in brief...
Two cheers for Anglo-Saxon financial markets?

Institutional investors are good for industrial innovation, according to a study by CEP's director **John Van Reenen** and colleagues.

The increasing dominance of pension funds, mutual funds and other institutional owners in the US and UK stock markets has been a positive force for industrial innovation and growth over the past 30 years, according to a recent study that I have conducted with Philippe Aghion of Harvard and Luigi Zingales of Chicago.

Our research indicates that publicly traded companies in which institutional investors have raised their equity stake will increase their innovation. These large companies have dispersed ownership so no individual has much of an incentive to keep an eye on the chief executive officer (CEO).

We suggest that the positive role of institutional investors is because of their greater incentive and ability to monitor companies' performance. They can offer a kind of job insurance to CEOs who are prepared to take a chance on risky, but potentially rewarding, longer-term investments.

At a time when deregulated financial markets are under attack from many quarters, it rare to hear any positive words for some aspects of the Anglo-Saxon financial model. Even before the financial crisis, the takeover of the stock market by institutions – pension funds, hedge funds, mutual funds and the like – was condemned for breeding a bias against long-term investments in innovation. Whereas Japanese and German research and development (R&D) created better cars, it was said, British and Americans specialised in producing better quick-fix derivatives of no long-term value.

Our study takes a contrary position, arguing that the rise in institutional ownership – from under 10% in the 1950s to over 60% today – has actually been a positive force for innovation and growth. We look at publicly traded US corporations that were responsible for the bulk of private sector R&D over the past 40 years and track what happens when institutions increase their equity share.

Analysing data on the accounts and patenting activity of 803 publicly traded US firms from the mid-1970s to the early 2000s, we find that a greater role for institutional investors is followed by a burst of innovation in future years as indicated by patents (weighted by citations to reflect their importance), R&D and productivity.

This does not seem to be because institutions are better at predicting future breakthroughs, as the burst of innovation occurs even after events that increase institutional investors' role, such as policy changes favouring investor activism and gaining membership of the S&P 500 index of the US stock market (which boosts institutional ownership).

We argue that institutions have a greater *incentive* to monitor top managers than individual owners as they typically have larger blocks of company shares. They also have a better *ability* to monitor managers as they own shares in many companies and know how to set up better systems for keeping an eye on CEOs.

Publicly traded companies in which institutions have raised their equity stake increase their innovation

> Institutional investors offer job insurance to CEOs who make risky but potentially rewarding investments

Monitoring might improve incentives for innovation because lazy managers are forced to put in more effort rather than lazing around on the golf course or the ski slopes of Davos. This would imply that the impact of institutional investors is stronger when managers are more entrenched due to weak competition or protection from takeovers.

In fact, we find that the role of institutions is greater when managers are less entrenched, so we prefer an explanation based on 'career concerns'. Innovation is a risky business, so top managers fear that they will be fired if they take a chance by investing in innovation and things turn out badly through no fault of their own. By gathering more information on managerial quality, institutions offer some insurance to CEOs who are prepared to take a chance on risky, but rewarding, investments.

One test of our career concerns theory is to look at CEO firing. Poor profitability performance is often followed with the abrupt booting out of the incumbent CEO. But our research shows that decreases in profit – which may not be the sole fault of the CEO – are less likely to cause a firing when institutional investors are stronger. This is in line with the view that institutions give some insurance protection to managers and encourage them to take on more risky innovation.

Since innovation is the engine of growth, the institutional ownership that characterises the Anglo-American financial system clearly has long-run benefits. These benefits should not be regulated away in the current backlash.

This article summarises 'Innovation and Institutional Ownership' by Philippe Aghion, John Van Reenen and Luigi Zingales, CEP Discussion Paper No. 911 (http://cep.lse.ac.uk/pubs/download/dp0911.pdf) and forthcoming in the *American Economic Review*.

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