



**"The Impact of Institutional Investors on  
Performance of Palestinian Companies listed at the  
PSE"**

BY: Murad H. Harasheh

Supervised By:  
Dr. Munther Nijim

**Faculty of Graduate Studies  
Birzeit University**

**July 2008**

**BIRZEIT UNIVERSITY**

**Faculty of Graduate Studies**

**MBA Program**

**"The Impact of Institutional Investors on  
Performance of Palestinian Companies listed At  
the PSE"**

**"تأثير المستثمرين المؤسسيين على اداء الشركات المدرجة في سوق فلسطين"**

**By: Murad H. Harasheh**

**Supervised by: Dr. Munther Nijim**

**Submitted in a partial fulfillment of the requirements for the  
Master's Degree in Business Administration from the faculty of  
Graduate Studies at Birzeit University, Palestine**

**Date of Discussion: July 28, 2008**

**Approved by:**

**Dr. Munther Nijim**

(Chairperson of Supervisory Committee) .....

**Dr. Nidal Sabri**

(Member of Supervisory Committee) .....

**Dr. Naser Abdelkarim**

(Member of Supervisory Committee) .....

**Palestine 2008**

## **ACKNOWLEDGEMENT**

Accomplishing this thesis has occupied most of my time this semester. Though it has been interesting and challenging task, which I feel has opened my mind to new knowledge. It is my wishes that you will enjoy reading this thesis.

After finishing this thesis, I would like to send some words of gratitude to a number of people who have made the accomplishment possible.

Firstly, I would like to thank my supervisor Dr. Munther Nijim and the members of the supervisory committee, Dr. Nidal Sabri and Dr. Naser Abdelkarim for not giving up on me, and helping me to make this thesis better through advice and guidance.

I also would like to thank my family, father, mother, brothers and sisters, friends, and fellow classmates for support and distraction when needed.

## Table of contents

<b>1. CHAPTER ONE: INTRODUCTION</b>	<b>1</b>
1.1. OVERVIEW	2
1.2. PROBLEM STATEMENT	4
1.3. OBJECTIVES OF THE STUDY	4
1.4. RESEARCH QUESTIONS	4
1.5. NEED & IMPORTANCE OF THE STUDY	5
1.6. THE RESEARCH ORGANIZATION	6
1.7. STUDY LIMITATIONS	7
<b>2. CHAPTER TWO: LITERATURE REVIEW</b>	<b>8</b>
2.1. INTRODUCTION	9
2.2. MAIN TYPES OF INSTITUTIONAL INVESTORS	12
2.2.1. <i>Pension funds</i>	12
2.2.2. <i>Insurance companies</i>	12
2.2.3. <i>Investment companies</i>	13
2.3. FACTORS BEHIND THE RISE OF INSTITUTIONAL INVESTORS	15
2.4. INSTITUTIONAL INVESTORS AND CORPORATE PERFORMANCE	17
2.5. INSTITUTIONAL INVESTORS AND CORPORATE GOVERNANCE	21
2.6. INFLUENCE OF INSTITUTIONAL INVESTORS	24
2.7. INDIRECT MONITORING	28
2.8. INSTITUTIONAL INVESTORS AND INFORMATION ASYMMETRIES	29
2.9. INSTITUTIONAL INVESTORS' IMPACT ON STOCK LIQUIDITY	33
2.10. THE PALESTINIAN CONTEXT	36
2.11. HYPOTHESES	39
<b>3 CHAPTER THREE: METHODOLOGY &amp; RESEARCH DESIGN</b>	<b>40</b>
3.1. INTRODUCTION	41
3.2. STUDY PROCEDURES	42
3.3. REGRESSION MODEL AND DEFINITION OF VARIABLE	42
3.4. SAMPLE OF THE STUDY	44
3.5. DATA COLLECTION	45
<b>4 CHAPTER FOUR: RESULTS &amp; ANALYSIS</b>	<b>49</b>
4.1. INTRODUCTION	50
4.2. REGRESSION RESULTS	52
4.2.1. <i>2005 Analysis</i>	52

