Press Release: Embargo – 00:01 Hours Thursday 12 February 2009

Two cheers for Anglo-Saxon Financial Markets?
Institutional investors are good for industrial innovation

The increasing dominance of pension funds, hedge 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 new research report from the Centre for Economic Performance (CEP).

Professors John Van Reenen (LSE), Philippe Aghion (Harvard) and Luigi Zingales (Chicago) find that publicly traded companies in which institutional investors have raised their equity stake will increase their innovation. The research suggests that this is because of institutions’ greater incentives and ability to monitor companies’ performance.

At a time when deregulated financial markets seem to be blamed for everything from the global meltdown to the snowstorms engulfing the UK, it is rare to hear any positive words for the Anglo-Saxon financial model. Even before the current 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 R&D created better cars, British and Americans specialised in producing better quick fix derivatives of no long-term value.

The new 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. The researchers look at publicly traded American corporations responsible for the bulk of private sector research and track what happens when institutions increase their equity share.

They 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). This does not seem to be because institutions are better at predicting future breakthroughs, as it occurs even after events that increase the institutional investors’ role, such as policy changes and gaining membership of the S&P 500 Index.

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

Monitoring could improve innovation incentives 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 institutions is stronger when managers are more entrenched due to weak competition or protection from takeovers.

In fact, the authors find that the role of institutions is greater when managers are less entrenched, so they 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 more prepared to take a chance on risky, but rewarding, investments.

One test of the authors’ career concerns theory is to look at CEO firing. Poor profitability performance is often followed with the abrupt booting out of the incumbent CEO: in 2008, 61 of the S&P 500 companies removed their CEO and the numbers will surely rise this year.

But the research shows that profit declines (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.

John Van Reenen comments:

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

The research was based on the accounts and patenting activity of 803 large publicly traded US firms from the mid 1970s to the early 2000s.

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NOTES FOR EDITORS:

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