

# **The Impact of Institutional Ownership: a Study of the Australian Equity Market**

**by**

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## Certificate

I certify that this thesis has not previously been submitted for a degree nor has it been submitted as part of the requirement for a degree except as fully acknowledged within the text.

I also certify that the thesis has been written by me. Any help that I have received in my research work and the preparation of the thesis itself has been acknowledged. In addition, I certify that all information sources and literature used are indicated in the thesis.

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Date .....

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## **Abstract**

Institutional investors are now the predominant type of investor in global financial markets. Institutional investors now own more than 64% of the equity in the US stock markets (Federal Reserve Board 2011). In Australia, institutional investors own approximately 60% of the stock market. They are also responsible for the majority of the trades (96% of all trades) in US markets. Yet there still remain many unanswered questions about the impact of institutional investors. The most basic and obvious of these questions is whether institutional investors possess superior investments skills. Given that institutional investors controlled trillions of dollars of funds under delegated management, it seems incongruous that there is still no consensus in the literature about whether they possess superior investments skills. The increase in size has also given institutional investors significant influence. This prompts the question of how these large investors choose to utilise their influence. Whether institutional investors' presence and activities improve the efficiency of the financial markets, and what role institutional investors play in important corporate decisions.

Using a unique set of daily institutional ownership data, we present four empirical studies on the Australian stock market that aims to provide greater understanding of the impact of institutional ownership. Study 1 examines the question of whether institutional investors possess superior skills. The empirical findings suggest that institutional trading as measured by institutional ownership flows prove to be a good gauge of stock returns. The firms that experience the greatest inflow in institutional ownership exhibited superior performance throughout the 12-month period. Consistent with literature, we showed that institutional investors exhibited superior judgement in their trading in stocks of particular characteristics including small, large stocks, growth stocks and value stocks.

In the second study, we turn our attention to an evaluation of the impact of institutional investors in IPOs. In spite of the plethora of studies in the Initial public offerings (IPOs) literature, there have been few studies on the impact of institutional ownership in IPOs. Our results suggest that institutional ownership plays an important role in explaining the two anomalies of IPO underpricing and the long-run underperformance of issuers. Consistent with previous studies, we found large underpricing which was greatest in those issuers with the highest initial institutional ownership levels. Yet these issuers experienced the worst long-run underperformance. The findings are consistent with overreactions driven by informational cascade in the IPO market. High level of initial institutional interests generates informational herding that drives these issuers' prices beyond the fundamental. Over time, market correction leads to the long-run underperformance of issuers. The findings suggest that Institutional investors' presence in IPO may lead to greater mispricing in process already beset with uncertainty.

Study 3 of the thesis examine whether there is any evidence that institutional investors fulfil the very important role as monitors of corporate managers' actions. Many have hoped that the large equity stakes that institutional investors owned in corporations will give them sufficient incentives to act as an important source of corporate governance (see Black 1992; Kahn & Minton 1998). In so doing, institutional investors can help to reduce the agency problem that arise as the result of the separation of ownership and management. We test whether institutional investors fulfil this key role as monitors in a sample of Australian mergers and acquisitions. We found limited support for institutional monitoring. While the market have more favourable reactions to the takeover announcements made by bidders with high levels of institutional ownership, these bidders did not exhibit superior stock market performance in the long-run. Rather than performing the very important role as monitor, our results suggest that institutional investors may have a preference for following the *Wall Street Rule* and vote

with their feet. Institutional trading (as measured by changes in institutional ownership) immediately prior to the takeover announcement provided a good indication of the long term performance of the bidder.

In the final study, we examined whether institutional investors' activities contribute to the turn-of-the year effect in the Australia. We do so with the view that the results may be a reflection of the impact of institutional investors on market efficiency more generally. The Turn-of-the-year effect refers to the abnormally high returns for small stock in the month of January (and July for countries like Australia). The anomalous seasonality in returns is one of the most enduring anomalies in global financial markets. For both the December/January and the June/July period, we examine the institutional investors' flows to determine whether there is a link with institutional investors' action and the turn-of-the-year effects. Our results are consistent with institutional investors conducting window dressing trades in the December/January period. It is important to note that Australia's financial year ends in June, so there are incentives for institutions to conduct both window dressing and tax-related selling in the June/July period. We found strong evidence that institutional investors conduct tax-related transactions and that these trades significantly impact on the stock returns in the June–July period. We come to the conclusion that institutional investors put greater importance on tax related selling than window-dressing in the June July period.

These four empirical studies have served to enhance our understanding of the impact of Institutional Investors who are an ever-growing influence on global financial markets.