4.2.2	2006 Analysis -----	57
4.2.3	2007 Analysis -----	65
<b>5</b>	<b>CHAPTER FIVE: CONCLUSIONS &amp; RECOMMENDATIONS-----</b>	<b>71</b>
5.1	INTRODUCTION -----	72
5.2	CONCLUSIONS -----	72
5.3	RECOMMENDATIONS -----	73
5.4	SUGGESTIONS FOR FURTHER RESEARCH -----	74
5.5	REFERENCES -----	76
<b>6</b>	<b>APPENDIX -----</b>	<b>84</b>

## List of tables

Table 1: US Equities Distribution (%).....	17
Table 2: Descriptive Statistics 2005 .....	52
Table 3: Correlations matrix 2005 .....	52
Table 4: Model Summary 2005 .....	53
Table 5: ANOVA(b) .....	53
Table 6: Coefficients(a) .....	53
Table 7: Descriptive Statistics 2006 .....	57
Table 8: Correlation Matrix 2006 .....	58
Table 9: step-wise regression, 2006.....	61
Table 10: Model Summary .....	61
Table 11: ANOVA(b) .....	61
Table 12: Coefficients(a) .....	61
Table 13: Correlation Matrix 2007 .....	65
Table 14: Model Summary .....	66
Table 15: ANOVA(b) .....	66
Table 16: Coefficients(a) .....	66
Table 17: Summary of regression results .....	69
Table 18: 2006 regression variables .....	85
Table 19: 2005 regression variables .....	86
Table 20: 2007 regression variables .....	87
Table 21: Investment distribution in the PSE .....	88

## **Abstract**

Institutional investors have grown substantially in international, mature markets in last two decades parallel with the increase in their impact. They seek to own large proportions of equities; as a result they have become influential on performance of companies in which they invest. Previous studies show no conclusive evidence on the direction in the role of institutional investors on performance.

This research attempts to examine the impact of institutional investors' involvement on performance of investee companies. This study relates corporate governance to performance by considering institutional investors' involvement as one of the governance dimensions. This thesis considers two variables for institutional investors' involvement, one is the whole number of institutional investors holding a particular stock, and the other is the institutional investors' representation on boards of investee companies. Performance was measured by using Tobin's q. The study was conducted using regression for three consecutive years, 2005, 2006, & 2007. The results show a statistically significant positive relation between the whole number of institutional investors and corporate performance in 2005 & 2006, but none in 2007. The results also show a statistically significant negative relation between institutional investors represented on board and firm's performance in 2005 & 2006, but none in 2007. These results call for further examination of the ownership by institutional investors and their relations with performance of investee companies.

**Key words:** *institutional investors, investee company, active monitoring, corporate governance, performance.*

## Arabic Abstract

### الملخص بالعربية

زاد حجم الاستثمار المؤسسي في العقدين الأخيرين, وبذلك زاد تأثيرها, أصبحوا يملكون نسب كبيره من ملكية الشركات , بذلك أصبحوا يؤثرون على اداء الشركات التي يستثمرون بها . الدراسات السابقة لم تخرج بأدلة ونتائج دقيقة حول أهمية ودور الاستثمار المؤسسي على الأداء المالي للشركات.

تهدف هذه الدراسة لفحص العلاقة بين الاستثمار المؤسسي وأداء الشركات التي يستثمرون بها, وتربط بين حوكمة الشركات والأداء المالي على اعتبار أن الاستثمار المؤسسي هو أحد أبعاد الحوكمة . وتأخذ هذه الدراسة متغيرين لقياس حجم الاستثمار المؤسسي , الأول هو العدد الكلي للمستثمرين المؤسسيين والآخر هو عدد المستثمرين المؤسسيين في مجالس إدارة الشركات التي يستثمرون بها . وتم قياس الأداء المالي للشركات المستثمر بها بمقياس ( Tobin's Q ) .

وتم تنفيذ الدراسة بإستخدام تحليل الإنحدار لثلاث سنوات متتالية, 2005, 2006 & 2007 . النتائج بينت وجود علاقة طردية بين العدد الكلي للمستثمرين المؤسسيين وأداء الشركات المستثمر بها للسنوات 2005 & 2006 ولم يثبت في سنة 2007 , وكذلك وجود علاقة عكسية بين عدد المستثمرين المؤسسيين في مجالس الإدارة للشركات المستثمر بها في سنة 2006 فقط .

