comply with management’s opportunistic behavior (Mehrani, Moradi, and Eskandar, 2017). The results of previous research indicate that institutional investors maintain a long-term investment horizon to earn safe returns and allow for a constant and slow increase in share prices. This is indicative of the passive portfolio management style adopted by fund managers in institutional investors management firms (Nix and Chen, 2013). A long-term investment horizon entails investing in shares that are to be held in the portfolio for more than one year, whereas a short-term investment horizon refers to a holding period of just a couple of days up to a year at most (Carhart, 1997; Barber and Odean, 2000; Gaspar et.al., 2005; Cella, 2009). Previous studies have shown that institutional investors prefer investing in large, established firms, which are perceived as safe investments offering higher expected returns (Agrawal and Knober, 1996; Holland, 1998; Mallin, 1999; Tam and Tan, 2007). Accordingly, the goal which a particular institutional investor seeks to achieve by creating an investment portfolio includes an investment that can guarantee steady returns and annual dividend payments over a long-term investment horizon, i.e. shareholder wealth maximization. In their research, McCahery, Sautner, and Starks (2016) support the thesis that investors prefer long-term investment horizons, hence their interest in corporate governance. Furthermore, Annuar (2015) indicates that institutional investors are inclined to favor conservative investment strategies as they promise steady returns on low-risk investments. The decision to invest in a particular firm depends on a clearly defined business development strategy and an elaborate business plan, which investors consider to be important indicators of future returns, as well as the dividend policy. Additionally, particular importance is given to continual strategic assessments (Low and Arumugam, 2001).

3. METHODOLOGY
The research problem of the study is focused on examining the involvement of institutional investors in the corporate governance of companies in their portfolios. Previous research confirms the thesis that the presence of institutional investors in the ownership structure of joint-stock companies positively affects the value of companies by limiting the actions of company management to act solely for their benefit, thus reducing the gap between ownership intentions and business operations, which results in increased performance and financial position. Based on the literature researched so far, it is possible to define research questions by looking at institutional investors as homogeneous and heterogeneous groups:

RQ1: Are institutional investors involved in the corporate governance of companies in their portfolios?
RQ2: What is the nature of the impact of institutional investors on the business performance and financial position of companies in their portfolios?
RQ3: Which are the main corporate governance control mechanisms used by institutional investors to control the corporate management of companies in their portfolios?
RQ4: Does the impact of institutional investors on corporate governance and the level of involvement in the corporate governance process differ according to institutional investor management characteristics, type of institutional investors, and period of the investment time?

The theoretical contribution of this study is a critical analysis and a comprehensive and systematized review of existing theoretical and scientific findings from the domain dealing with the impact of institutional investors on the corporate governance of companies. To answer the defined questions, a mixed-method approach was used, that involves qualitative research through databases and after that in-depth analysis, i.e. qualitative coding. The analyzed papers were collected primarily from the Web of Science and additionally from Scopus and Ebsco databases. The period was not defined, so various articles, regardless of the year of publication, were included in the study, in total 2,483. More than 100 articles were identified as potentially relevant.
These articles were subsequently reviewed to assess their relevance concerning the research aims, and the following keywords were used: institutional investors, corporate governance, agency theory, business performance, financial position, portfolio investment style, corporate governance mechanisms. After the relevance analysis of the initial base of articles, only articles that are in line with the aims of this paper were analyzed.

4. FINDINGS

The following subsections present the literature review, i.e. findings of the identified literature on the involvement of institutional investors in the corporate governance of companies in their portfolio by analyzing characteristics of institutional investors. The paper outlines the attitudes of managers on the level of investors’ involvement in the governance process to identify determinants of investment decisions, decisions to take corrective actions to enhance corporate governance, or decisions to leave the ownership structure.

