Do Institutional Investors Alleviate Agency Problems by Influencing

Payout Policy in Firms with Poor Investment Opportunities?

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**Abstract**

This paper seeks to determine if institutional investors influence corporate payout policies. Specifically, this study tests whether institutional investors encourage higher payouts in firms with higher free cash flow and poor growth opportunities. Firm and year fixed effect regressions examining the effect of changes in institutional investor levels to subsequent changes in payout levels are used. For robustness, difference-GMM regressions and regressions for different time periods are performed on the same relationship. Increased institutional ownership leads to increases in total payouts, especially in firms with high free cash flow and poor investment opportunities (low *q*). According to agency-based free cash flow theory, stockholders should prefer that the management of firms with higher free cash flow and poor investment opportunities increase payouts to shareholders. The results indicate that institutional shareholders reduce agency costs by encouraging management to raise payouts, thus benefiting institutional investors and non-institutional shareholders.

**Keywords:** Corporate governance, Corporate finance, Dividends, Repurchases, Agency costs

**1. Introduction**

Corporations have been using purposeful payout policies for quite some time, despite the fact that, in theory, payouts should have no effect on shareholder wealth, except for perhaps negative tax consequences (Lintner, 1956; Poterba & Summers, 1984). Furthermore, repurchases and dividends are theoretically equivalent methods of payouts except where tax differentials favor one method over the other. Still, it is known that corporate payout policies vary widely, but what forces shape corporate payout decisions?

One force that appears to influence the payout decisions of corporate managers is institutional investors. Institutions have become the dominant force in corporate ownership. They owned 24% of all U.S. stocks in 1980. Now, institutions own over 70% of the shares of U.S. corporations (Gaspar, Massa, Matos, Patgiri, & Rehman, 2013). Institutional investors are also important internationally. For example, institutional investors hold 50 to 60 percent of large listed European companies (Brossard, Lavigne, & Sakinç, 2013). The predominance of institutional investors underscores the importance of the relationship between institutional investors and corporate financial policies.

Institutional investors have been shown to affect corporate governance in many areas (Becht, Bolton, & Röell, 2003). Institutional investors should be better corporate stewards than individual investors because they are more informed and influential. On the other hand, institutional investors are agents that may take actions for their own benefit at the expense of their principals. One example in which institutional investors seem to have failed their principals as monitors is executive compensation. Institutional ownership has grown rapidly since 1980. In the meantime, the average U.S. corporate chief executive’s salary has grown from 42 times to 400 times an average worker’s salary without an accompanying improvement in firm performance (Bogle, 2010).

Institutional investors must actively monitor management to influence financial policies effectively, but institutions with different characteristics have different incentive levels to expend costly effort to monitor. Institutional investors are likely to fill one or more of three roles in monitoring management: active monitoring, passive monitoring, or cooperating with management at the expense of other shareholders (Elyasiani & Jia, 2010). Since institutions are likely to be better informed and have larger holdings than other investors, engaging in active monitoring and positively influencing corporate governance is likely to lead to improved firm performance (Shleifer & Vishny, 1986). Passive institutional owners such as index funds and many short-term traders are likely to have little effect on corporate

governance or firm performance. Chung and Zhang (2011) find that institutional investors gravitate to companies with pre-existing good governance to minimize monitoring costs. Cooperating with management to exploit other shareholders is likely when the institution has a business relationship (e.g. an investment banking relationship) with the firm (Cornett, Marcus, Saunders, & Tehranian, 2007).

Easterbrook (1984) and Jensen (1986) develop an agency-based theory which implies that higher payouts keep managers in the capital markets where monitoring costs are lower than those alternatively incurred by current shareholders. Therefore, payouts reduce agency costs. Agency-based theory recognizes that investment policies and payout policies are not independent. Payouts serve to prevent management from investing excess free cash flow in marginal or value-reducing projects. According to agency-based theory, better informed investors, such as institutions, should encourage higher payouts in firms that are likely to overinvest. Based on this theory, I test a prediction that institutional investors will encourage firms to pay out more of their free cash flow, especially in firms with high free cash flow and poor investment opportunities.