نتائج هذه الدراسة على الرغم من عدم اثباتها القاطع تنادي بإهتمام أكبر لإامتلاك المستثمرين المؤسسيين وعلاقتهم بإدارة الشركات التي يستثمرون بها وتأثيرها على الحوكمة ولأداء المالي .



# **1 CHAPTER ONE: INTRODUCTION**

## 1.1 Overview

One of the clear differences between regional and global stock markets is the trade volume of the institutional investors which constitute more than 85% of the total trading volume in developed stock markets, while individual investors are the majority in the Arab region. As a result, it will be difficult for the region's stock markets to substantially evolve and earn the depth and maturity they require in the absence of local or global institutional investments. (Azzam, 2007)

The expanding role of institutional investors in emerging markets can help promote these developments. They may also have a positive impact on the more efficient mobilization of domestic savings and thus encourage the supply of productive capital (Blommestein and Funke, 1998).

The change in equity ownership mirrored the shift in household portfolio composition away from direct ownership of financial claims and toward ownership through financial intermediaries. Lower transaction costs of mutual funds, tax-favored promotion of pensions and saving, and the increased willingness of state and local government retirement funds to hold equities contributed to the new importance of institutional investors.

While equity holdings by institutional investors have grown substantially since 1980, they have not grown uniformly. In particular, holdings by banks and insurance companies have declined in relative importance to holdings by mutual funds and pension funds. Since 1990, the period of the most explosive growth of institutional-investor holdings, the greatest relative growth has been of holdings by mutual funds and private pension funds (Hubbard, 1999). The rise and

volatility of international capital flows has often been regarded as a major source of financial crises in emerging markets during the 1990s. An important component of these flows has been portfolio investment in the form of investment in equities and bonds. In most cases, investors behind these portfolio flows to emerging markets are institutional investors, such as mutual or pension funds and insurance companies. As a matter of fact, institutional investors can be regarded as the kingpins of financial globalization. At least for mature markets (Frenkel & Menkhoff, 2003).

This study focuses on the impact of institutional investors on corporate management in relation to performance, and active monitoring.

## **1.2 Problem Statement**

This thesis investigates the impact of institutional investors on performance of Palestinian companies listed at the PSE.

## **1.3 Objectives of the Study**

Due to the size and professional advantage of institutional investors, they usually play an important role in companies in which they invest.

This study investigates the impact and of institutional investors on corporate performance, this will include the impact of

- The size of institutional investors in Palestine Securities Exchange
- The difference between the impact of the whole number of institutional investors and the number of institutional investors represented on the board of the investee companies on investee company' performance.

## **1.4 Research questions**

Through investigating the impact of institutional investors on corporate performance, this study should answer the following questions,

1. Does the involvement by institutional investors have an impact on corporate financial performance?
2. Is there a difference between the involvement of whole number of institutional investors and board member institutional investors?

## **Definitions**

**Institutional investor:** An entity with large amounts to invest, such as investment companies, mutual funds, brokerages, insurance companies, pension funds, investment banks and endowment funds. Institutional investors are covered by fewer protective regulations because it is assumed that they are more knowledgeable and better able to protect themselves. ([www.investword.com](http://www.investword.com)). This research considers all corporate investment (local & foreign) as institutional investment due to the insufficient of data at the Palestine Securities Exchange (PSE).

**Performance:** is the financial performance of investee companies listed at the PSE and was measured by Tobin's q (**market value of firm / corporate net worth**).

## **1.5 Need & Importance of the Study**

Institutional investors have become increasingly willing to use their ownership rights to pressure managers to act in the best interest of the shareholders (Cornett, M et al, 2005). As these investors have increased their ownership share in firms, there has been an increased focus by researchers on their role in monitoring, disciplining and influencing financial performance.

The importance of this study stems from the fact that corporations in Palestine operates in an emerging, less efficient market, so that this study will show the importance of institutional investors in emerging markets, to what degree they are

participating in corporate ownership in Palestine, and to what extent they are enhancing corporate financial performance and governance.

## **1.6 The Research Organization**

This study will be divided into two parts, including chapters; the first part is the literature review of what have been written about the subject.