4.1. Impact of Institutional Investors on Corporate Governance

Velury and Jenkins (2006) assert that the presence of institutional investors in the ownership structure of firms and their monitoring role change management’s behavior. However, the question of the efficiency of their monitoring role, if it even exists, remains understudied. The available literature identifies two theories that try to explain the monitoring role of institutional investors in a firm. The first research group advocates institutional investors’ initiative in the domain of corporate governance with the function of monitoring firm management (Fan and Wong, 2002; Velury and Jenkins, 2006; Hadani, Goranova, and Khan, 2011). Although Pound (1988) points out the problem of high monitoring costs their role entails, institutional investors, given their size, can afford them, unlike individual investors. An opposing view is that institutional investors do not have a monitoring role in the corporate governance of firms due to a lack of necessary knowledge despite having informational advantage; therefore, they collaborate with management (Admati, Petleidere, and Zechner, 1994; Mehreni, Moradi and Eskandar, 2017).

Morck, Shleifer, and Vishny (1986) assert that the size of institutional investors and their informational advantage provide a basis for launching an intensive initiative into effective management control. Unlike individual investors, institutional investors have more knowledge, and consequently more power to monitor a firm, and financial reporting as well (Mehreni, Moradi, and Eskandar, 2017). This thesis is supported by Bathala, Moon, and Rao (1994), who indicate that institutional investors have incentives to monitor financial reporting and are willing to penalize managers for the low quality of their financial reporting by selling a part of their shares. In cases of majority ownership, institutional investors may lay off managers if they are not satisfied with their work, which directly affects the performance outcomes of the firm. In their research, Chung et al. (2002) study the impact of institutional investors on the quality of financial reporting and information preparation methods. Their findings reveal that institutional investors' ownership simultaneously reduces managers’ fees and increases the quality of accounting processes.

Research conducted by Davis (2002) upholds the thesis that institutional investors directly influence corporate governance by performing their monitoring role. According to the results, the average fraction of shares owned by institutional investors sufficient to encourage these investors to engage in corporate governance to improve firm performance stands at 5 % in Anglo-Saxon countries. There is a growing power of institutional investors as direct monitors of managerial behavior in developed economies. Ultimately, enhanced corporate governance increases the stock prices and performance of firms in their portfolios; however, increased dividend distribution decreased amount of fixed investment and growing productivity may also be a sign of positive effects. According to the findings, such an effect primarily concerns the analyzed insurance firms, life insurance, and pension funds, seeing that they have the greatest power of influence.
Chung, Elder, and Kim (2009) claim that good corporate governance practices improve the operational and financial transparency of a firm, thus reducing information asymmetry between the principal (owners) and the agent (managers) and resulting in a reduction of agency costs. Firms with good corporate governance practices in place consequently have more liquid stocks and lower transaction costs, which explains why institutional investors choose to include particularly such firms in their portfolios. Stock liquidity is more important to them than, for example, to individual investors. Moreover, Chung and Zhang (2011) indicate that institutional investors base their decision on the fact that well-governed firms require less management control and the liquidity levels of their stocks will increasingly grow, making it simpler for investors to perform their fiduciary duties. Chhaochharia, Kumar, and Niessen-Ruenzi (2012) also show a direct influence of institutional investors' ownership on firm performance in their study.

Their findings reveal that firms with institutional investors in their ownership structures operate more profitably and have more independent boards, which leads to the conclusion that institutional investors use their monitoring role in corporate governance in an effective manner. Jabeen and Ali (2017) investigate the role of institutional investors' ownership in monitoring managers of Pakistani firms over the period 2006–2014. They expand their analysis by classifying institutional investors into different groups and examining their impact on firm performance as monitors of managerial behavior. They measure operating performance by using the net profit margin ratio, while expense ratio and sales growth ratio are used as proxies for investment efficiency. Their findings show that open-ended investment funds take the most active role in disciplining managers to act in the interest of shareholders rather than their own, which indirectly enhances firm performance. Previous empirical research indicates that institutional investors’ involvement in corporate governance intensifies as their shareholdings in a firm increase and their participation is directly conditional on their investment time horizon. Grossman and Hart (1987) claim that institutional investors who stay in the ownership structure longer access the information they need more cheaply and quickly, and therefore derive longer-lasting and more benefits from their involvement in the corporate governance process. McConnel and Servaes (1990) confirmed the positive correlation between firm performance as measured by using Tobin’s Q and the fraction of shares owned by institutional investors. Additional empirical research identifies pension funds and insurance firms as the institutional investors whose ownership positively affects firm performance, considering that a long-term horizon is characteristic of these investors.

