

# Institutional Investors & Corporate Governance: International Evidence

NSE-ECGI  
ROUNDTABLE  
13 November 2017  
Mumbai, India

## PEDRO MATOS

John G. Macfarlane Family Chair and  
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DARDEN SCHOOL  
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CHARLOTTESVILLE, VA | WASHINGTON, DC | SAN FRANCISCO, CA | SHANGHAI, CHINA

# FOREIGN INSTITUTIONAL INVESTORS (“FPI”)

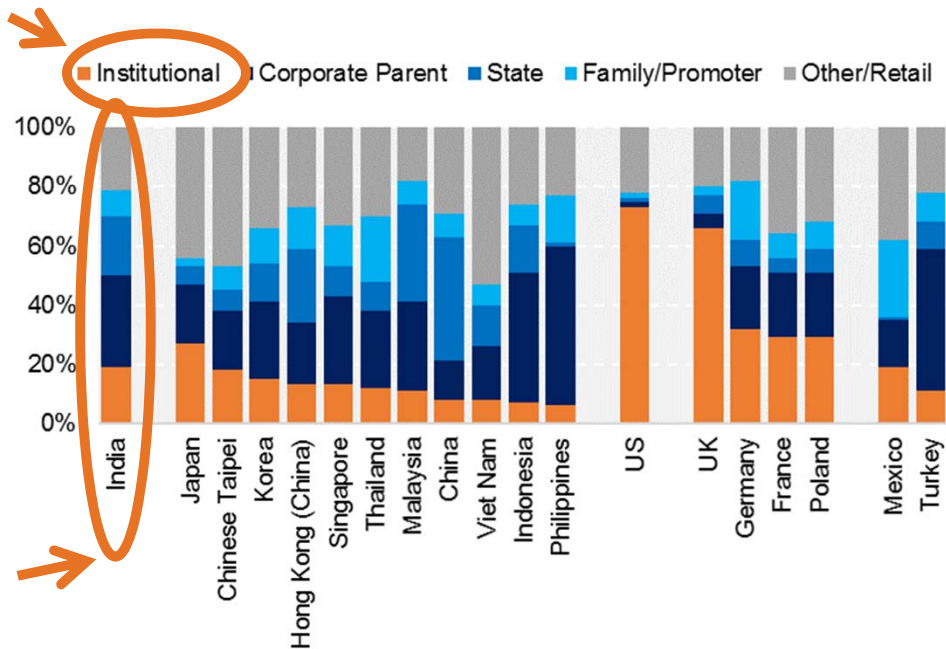
- Perception:
  - Foreign Direct Investment (FDI): take control of the company in which investment is made ... long term and less fluctuating?
  - Foreign Portfolio Investment (FPI): minority investment in shares, etc. ... speculative, “hot money” and unpredictable?
- Focus of my work: micro (not macro, as in balance of payments)
  - International evidence that FPI reduces firms’ cost of capital and it can play a value-increasing governance/monitoring role



# OWNERSHIP STRUCTURE IN INDIA

## Average Share Ownership

(100 largest listed companies, end-of-2016)



Source: Table 4 - OECD Equity Markets Review ASIA 2017  
(based on data from FactSet Ownership)

## Governance Issues:

### Corporate Parent / MNC

- > RPTs and royalty payments (vs. dividends)
- > Control & squeeze out

### Indian State

- > RPTs and weak governance protections
- > Executive turnover with government change

### Family/Founder

- > RPTs and family control & strength
- > Family disputes: loss of strategic focus