The second part is an analytical view for the impact if institutional investors on Palestinian corporations in particular.

- Chapter one: Introduction
- Chapter two: Literature review
- Chapter three: Research design & Methodology
- Chapter four: Data analysis & results
- Chapter five: Conclusion & recommendations

**Data source:** data used by the study was gathered through secondary source (previous studies, books & articles), and a primary source: through observations & some research instruments like empirical testing for data sets using regression analysis.

**Research approach:** the primary data was collected through descriptive data using empirical testing for 18 randomly selected companies listed on the Palestine Securities Exchange (PSE), data acquired from corporate annual reports & the PSE year book to assess the impact on financial performance.

## **1.7 Study limitations**

During conducting the research, many limitations were encountered. First of all, the lack of data about corporate governance in Palestine and the lack of data and literature about institutional investors & ownership structure in Palestine. The use of other measure of financial performance, other than Tobin's q may show different results. And one of the limitations was considering all corporate investment as institutional investment due to the absence of data about the size of ownership & classification of financial institutions in Palestine. Another important limitation is that the lack of sufficient years that limits the use of time series analysis before & after the involvement of institutional investors.

## **2 CHAPTER TWO: LITERATURE REVIEW**



## 2.1 Introduction

Institutional investors can be defined as economic entities with large amount of capital to invest; they include mutual funds, brokerages, insurance companies, pension funds, investment banks and endowment funds. Their potential influence as large shareholders was traced back to 1930 in the separation of owners from control of business to be in the hand of directors when was first introduced by Berle & Means, (1932). This separation of ownership was behind the agency problem, when managers (agents) might look for their own interest rather than on behalf the interest of shareholders. Over time the impact of institutional investors have been increasing, their shareholding in equities have grown dramatically since the middle of the 20th century, we can't underestimate their influential role on the macro & micro levels in the economy especially when we talk about foreign institutional investment in the form of portfolio investment in the equities of emerging financial markets. On the macro level as outlined in Davis and Steil (2001), the growth of institutional investors can be traced to various supply and demand factors that have made investing via institutions attractive to households. Supply-side factors suggest that institutions have offered their services relatively more efficiently than banks and direct holdings, thus fulfilling the functions of the financial system more effectively, while demand-side factors imply households have enhanced requirements for the types of financial functions that institutional investors are able to fulfill. On the supply side, there is an ease of diversification, liquidity, improved corporate control, deregulation, ability to take advantage of technological developments, and enhanced competition, as well as fiscal

inducements and the difficulties of social security pensions. On the demand side, one may highlight demographic aspects (notably funding of pensions and population ageing) and growing wealth.

On the other side, on the micro level which is our concern in this study, it seems to be that institutional investors have a positive influence on corporate finance that includes value maximization (stock price maximization), corporate financial performance and corporate governance. They enhance transparency, accountability and better information disclosure, they also contribute to more stock liquidity, and they also have more interest than other parties or minorities in monitoring management. Those practices by institutional investors are referred to "shareholders' activism".

But some literature has pointed the inverse effect of involving institutional investors in the firm's ownership, such as high volatility in stock prices, and the possible conflict of interest between large shareholders and small investors.

Equity holding by institutional investors have grown substantially since 1980, then they held about 36% of total equities in the in the developed markers. This percentage has grown to more than 70% after the year 2000. In 1995 the total assets of such institutions in the main regions in the OECD (Organization of Economic Cooperation & Development) area amounted to more than \$24.4 trillion (an astonishing 106.7% of GDP). And between 1990 and 1995 the average annual growth of holdings by institutional investors reached 10.5%.

This increasing importance of the new market engines (institutional investors) makes it valuable to investigate their role on corporate performance in the

Palestinian listed companies. In this part of the study, we will review the literature in a descriptive and analytical approach and the impact of institutional investors on corporate governance, and that will focus on corporate financial performance measured by Tobin's Q (market value/book value) as one of the corporate governance dimensions.

This chapter will be divided into two main parts; the first discusses empirical evidences by research studies and what has been written in the institutional investors and performance, the other focuses on the Palestinian context, in other words, what already exists in topic about the Palestinian market.