4.2. Corporate Governance Control Mechanisms and Institutional Investors

In the context of corporate governance, there are several control instruments. The objective of them all is to increase shareholder wealth while limiting the satisfaction and social goals of the company (Matic, Papac, 2010; Orsag, Sabol, 2014). Weir, Laing, and McKnight (2002) differentiate between internal (supervisory board structure, executive compensation, concentration of ownership, corporate reporting, relation with stakeholders) and external mechanisms of corporate governance (market for corporate control, legislative and regulatory framework, competition circumstances, protection of minority shareholders (Tipuric, 2008). Annuar (2015) asserts that institutional investors’ participation in corporate governance is highly important in that they control company management and maintain the value of their investment. Previous studies distinguish three mechanisms used by institutional investors to control corporate management. Mallin (1999) indicates that the most important mechanism is (1) the exercise of voting rights at the general assembly of shareholders, which grants explicit power in management control to investors. Solomon and Solomon (2004) contend that financial reporting is insufficient and specifies (2) face-to-face communication with the board as the second management control mechanism. Based on Holland (1998), Annuar (2015) indicates that the domain of communication refers to the meetings at which company strategies and management quality are discussed, which ultimately improves the efficacy of governance devices. The third control mechanism refers to (3) cooperation with other institutional investors in the ownership structure of a company to create a representative group safeguarding their interests.
Answers obtained in an interview conducted by Nix and Chen (2013) support all of these points by revealing that the most common methods institutional investors use to exercise their power include communication with the board, the exercise of voting rights, and cooperation with other shareholders. In addition to the mechanisms enabling institutional investors to engage in corporate governance, some hindrances to their intervention in the management process have also been identified. One of the major challenges includes complex legislative frameworks imposing various investment restrictions on institutional investors, depriving them of the opportunity to take a more active role in the process of corporate governance (David and Kochhar, 1996). Gillan and Starks (2003) argue that another important obstacle is investors’ lack of expertise to adequately advise corporate management in particular processes of their governance, as well as focusing too much exclusively on financial performance indicators. The question arises as to what institutional investors can do if they are not content with the governance of their portfolio company. Literature and previous research highlight two possible active choices investors have when it comes to management control: the first one includes communication with management, i.e. the exercise of voting rights, whilst the second one refers to investors’ decision to leave the company by selling shares (“voting with their feet”) (Hirschman, 1970 cited in McCahery, Sautner and Starks, 2016). As indicated above, institutional investors favor long-term investment horizons. Therefore, their threat to exit the ownership structure can be regarded as a disciplinary threat to management. Investors specify that they resort to this strategy only after having engaged in direct discussions with management, which illustrates how these two devices complement each other rather than substitute, with discussions typically occurring before a potential exit (McCahery, Sautner and Starks, 2016).

4.3. Determinants of Institutional Investors’ Engagement in Corporate Governance

It has been established that institutional investors have a significant impact on the corporate governance of portfolio companies, but it is also necessary to identify various factors determining their ownerships engagement in corporate governance. Previous studies indicate several determinants such as institutional investors’ objective, investment time horizon, investment strategy, portfolio structure, etc. Moreover, studies have shown that determinants may vary according to the type of institutional investor (investment funds, pension funds, insurance companies) and within the same type. Their engagement may range from a completely passive to a completely active management style (McNulty and Nordberg, 2016). An in-depth analysis of theoretical premises helps to identify five key determinants of institutional investors’ engagement in corporate governance (represent in Table 1) which can be grouped into five classes.