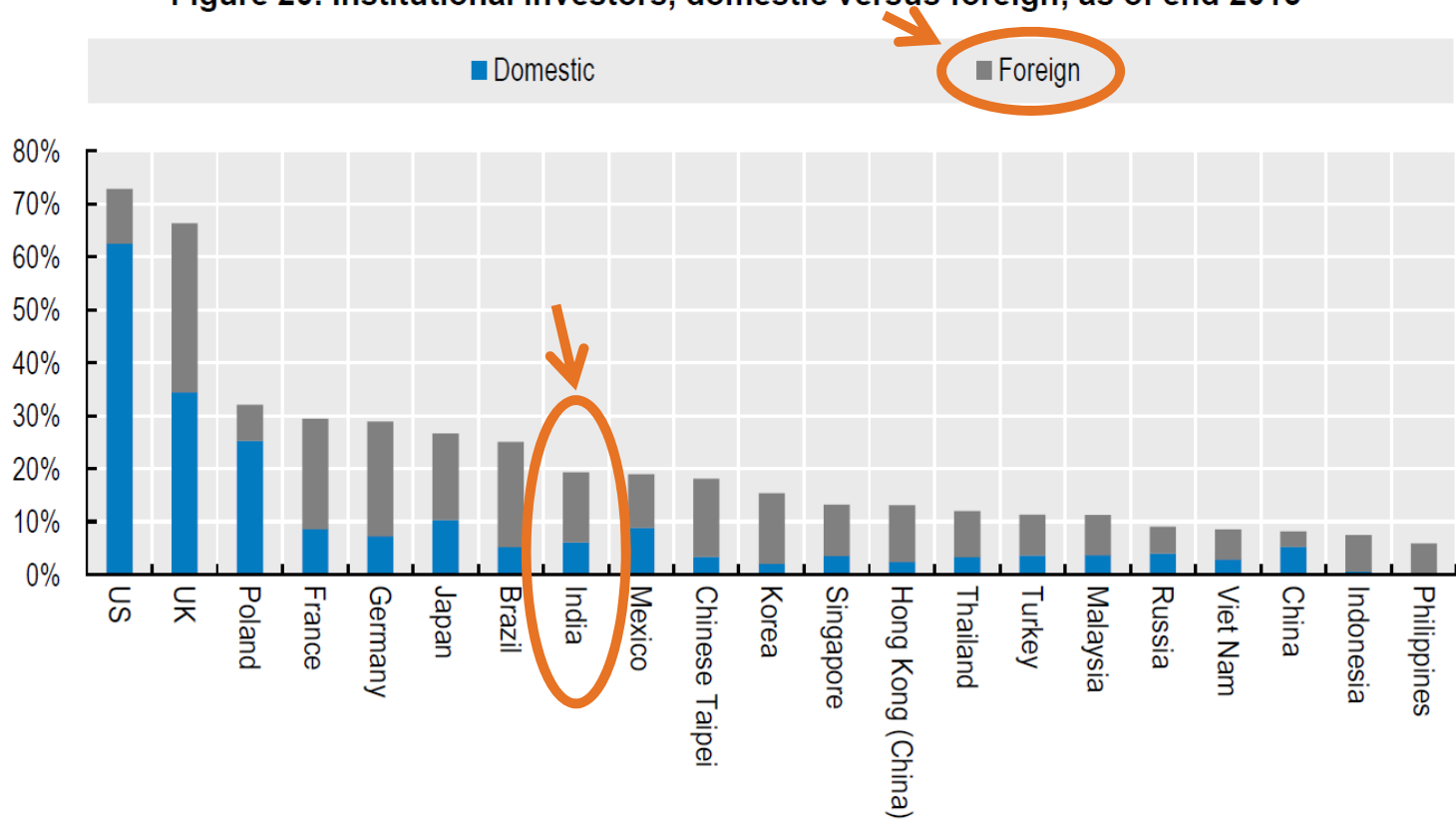
### Institutional [19%]

Source: MSCI Corporate Governance in India (Feb 2017)



# (FOREIGN) INSTITUTIONAL INVESTORS IN INDIA

Figure 20. Institutional investors, domestic versus foreign, as of end 2016



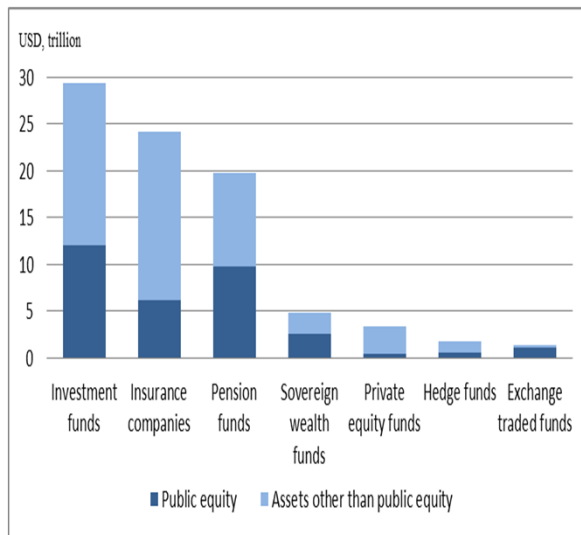
Source: Table 4 - OECD Equity Markets Review ASIA 2017  
(based on data from FactSet Ownership)



# THE INCREASING ROLE OF INSTITUTIONAL OWNERSHIP (IN ADVANCED ECONOMIES)



Institutional Investor Holdings = \$28 Trillion in Public Equities [2011]

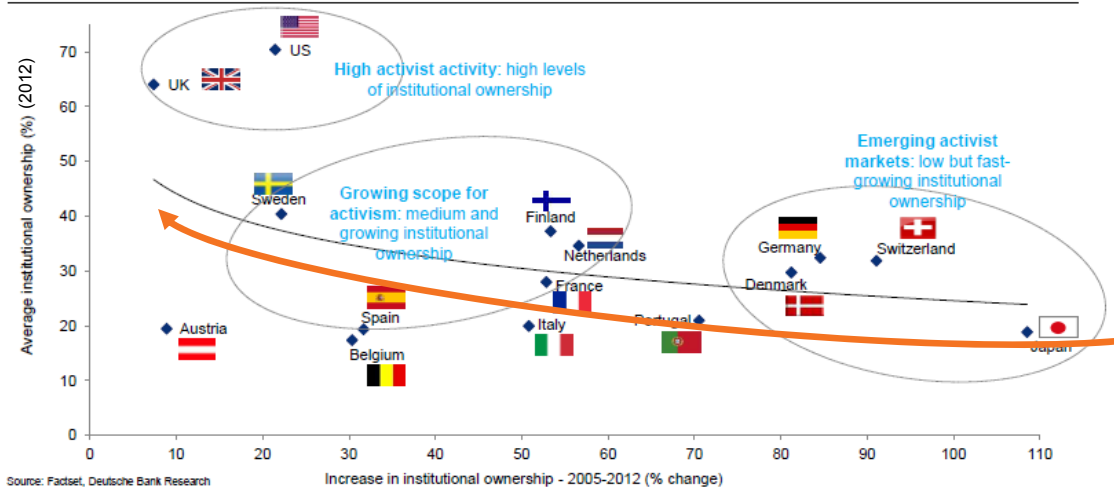


Source: OECD Institutional Investors Database, SWF Institute, IMF, Prequin, BlackRock, McKinsey Global Institute

## Analysis of the level and change in institutional ownership highlights areas of relative opportunity



Level and change in institutional ownership by country (weighted by market cap): higher levels of institutional are more attractive for activists as it implies a dispersed shareholder base as opposed to a concentrated base with a higher level of insider ownership



Source: Factset, Deutsche Bank Research

Note: Institutional ownership is one variable to measure the potential for activism. Other factors for consideration would be factors such as country specific regulatory environment or minority shareholder rights

Deutsche Bank Research Corporate Themes – Activist Investing. [activistinvesting@list.db.com](mailto:activistinvesting@list.db.com), +44 207 545 8465

13

Source: Deutsche Bank Research "Shareholder Activism: Battle for the Boardroom" [2014]



# THE GOVERNANCE ROLE OF (FOREIGN) INSTITUTIONAL INVESTORS: THE THEORY

- In widely-held firms, investors may be disengaged. Given the size of their holdings as a group, **institutional owners** can impact corporate governance:
  - through “**voice**” (voting their shares, using quiet diplomacy in persuading management, via confrontational proxy fights)
  - and/or by threatening to “**exit**” (selling and depressing stock prices)
- Special role played by **foreign institutions** (Foreign IO) since domestic institutions (Domestic IO) are more prone to be loyal to management due to “business ties” and other conflicts of interest



# THE GOVERNANCE ROLE OF (FOREIGN) INSTITUTIONAL INVESTORS: INTERNATIONAL EVIDENCE

## PERFORMANCE



**P1: “THE COLORS OF INVESTORS’ MONEY ...”**

JOURNAL OF FINANCIAL ECONOMICS (2008)

## GOVERNANCE



**P3: “DOES GOVERNANCE TRAVEL AROUND THE WORLD? ...”**

JOURNAL OF FINANCIAL ECONOMICS (2012)

## LONG-TERM



**P5: “ARE FOREIGN INVESTORS LOCUSTS? ...”**

JOURNAL OF FINANCIAL ECONOMICS (2017)

## M&As



**P2: “SHAREHOLDERS AT THE GATE? ...”**

REVIEW OF FINANCIAL STUDIES (2010)

## CEO PAY



**P4: “ARE US CEOS PAID MORE? ...”**

REVIEW OF FINANCIAL STUDIES (2013)

## INDIA?

**IMPLICATIONS FOR INDIA**



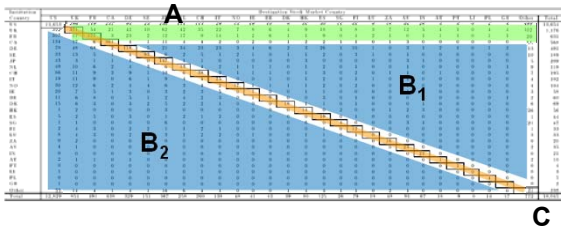
<b>PERFORMANCE</b> P1: "THE COLORS OF INVESTOR'S MONEY ..." JFE (2008)	<b>GOVERNANCE</b> P3: "DOES GOVERNANCE TRAVEL AROUND THE WORLD? ..." JFE (2011)	<b>LONG-TERM</b> P6: "ARE FOREIGN INVESTORS LONGSTAY? ..." JFE (2012)
<b>M&amp;As</b> P2: "SHAREHOLDERS AT THE GATES ..." RFS (2010)	<b>CEO PAY</b> P4: "ARE US CEOs PAID MORE? ..." RFS (2010)	<b>INDIA?</b> P5: "IMPLICATIONS FOR INDIA ..." RFS (2010)

# P1: THE COLORS OF INVESTORS' MONEY: THE ROLE OF INSTITUTIONAL INVESTORS AROUND THE WORLD

## DATA:

Institutional holdings:  
FactSet/LionShares [>5,000 institutions, >35,000 stocks, 27 countries 2005: \$ 18 trln, 39% of world market cap]

... by country of institution (rows) and stock (columns)



- A** US\$2 trillion from **US-BASED Foreign** institutions
- B<sub>1</sub>** **B<sub>2</sub>** US\$1.7 trillion from **NON-US Foreign** institutions
- C** US\$1.5 trillion from **DOMESTIC** institutions

## RESULT #1:

Different investor preferences by **US-BASED** vs **NON-US Foreign** vs **DOMESTIC** investors

### ► Firm-level characteristics:

Instl preferences (Gompers&Metrick(01));	"Prudent-man" Rules (Del Guercio(96));
+ Firm Size (SIZE)	+ Past Return (RET)
+ "Value" Stocks (BM)	+ Dividends (DY)
+ Turnover (TURN)	+ Profitable (ROE)
+ Investment Opportunities (INVOP)	+ Volatility (SIGMA)
	+ MSCI Members (MSCI)
Governance Indicators (Gillan&Starks(04));	Visibility:
- Leverage (LEV)	+ Free-Cash-Flow (CASH)
+ Free-Cash-Flow (CASH)	+ ADR Listing (ADR)
- Closely-Held Shares	+ ISS Governance Ranking
	+ Foreign Sales
	+ Nr of Analysts

### ► Country-level factors:

Investor Protection (LLSV(97));	Distance/Familiarity (Chan et al.(05));
+ Legal = ANTI-RULE (LEGAL)	- Geographical distance (DISTANCE)
+ Disclosure quality (DISC)	+ English language (ENGLISH)
	Size & Development of Market:
	+ GDP per capita (GDP)
	+ Stock Market Cap (MCAP)

## RESULT #2:

Firms with higher Foreign IO have  
 ➤ Higher valuation (Tobin Q)  
 ➤ Higher ROA  
 [Note: IV results using MSCI]

## INTERPRETATION:

Better performance suggest investor **MONITORING** (rather than just **OVERVALUATION**)

## TAKEAWAY:

Performance increases due to increased shareholder pressure







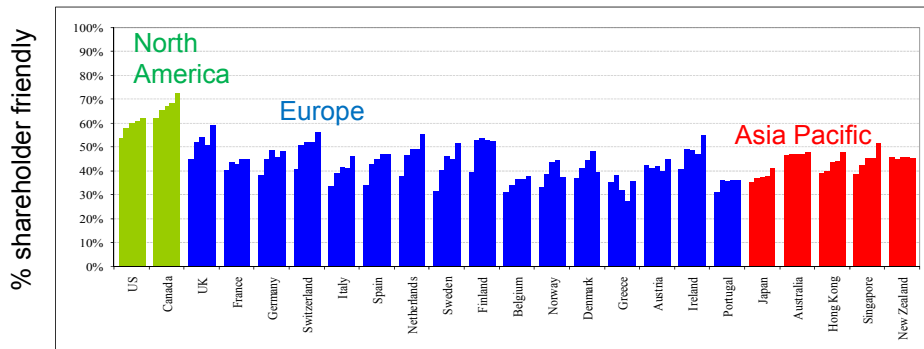
<b>PERFORMANCE</b> P1: "THE COLOR OF INVESTOR MONEY ..." JFS (2011)	<b>GOVERNANCE</b> P2: "DOES GOVERNANCE TRAVEL AROUND THE WORLD? ..." JFS (2011)	<b>LONG-TERM</b> P3: "ARE FOREIGN INVESTORS LOGGING OFF ..." JFS (2011)
<b>M&amp;As</b> P4: "SHAREHOLDERS AT THE DATEN ..." RFS (2011)	<b>CEO PAY</b> P5: "ARE US CEOs PAID MORE ..." RFS (2011)	<b>INDIA?</b> P6: "ARE IMPLICATIONS FOR INDIA ..." RFS (2011)

## P3: DOES GOVERNANCE TRAVEL AROUND THE WORLD? EVIDENCE FROM INSTITUTIONAL INVESTORS

### DATA:

Institutional holdings: FactSet

Governance Index ( $GOV_{41}$ ): Institutional Shareholder Services (ISS) (2004-08) ... % of attributes that a firm satisfies: Board (24); Audit (3); Anti-takeover provisions (6); Compensation & ownership (8)



1,983 non-U.S. firms in **22 developed countries**

- . Highest: **Canada** (73%), **U.S.** (62%), **U.K.** (59%)
- . Lowest: **Greece**, **Portugal** (36%), **Belgium** (38%)
- . Index improved over time (yearly change +2.1%)

### RESULTS:

Foreign IO drives governance improvements  
Changes in IO over time drive changes in governance  
[Endogeneity: IV using MSCI]

### REAL OUTCOMES (NOT COSMETICS!):

Governance indexes criticized ("check-the-box", etc.) but evidence that IO affects outcomes – ex: higher CEO turnover-performance sensitivity

### INTERPRETATION:

International institutional investors lead to convergence in corporate governance worldwide

### TAKEAWAY:

Adopt more shareholder-centric (US-style) practices



<b>PERFORMANCE</b> P1: "THE COLORS OF INVESTORS' MONEY ..." JFE (2002)	<b>GOVERNANCE</b> P2: "DOES GOVERNANCE TRAVEL AROUND THE WORLD? ..." JFE (2011)	<b>LONG-TERM</b> P3: "ARE FOREIGN INVESTORS LOCUSTS? ..." JFE (2011)
<b>M&amp;As</b> P4: "SHAREHOLDERS AT THE BAY? ..." RFA (2010)	<b>CEO PAY</b> P4: "ARE US CEOs PAID MORE? ..." RFA (2010)	<b>INDIA?</b> IMPLICATIONS FOR INDIA JFE (2011)

## P4: ARE US CEOS PAID MORE? NEW INTERNATIONAL EVIDENCE

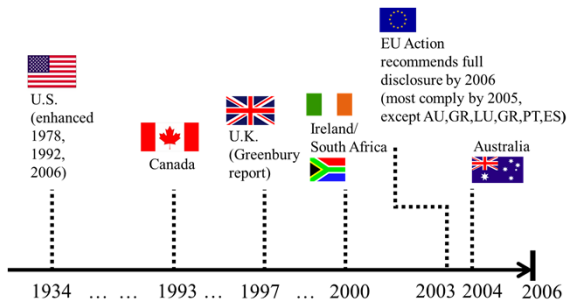
### DATA:

Institutional holdings: FactSet

US: S&P's ExecuComp

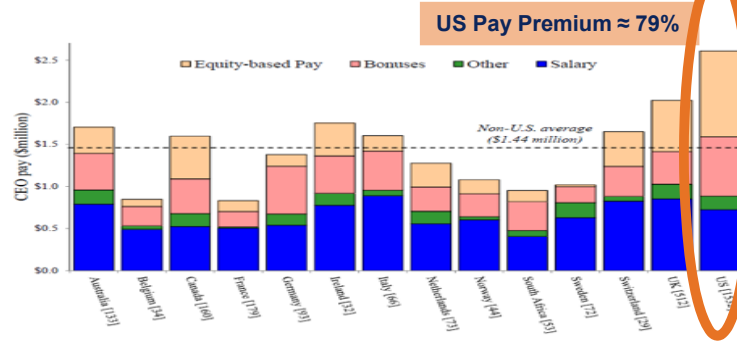
Non-US: BoardEx + filings

[2006, 14 countries with mandated disclosure]

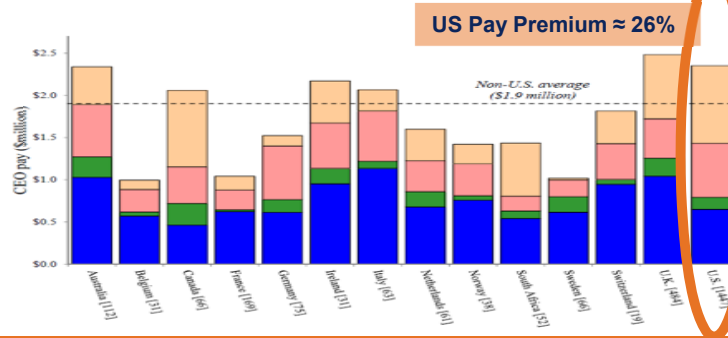


### RESULT #1:

Predicted level & structure of CEO pay (\$1 billion sales, average industry)



Control also for ownership (Foreign IO) and board (independence) structures



### RESULT #2:

Pay Gap smaller if :

- Foreign IO (MSCI, ADR)
- Foreign sales
- Foreign acquisitions
- Board members with foreign (US) experience

### INTERPRETATION:

"Law of One Price"?

### TAKEAWAY:

International convergence in executive pay practices



# SOME PRESS COVERAGE ...

## MY OP-ED:

**Forbes**

LEADERSHIP | 3/13/2013 @ 11:20AM | 465 views

## Do CEOs Make Much More In The U.S. Than Elsewhere?

This article is by Pedro Matos, an associate professor of business administration at the [University of Virginia's Darden School of Business](#).

ONE TYPE OF  
COVERAGE:



## The Myth of the Overpaid American CEO

John Carney | @carney

Published 3:31 PM ET Tue, 9 July 2013 | Updated 3:51 PM ET Tue, 9 July 2013

OR OPPOSITE?



## U.S. Corporate Executives Aren't the Only Ones Making Tons of Money

CEO pay has been skyrocketing on both sides of the Atlantic. Now, a flurry of policies in the EU aims to put the massive earnings in check.

OLGA KHAZAN | MAR 19, 2013 | GLOBAL

**FORTUNE**

## How to get paid like a U.S. CEO

July 5, 2011: 10:57 AM ET

While millions are still out of work, U.S. CEOs received a 28% pay raise this past year. A lot of factors are driving the increases. Job performance isn't one of them.



# BUT WHAT'S THE IMPACT OF INSTITUTIONAL INVESTORS ON THE LONG-TERM?

## FOREIGN OR LONG-TERM INVESTORS?



“We support those companies, who act in interest of their future and in the interest of their employees against irresponsible **locust swarms**, who measure success in quarterly intervals, suck off substance and let companies die once they have eaten them away.”

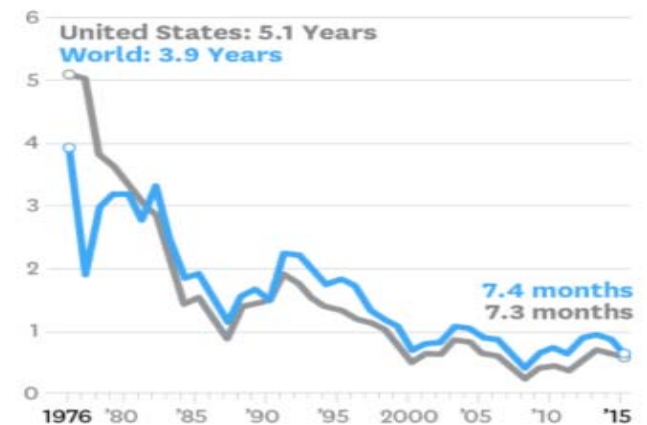
Franz Müntefering, German SPD Chairman (2005)



“The effects of the **short-termist phenomenon** are troubling (...) corporate leaders have responded with actions that can deliver immediate returns to shareholders, such as buybacks or dividend increases, while **underinvesting in innovation, skilled workforces or essential CAPEX necessary to sustain long-term growth.**”

Laurence Fink, CEO, BlackRock (2015)

HOLDING PERIOD BY YEAR



SOURCE: THE WORLD BANK, WORLD FEDERATION OF EXCHANGES DATABASE

Measuring Investor Horizon? ...  
infer Horizon = 1/ Investor Turnover Rate  
[Gaspar, Massa and Matos (Journal of Financial Economics, 2005)]

<b>PERFORMANCE</b> P1: THE COLOR OF INVESTORS' MONEY ... JFE (2012)	<b>GOVERNANCE</b> P2: DOES GOVERNANCE TRAVEL AROUND THE WORLD? ... JFE (2011)	<b>LONG-TERM</b> P3: ARE FOREIGN INVESTORS LOCUSTS? ... JFE (2017)
<b>M&amp;As</b> P4: SHAREHOLDERS AT THE DATUM ... RFS (2016)	<b>CEO PAY</b> P4: ARE US CEOs PAID MORE ...? RFS (2015)	<b>INDIA?</b> IMPLICATIONS FOR INDIA

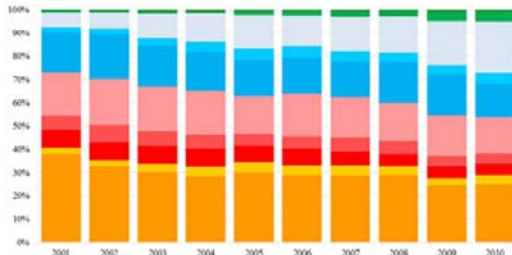
## P5: ARE FOREIGN INVESTORS LOCUSTS? THE LONG-TERM EFFECTS OF FOREIGN INSTITUTIONAL OWNERSHIP

### DATA:

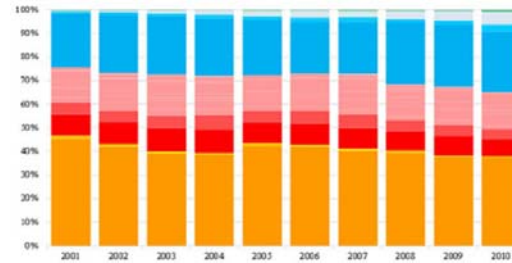
Coloring by geographical region



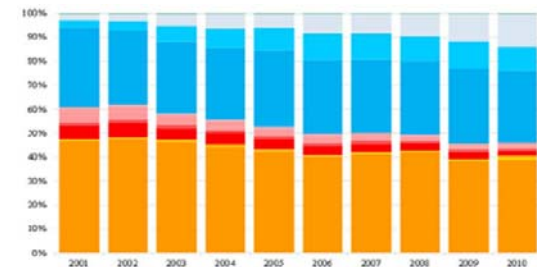
Physical Capital (CAPEX)



Intangible Capital (R&D)



Innovation Output (Patents)



### RESULTS:

MSCI addition => +3% Foreign IO ... positively associated with:  
 +0.3% long-term investment (CAPEX + R&D)  
 +12% employment  
 +11% innovation output (Patent counts)  
 [MSCI index suggest causal effect]

Foreign IO positively linked to productivity + shareholder value

### INTERPRETATION:

Foreign institutional investors are not “locusts”. Evidence in support of monitoring role of Foreign IO.

### TAKEAWAY:

Can sustain long-term investing



# TO RECAP ...

- Globalization of a firm's shareholder base can be a positive force!  
Rise of Foreign Institutional Ownership (Foreign IO) on average leads to:
  - **Performance**: Increased shareholder pressure to perform
  - **M&As**: Increased likelihood of cross-border takeovers
  - **Governance**: Adoption of more shareholder-centric (US-style) practices
  - **CEO Pay**: Convergence to international (US) executive compensation practices
  - **LT Investing**: Can sustain long-term investing
- Back to “theory” ...
  - **Voice** (Long-term Foreign IO)
  - **Exit** (Short-term Foreign IO)



# IMPLICATIONS FOR INDIA

## • CORPORATE GOVERNANCE

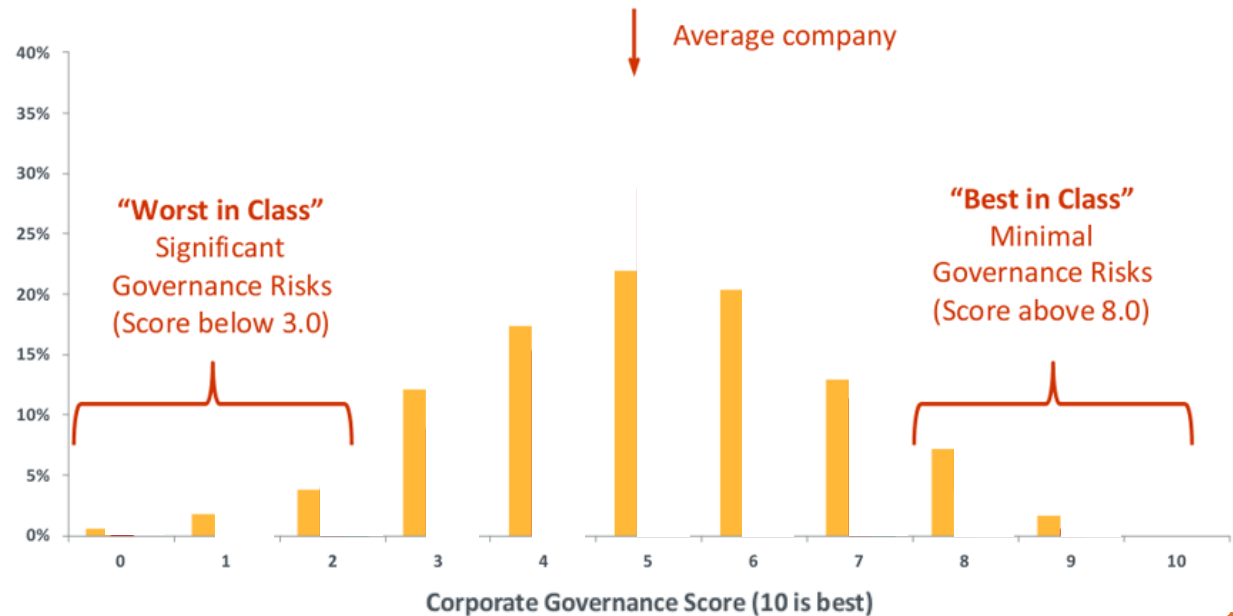


*India underperforms.  
Key areas of concern: audit committee composition, auditor report concerns, related party transactions, poor board attendance*

■ MSCI ACWI ■ MSCI India ■ MSCI Emerging Markets

### GOVERNANCE METRICS SCORE DISTRIBUTION

MSCI ACWI INDEX CONSTITUENTS VS MSCI EMERGING MARKETS INDEX CONSTITUENTS VS MSCI INDIA CONSTITUENTS (FEB 2017)

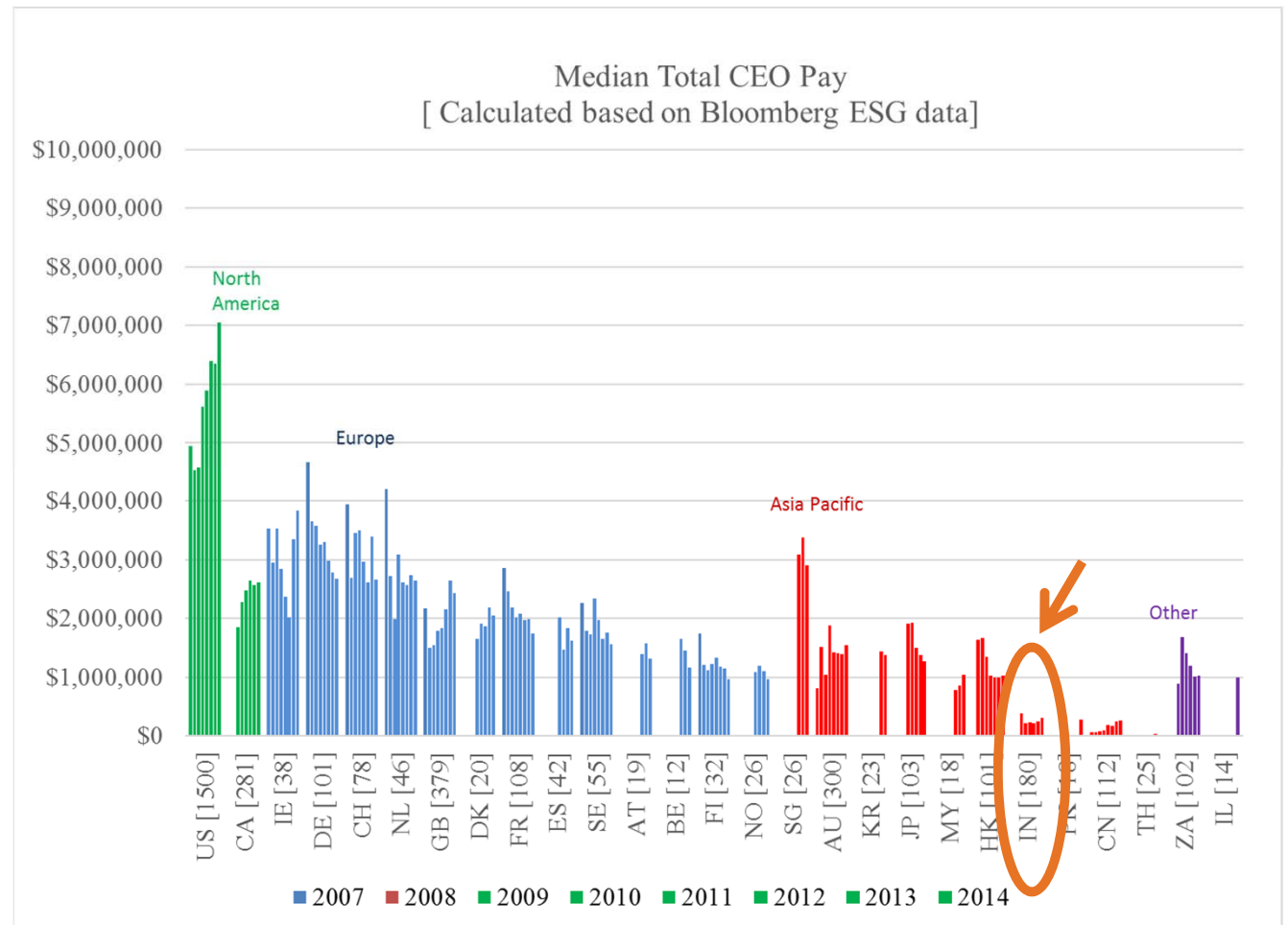




# IMPLICATIONS FOR INDIA (2)

- CEO PAY

“INTERNATIONAL CORPORATE GOVERNANCE SPILLOVERS ...”, WITH R. ALBUQUERQUE, M. FERREIRA AND L. MARQUES (REVISE & RESUBMIT)



# IMPLICATIONS FOR INDIA (3)

## • LONG-TERM INVESTING

The Economist

### Globalisation The fear factor

Why Asian firms need to take on the world  
May 31st 2014 | From the print edition

### Governance Avoiding the dinosaur trap

State firms and family conglomerates are Asia's favourite kinds of companies. Both must change  
May 31st 2014 | From the print edition



# CONCLUSIONS

- Policy-making should be evidence-based! Support academic research on the Indian market!



***“It is a capital mistake to theorize before one has data. Insensibly one begins to twist facts to suit theories, instead of theories to suit facts.”***

The Adventures of Sherlock Holmes

“A Scandal in Bohemia”

- I look forward to learn more at ACGA in the next couple of days!



# WEBLINKS TO PUBLICATIONS

P1: [The Colors of Investors' Money: The Role of Institutional Investors Around the World](#) with M. Ferreira, *Journal of Financial Economics*, Vol. 88 (3), p. 499-533, (June 2008)

P2: [Shareholders at the Gate? Institutional Investors and Cross-Border Mergers and Acquisitions](#) with M. Ferreira and M. Massa, *Review of Financial Studies*, Vol. 23 (2), p. 601-644, (February 2010)

P3: [Does Governance Travel Around the World? Evidence from Institutional Investors](#) with R. Aggarwal, I. Erel and M. Ferreira, *Journal of Financial Economics*, Vol. 100 (1), p. 154-181, (April 2011)

P4: [Are US CEOs Paid More? New International Evidence](#) with N. Fernandes, M. Ferreira and K. Murphy, *The Review of Financial Studies*, Vol. 26 (2), p. 323-367, (February 2013).

P5: [Are Foreign Investors Locusts? The Long-Term Effects of Foreign Institutional Ownership](#) with J. Bena , M. Ferreira and P. Pires, *Journal of Financial Economics* ,(forthcoming)





Thank you!



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## APPENDIX

**Table 3-4: Shareholding pattern at the end of March 2016 for the companies listed at NSE**

Sectors	PROMOTERS		PUBLIC								Shares held by Custodians and against which Depository Receipts have been issued	Shares held by Employee Trust
			INSTITUTIONAL					NON-INSTITUTIONAL		Central Government/state Government		
	Indian Promoters	Foreign Promoters	Financial Institutions/Banks/ Insurance Companies	Foreign Institutional Investors	Mutual Funds	Venture Capital Funds including Foreign Venture Capital Funds	Any other	Individuals	Any other			
Banks	46.0%	0.3%	10.9%	16.7%	5.8%	0.0%	0.9%	9.6%	4.9%	0.5%	4.4%	0.0%
Engineering	52.0%	2.2%	9.7%	3.6%	1.1%	0.1%	3.5%	11.6%	16.1%	0.0%	0.2%	0.0%
Financial Services	43.1%	1.1%	3.7%	19.7%	3.1%	0.0%	4.9%	14.9%	7.8%	1.3%	0.1%	0.2%
FMCG	33.7%	9.0%	10.4%	10.5%	2.0%	0.0%	2.3%	18.2%	13.8%	0.0%	0.2%	0.0%
Infrastructure	49.7%	2.6%	5.7%	11.3%	3.6%	0.0%	1.9%	15.2%	9.7%	0.1%	0.1%	0.1%
IT	36.9%	6.7%	3.9%	13.5%	2.7%	0.6%	3.1%	19.7%	12.5%	0.0%	0.0%	0.2%
Manufacturing	52.2%	6.4%	5.7%	8.4%	2.6%	0.3%	1.1%	13.2%	8.6%	1.0%	0.3%	0.0%
Media and Entertainment	39.2%	2.8%	0.1%	8.7%	2.5%	0.0%	6.3%	22.6%	17.4%	0.1%	0.2%	0.0%
Miscellaneous	21.0%	0.0%	1.8%	0.9%	0.2%	0.0%	0.1%	14.3%	61.7%	0.0%	0.0%	0.0%
Petrochemicals	57.9%	4.2%	6.3%	5.1%	2.4%	0.0%	4.2%	9.5%	9.2%	0.3%	0.9%	0.0%
Pharmaceuticals	50.5%	3.3%	2.7%	13.1%	3.3%	0.0%	3.0%	15.7%	7.3%	0.0%	0.8%	0.1%
Services	52.8%	4.2%	4.0%	5.0%	3.8%	1.0%	5.2%	11.1%	12.8%	0.0%	0.0%	0.1%
Telecommunication	48.8%	5.9%	9.1%	13.0%	1.3%	0.0%	1.5%	9.8%	10.2%	0.0%	0.2%	0.1%
<b>Grand Total</b>	<b>43.1%</b>	<b>3.9%</b>	<b>5.8%</b>	<b>8.9%</b>	<b>2.5%</b>	<b>0.1%</b>	<b>1.8%</b>	<b>13.9%</b>	<b>18.9%</b>	<b>0.4%</b>	<b>0.6%</b>	<b>0.0%</b>

Source: NSE Factbook 2016