## **2.2 Main types of institutional investors**

### **2.2.1 Pension funds**

The purpose of a pension fund is to pay retirement benefits in the future (Fabozzi & Modigliani, 1992). Private state and local entities acting on behalf of their employees, unions acting for their members and individuals acting on their own behalf are so-called plan sponsors when they establish pension plans. These plans are financed through either employer's or both employer's and employee's contributions. The plans can be divided into two groups: *defined contribution plans and defined benefit plans*. In the first the plan sponsor makes specified contributions, usually as a percentage of the salary of employees, on behalf of qualified members. The actual retirement payment is known, but depends on the performance of the assets of the fund. In the second, however, the retirement payment is known, and depends on how long the employee has served the entity and the level of earnings. The assets of a corporate plan sponsor can be managed: in-house (i.e. by the company itself), by one or more money management entities on behalf of the company, or by a combination of these alternatives.

### **2.2.2 Insurance companies**

Insurance companies can be divided into life insurance companies and property and casualty insurance companies (Van, Boender & Guus, 1995). In case of death, a life insurance company makes a payment for the beneficiary as agreed when making the insurance agreement. However, life insurance companies offer several other products as well. Insurance for death can be combined with an investment

policy, where the payment depends on interest rates in the market. Alternatively the payment may depend on the market value of the investment at the time of death. Typically, pension funds apply an investment policy which guarantees a certain payment on a certain day in the future. The contracts of life insurance companies are in most cases characterized by this long maturity which means that these companies have to match their liabilities and investment income at any given point of time.

### **2.2.3 Investment companies**

Investment companies are pools of funds of individual investors, they offer the possibility to diversify risk and lower the costs of contracting and processing information (Dobson, 1994). An individual investor can buy shares in an investment company, which are in proportion to the company's diversified portfolio of investments. Investment companies can be categorized into three groups: *open-ended funds*, *closed-ended funds* and *unit trusts*. Open-ended funds, commonly called mutual funds, sell shares to individual investors and are willing to redeem their outstanding shares on demand.

The price equals an appropriate share of the market value of the funds' portfolio. An open-ended fund, called a mutual fund in the US and a unit trust in the UK, means that the outstanding shares will be redeemed on request, and that the number of shares is not fixed, but fluctuates as new shares are sold and outstanding are redeemed. Closed-ended funds sell shares but in most cases don't redeem the shares. The price of a share depends on the supply and demand in the market place, and can be lower or higher than the net asset value. As is the case of

closed-ended fund, the number of shares of a unit trust is fixed. This type of fund invests mainly in bonds, but in a different way from mutual funds and closed-ended funds. Trading in bonds is passive, the termination date of unit trusts is fixed and the portfolio of trust remains.

But there are other considerations when categorizing institutional investors. Several recent studies suggest that not all institutional investors are equal [Brickley, Lease, and Smith (1988); Almazan, Hartzell, and Starks (2005); Chen, Harford, and Li (2005)]. These papers hypothesize that some institutional investors (e.g., insurance companies or banks through their trust departments) have either existing or potential business relations with firms, and, in order to protect those relations, might be less willing to challenge management decisions. These investors are therefore labeled pressure-sensitive. In contrast, institutions such as investment companies and independent investment advisors may be less subject to pressure from the firms in which they invest and therefore better suited to monitor, discipline, and impose controls on corporate managers. These institutional investors are labeled pressure-insensitive. Using this classification, Almazan et al. (2005) show that greater share ownership by pressure-insensitive investors is associated with greater discipline on executive compensation. Using the same classification, Chen et al. (2005) find that pressure-insensitive ownership is associated with better acquisition decisions.

### 2.3 Factors behind the rise of institutional investors

According to the Organization of Economic Cooperation and Development (OECD) publications (1998), several common factors have been crucial in driving the growth of institutional investors as a group. Four are particularly important. **First**, the aging of populations has produced a rising demand for retirement 'products' such as mutual-fund products, equity-indexed annuities, asset-backed securities and guaranteed-equity plans by increasingly well-off and sophisticated individual investors. Simultaneously, the baby-boom cohort of the 1940s and '50s is causing looming fiscal problems in countries relying predominantly on pension systems financed by 'pay-as-you-go' contributions made through the state. This has stimulated the introduction of advance-funded pension schemes.

**Second**, technological progress in communications and information processing has enhanced the capacity of the financial-services industry to provide intermediation and risk-management services by handling vast flows of information at very high speed and at very low costs. This trend is giving rise to a new breed of sophisticated investment products (money-market mutual funds, swaps, options and credit derivatives, for example) – a process supported by methodological break-through in the pricing of sophisticated financial instruments. The innovation and creativity characteristic of the US capital market has had a powerful impact on financial services in the world as a whole. The **third** influence has been the deregulation of the banking and securities industries since the beginning of the 1980s, which has heightened competition between and among banks and other financial institutions. At the same time, the elimination of

restrictions on cross-border capital flows and on the entry of foreign financial institutions has further increased competition. These forces, together with the introduction of international capital standards for banks, have almost everywhere caused a massive move by banks into the fee and commission business associated with capital-market transactions, thereby further blurring separation lines between banks, insurance and fund-management. **Fourth**, disintermediation from banks, through reduced demand for bank deposits and traditional saving vehicles, has resulted in a shift in favor of more performance-oriented instruments like money-market funds and mutual funds investing in equity. This process is particularly noticeable in the North American capital market, where the percentage share of bank deposits in total financial assets of the personal sector has fallen from 26% in 1976 to around 15% in 1996. But there is evidence of this trend also in other countries; for example, in France, cash and deposits as a percentage of total household assets fell from around 65% in 1976 to around 34% in 1996; and in Germany from 62% to 43%. Apart from these broad trends, a number of other factors are important, such as special tax-treatment of retirement savings, the rate of return on institutional savings products offered (relative to those obtainable from other financial products), the regulatory and supervisory infrastructure (and changes in it), as well as existing attitudes to the various means of savings – for example, the differences in countries with an ‘equity culture’ (mainly English-speaking countries) versus those with a ‘banking culture’ (mainly continental Europe and Japan). In addition, many countries have policies that explicitly



promote particular types of institutional investors, private pension schemes chief among them.

**Table 1: US Equities Distribution (%)**

Year	Households	Mutual Funds	Insurance & Pensions
1950	89	2.3	4
1970	75	5	12
1980	59	3	23
1992	54	7	28
1997	43	10	30

Source: Hubbard, G, et al, (1999). Institutional investors and corporate behavior.

## 2.4 Institutional investors and corporate performance

Institutional investors as corporate monitors were a focus of many studies and researches. Many studies in that field hypothesized that there is a link between institutional investors & corporate governance in one side and corporate governance & long-term corporate performance, but the findings appear to be fairly mixed.

One of the earlier and much-quoted studies is that of Nesbitt (1994). Nesbitt reported positive long-term stock price returns for targeted firms. Subsequently, Millstein and MacAvoy (1998) found that corporations with active and independent boards appear to have performed much better in the 1990s than those with passive, non-independent boards in a study covered large US listed companies. Conversely, the work of Dalton, Daily, Ellstrand, and Johnson (1998) concluded that no such relation between board composition and firms'

performance, and that there was no relationship between leadership structure (CEO/Chairman) and firm performance.

Despite that evidence seems to appear quite mixed, there is a common perception that corporate governance can make a difference to the bottom line. A study by McKinsey (2002) found that investors are most likely willing to pay a premium to invest in a company with good corporate governance. The findings indicate that investors would pay 11% more for the shares of a well-governed Canadian company, 12% more for the shares of a well-governed UK company, and 14% more for the shares of a well-governed US company, compared to shares of a company with similar financial performance but poorer governance practices. So it's a matter of investor's perception that good governance leads to improved long-term performance.

Gompers, Ishii & Metrick. (2003) investigated the ways in which shareholder rights vary across firms. They found that firms with stronger shareholder rights had higher firm value, higher profits, higher sales growth, lower capital expenditures, and made fewer corporate acquisitions. Deutsche Bank (2004) studied the impact of corporate governance on portfolio management and concluded that corporate governance standards are an important for equity risk.

Mallin & Runall (2006) pointed that shareholder activism is an important issue for deriving good corporate governance and without this there is less accountability and transparency, and hence management get more opportunities to work for their interest rather than owners' interest (value maximization).