My results provide support for agency-based theory. I find that an increase in institutional ownership leads to a rise in a firm’s total payout in the subsequent year, especially in firms with high free cash flow and poor investment opportunities (low *q*). This indicates that institutional investors reduce agency costs by inducing managers to make payouts in firms which are likely to overinvest.

This paper has six sections. The introduction discusses the purpose of the paper. Section 2 is a literature review. Section

3 discusses the development of the two central hypotheses. In section 4, the data and methods employed are explained. Empirical results are presented in section 5. A discussion of the results and suggestions for future research are included in section 6.

**2. Literature Review**

Institutional investors can influence management through methods such as proxy votes, shareholder proposals, publicity generation and the threat of “voting with their feet” by selling their shares. Graham, Harvey, and Rajgopal (2005) survey and interview CFOs who view institutional investors as the most important marginal investors. Many CFOs in their study declare that institutional investors are important because they can lower a stock’s price by herding out of a stock after an earnings miss. Additionally, many of the CFOs assert that institutional investors can provide more accessible and lower cost capital if they are pleased with firm management.

Research has provided evidence that the influence of institutional investors can improve corporate governance. In a study of companies from 23 countries, Aggarwal, Erel, Ferreira, and Matos (2011) find that higher institutional ownership increases the likelihood that poorly performing Chief Executive Officers (CEOs) will be terminated and that firm valuation will improve. Also, institutional investors help to control earnings management (Hadani, Goranova, & Khan, 2011).

Several studies have found a relationship between institutional investors and payout policies. Jagannathan, Stephens, and Weisbach (2000) find higher institutional ownership in firms that are increasing payouts, especially if the increased payout comes in the form of dividends. They explain that tax-exempt institutions that do not share in the tax benefits of repurchases may be behind the preference for increased dividends. Moser (2007) differentiates between classes of institutional investors and finds that firms increase the percentage of payouts that go towards repurchases as tax-disfavored (by dividends) institutional ownership increases, but decrease the percentage as tax-favored institutional ownership increases. The information advantage enjoyed by institutional owners reduces opportunities for companies to repurchase stock at bargain prices (De Cesari, Espenlaub, Khurshed, & Simkovic, 2012). Evidence is provided by Desai and Jin (2011) that management alters dividend policy to cater to institutional shareholders.

**3. Hypotheses**

Shareholders incur agency costs when a firm’s management uses its superior knowledge of the firm’s business activities to make decisions that benefit management at the expense of shareholders. Agency-based free cash flow theory suggests that firms with higher free cash flow and poor growth opportunities should have higher payouts through higher dividends or stock repurchases (Easterbrook, 1984; Jensen, 1986). The higher payouts serve to prevent management from using discretionary funds to invest in projects that provide less benefit to shareholders than the higher payouts do. Therefore, institutional shareholders should attempt to reduce agency costs by encouraging management to raise payouts.

Agency-based theory predicts that higher payouts force managers into capital markets to raise funds which lower the monitoring costs of current shareholders. Agency-based theory recognizes that payouts reduce managerial ability to engage in empire building by investing excess free cash flow in projects that reduce the value of the firm. Therefore,

informed investors should seek to influence management to increase payouts in firms that have high free cash flow and poor investment opportunities as indicated by a low *q* ratio.

There is empirical support for agency-based theories. Easterbrook (1984) and Jensen (1986) propose that payouts can be used to mitigate potential overinvestment or empire building problems. Grullon and Michaely (2004) find that repurchase announcements get a more positive reaction among firms that are likely to overinvest. Similarly, Officer (2011) finds that dividend initiation announcements lead to higher short-term returns in firms with poor investment opportunities and high cash flow.

Agency-based theory implies that larger institutional investor holdings will lead to higher payouts. Therefore, I state my first hypothesis as:

***H1***: Greater institutional investor holdings will lead to higher payouts through dividends or stock repurchases.

The relationship predicted by *H1* should be stronger in firms with high free cash flow and poor investment opportunities. My second hypothesis is derived from the agency-based theory:

***H2***: The relationship between greater institutional investor holdings and higher payouts will be stronger in firms with high free cash flow and poor investment opportunities.

The relationship between institutional investors and payout policy is an endogenous one. Therefore, it is important to show a causal relationship to support these hypotheses. The causal relationship in the agency-based theory predicts that institutional investor changes influence total payout (dividends and stock repurchases) policy changes.