<table>
<thead>
<tr>
<th>Determinants</th>
<th>Source</th>
</tr>
</thead>
<tbody>
<tr>
<td>Type of institutional investor</td>
<td>Maug, 1998; Ryan, Schneider, 2002; Parrino, Sias, Starks, 2003; Al-Hawamdeh, 2004; Gaspar, Massa, Matos, 2005; Chen, Harford, Li, 2007; Conrett et al., 2007; Nix, Chen, 2013; Çelik, Isaksson, 2014; Annuar, 2015; McCahery, Sautner, Starks, 2016 McNulty, Nordberg, 2016; Mehrani, Moradi, Eskandar, 2017</td>
</tr>
<tr>
<td>Institutional investor’s management style</td>
<td></td>
</tr>
<tr>
<td>Investment time horizon</td>
<td></td>
</tr>
<tr>
<td>Investment purpose</td>
<td></td>
</tr>
<tr>
<td>Legislative restrictions</td>
<td></td>
</tr>
</tbody>
</table>

Table 1: Key determinants of institutional investors’ engagement in corporate governance
(Source: created by the author of the paper)

In studies conducted to this date, additional nine characteristics related to the company’s business performance have been identified and they are represented in Table 2. These characteristics have an impact on the involvement of the institutional investor in the management process, on the one hand, but also, they can be observed as an important criterion by which these investors select a company in its portfolio.
By engaging in corporate governance, institutional investors perform not only their ethical but also fiduciary duties. However, they also serve a far more important purpose using effective capital allocation and management control, thus directly fulfilling their principal function – maximization of shareholder wealth. The overall observation that shareholders strive to gain returns on the invested capital, therefore choosing to invest in transparent companies whose value is expected to increase in the long term, is consistent with the relevant theory. Stakeholders, as much as institutional investors, are expected to continuously monitor the performance of a company to control the capital they invested themselves. If they duly fulfilled their primary function, shareholders will indirectly provide the whole market with the necessary information, which will result in the employment of new capital in particular companies, i.e. more effective allocation of capital employed at the moment. Engagement in the corporate governance of a company requires institutional investors to be highly informed, which is to be ensured by the company. This information is used primarily in discussions of crucial business issues such as development strategies, dividend policy, etc. In this manner, institutional investors contribute to the value-added of companies and help to enhance their financial position and performance.

5. CONCLUSION

Institutional investors intervene in the corporate governance process primarily using the three fundamental control mechanisms: (1) the exercise of their voting rights at general assembly meeting, which grants them explicit power in the fundamentals of corporate governance control, (2) direct communication with the management to discuss strategies for the future development of the company, and (3) cooperation with other institutional investors in the ownership structure of the company, whereby all parties make uncoordinated, but synergistic efforts to solve issues. This illustrates the underlying principle of investors’ practices – long-term investing, which protects both their investment and the interests of their shareholders. Following the theory, investors strive to gain returns on the invested capital, therefore they choose to invest in transparent firms whose value is expected to increase in the long term. By doing so, not only do institutional investors fulfill their interests as the principals to the firm, but also the fiduciary interests they have in their relationship with shareholders, i.e. stakeholders. It is in their interest to engage in the firm management process to ensure higher returns for their investors and attract new investors in this manner; consequently, the entire management firm will generate more profits. Under theoretical assumptions, the analysis identified the indicative importance of
financial leverage as a kind of investment risk measure. The results are consistent with the study conducted by Cella (2009), which indicates that solvency has a disciplinary effect on firm managers and may discourage them from making certain investments, especially when there is information asymmetry between the principal and the agent. The analysis also identified a positive significant correlation between the sales growth rate and the financial position of firms, which represents an investment opportunity for the analyzed investment and a factor taken into consideration upon deciding whether to invest in a particular firm. The analyzed investors invest in firms with dividend policies, clearly defined development strategies, and elaborate business plans, which they regard as important indicators of future returns, and they particularly emphasize the importance of continual strategic assessments as well. The results imply that the dividend policy has a disciplinary effect on the behavior of managers in firms, and by extension on the level of business growth. Financial leverage and dividend policy together make up a complementary device for controlling managerial discretion. Therefore, it can be concluded that institutional investors co-exist with good practices of corporate governance implemented by joint-stock firms, which ultimately leads to synergistic efforts in management control resulting in a better business performance and increased firm value.

LITERATURE:


