

ACADEMIC RESEARCH

A Taxonomy of Institutional Investors

How Investor Behavior Matters

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THE TARGETING OF SPECIFIC INSTITUTIONAL INVESTORS TO BUY and hold a company's stock has been an important trend in investor relations in the 1990s. Recently, academic research has begun to examine whether there are systematic differences in how different types of institutional investors influence the stock market and the decisions of corporate managers. In my research I have developed a technique for classifying institutional investors based on past trading behavior. This has yielded interesting insights into the types of institutional investors that may pressure managers into a short-term focus and destabilize a corporation's stock price. It is described in more detail in my study "The Influence of Institutional Investors on Myopic R&D Investment Behavior" (*Accounting*

Review, July 1998). This article presents an overview of my classification scheme and discusses the results of three studies that document the impact of different compositions of institutional ownership on market prices and managerial decisions.

CLASSIFYING INSTITUTIONAL INVESTORS

[14] Management scholars such as Michael Porter and Michael Jacobs have often asserted that the transient ownership behavior (i.e., frequent trading and fragmented ownership stakes) of U.S. institutional investors has contributed to the development of a myopic capital market in the U.S. These critics argue that institutions in Japan and Germany provide more patient, dedicated ownership that allows managers to manage for the long term. Though a useful starting point, this generalization does not account for the fact that a number of U.S. investors, such as Berkshire Hathaway and the California Public Employees' Retirement System, behave more like the dedicated investors of Germany than the allegedly transient investors in the U.S. The goal of my classification scheme is to identify those institutions within the U.S. that provide dedicated ownership and those that provide transient ownership. This classification can then serve as a basis for looking at the influence that each type of ownership behavior has in the U.S. market.

The first step is to calculate metrics that can be used to characterize an institutional investor's portfolio management behavior. There are three important metrics: portfolio turnover, diversification and momentum trading. Portfolio turnover is a measure of how frequently an institution trades shares of the companies in its portfolio. Diversification is a measure of whether an institution tends to take small ownership positions in a large number of companies or large ownership positions in a small number of companies. Momentum trading is a measure of whether an

institution tends to increase its holdings in firms that have just experienced positive earnings surprises and to decrease holdings in firms with bad earnings news.

The second step is to place institutions into groups based on where they rank on these metrics. I use a grouping technique called cluster analysis to form three groups of institutions: transient, dedicated and quasi-indexer. *Transient* institutions (26 percent of all institutions) are characterized by high portfolio turnover, high diversification and a high degree of momentum trading. As such, transient institutions tend to have short investment horizons; they key trade to short-term results and devote little effort toward understanding drivers of long-run value for their numerous portfolio firms. *Dedicated* institutions (4 percent of all institutions) exhibit low portfolio turnover, low diversification and almost no trading sensitivity to short-term developments. These institutions follow a relationship-investing strategy of taking big stakes in a small number of companies and holding these stakes for long periods of time. *Quasi-indexer* institutions (70 percent of all institutions) have low portfolio turnover, high diversification and exhibit contrarian trading strategies (i.e., buying losers and selling winners). Thus quasi-indexers tend to adopt passive buy-and-hold strategies of investing in a broad set of companies and trade only when there is a major change in the company (e.g., when it is dropped from an index).

INSTITUTIONAL INVESTOR MYOPIA AND MARKET MISPRICING

My first study tests whether, in making investment decisions, institutional investors focus more on expected near-term earnings than on long-run value, defining “long term” as any holding of more than four years (“Do Institutional Investors Prefer Near-Term Earnings over Long-Run Value,” Harvard Business School Working Paper, April 1999). The

evidence indicates that institutional investors as a whole do not exhibit a short-term focus on earnings. The same result holds for dedicated and quasi-indexer institutions. However, transient institutions exhibit strong preferences for corporations with more value in expected near-term earnings and less in long-run value. In a pricing test these preferences lead to an overvaluation of near-term earnings and an undervaluation of long-run value. Thus there is strong evidence that institutions with the shortest investment horizons create the potential for a myopia problem in the U.S. market by mispricing the future earnings potential of companies. Managers of companies with high levels of transient ownership likely face the strongest incentives to make myopic decisions to please their investors.

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INSTITUTIONAL INVESTORS AND R&D INVESTMENT DECISIONS

My second study examines arguments that the short-term focus of institutions leads U.S. corporate managers to underinvest in long-term, intangible projects such as R&D to maintain strong short-term earnings growth ("The Influence of Institutional Investors on Myopic R&D Investment Behavior," *Accounting Review*, July 1998). The focus of this study is on companies that could reverse an expected decline in earnings by cutting R&D expenditures. The results indicate that managers are less likely to cut R&D to reverse an earnings decline when total institutional ownership is high, suggesting that institutional investors as a group reduce incentives for managers to act myopically. If a corporation's investor base is dominated by dedicated or quasi-indexer institutions, the same result holds. However, if the corporation's investor base is dominated by transient institutions, the evidence indicates that managers are more likely to cut R&D to reverse an earnings decline. Thus managers faced with a high proportion of transient institutional ownership appear to act