Large shareholders such as institutional investors can achieve sufficient benefits because they have an incentive to monitor due to the high cost of monitoring. Indeed, Shleifer and Vishny (1986) note that large shareholders may have a greater incentive to monitor managers than members of the board of directors, who may have little or no wealth invested in the firm. Other studies have found consistent results.

The other side, Maug (1998) found that the size of shareholding is partially a function of institutions' ability to influence corporate decision. If institutional investor shareholdings are high, shares are less marketable and are thus held for longer periods. This is the case where there is greater incentive to monitor a firm's management. However, when institutional investors hold relatively few shares in a firm, they can easily liquidate their investments if the firm performs poorly, and therefore have less incentive to monitor.

However, it seems clear that large stockholders and institutional investors have become increasingly important to actively influence corporate governance, especially in poor performing firms. Gillan and Starks (2000) find that corporate governance proposals sponsored by institutional investors receive more importance in voting than those presented by individual investors.

Hartzell and Starks (2003) show that there is an inverse relationship between the level of executive compensation and the level of shareholding and a positive relationship with pay-for-performance sensitivity & the level of shareholding. Chung et al. (2002) find that large institutional shareholdings in a firm prohibit managers from declaring pre-determined earnings through managing discretionary

accrual choices. Finally, Parrino, Sias, and Starks (2003) show that institutional selling is associated with forced CEO turnover and that these CEOs are more likely to be replaced with an outsider, through effective voting against the dissatisfying CEO.

McConnell and Servaes (1990) find that the amount of institutional investor ownership is positively related to a firm's financial performance (Tobins' q measure).

On the opposite, other papers for Agrawal and Knoeber (1996), find no such significant relation. Thus, the relationship between institutional investor stock ownership and firm's performance is still unclear.

This research adds to the literature on institutional investor ownership and firm performance by examining this relation for some Palestinian listed companies that are involved with institutional investors. This line of research began with Brickley, Lease, and Smith (1988), who noted that pressure-insensitive institutional investors are more likely to discipline and/or vote against management than pressure-sensitive ones. Borokhovich et al. (2000) find that the relative holdings of these two groups of institutional investors affect the market reaction to announcements of anti-takeover amendments.

In the same manner Cornett, Marcus, Saunders and Terhranian (2005) found results consistent with the above and concludes that there is a relation between institutional investor involvement in a firm and its operating cash flow returns.

Specifically, they found a significant positive relation between the percent of institutional stock ownership and operating cash flow returns and, even more

strongly, between the number of institutional investors holding stock in a firm and operating cash flow returns. However, the positive relation between the number of institutional investors holding stock and operating cash flow returns was found only for pressure-insensitive institutional investors (those with no business relation with the firm).

## **2.5 Institutional Investors and corporate governance**

Corporate governance has recently received much attention due to Adelphia, Enron, WorldCom, and other high profile scandals, serving as the impetus to such recent U.S. regulations as the Sarbanes-Oxley Act of 2002, considered to be the most sweeping corporate governance regulation in the past 70 years, and enhancing the long standing bandwagon for increasing shareholder power, according to Huyghebaert & Hulle (2004), corporate governance concerns the development of performing top structures in corporate organization. One of the important dimensions of corporate governance is the creation of effective monitoring of managers, voting by shareholders is a legal exercise for monitoring and electing the board of directors, these directors are responsible for monitoring management, and if there are institutional investors and being dissatisfied with firm's performance they have three choices **one:** use the old "wall street rule" to sell their shares, **second:** hold their shares and voice their dissatisfaction, **third:** hold their shares and do nothing. Recently many questions have been raised if institutional investors should be assigned to an influential role in corporate

governance; the idea is that they are in a better position to monitor compared to small investors due to their size of investment and voting power.

During the past decades, institutional investors, such as pension funds, insurance companies and mutual funds, have become increasingly important as shareholders: the combined financial assets held by institutional investors in the major industrialized countries rose from 38% of GDP in 1981 to 90% in 1991 and to 144% in 1999 (Gompers and Metrick, 2001). There are two views about institutional investors activism, the one is "active monitoring". States that institutional investors are expected to exercise an active role to protect the value of their investment, including monitoring the performance of the firms in which they invest (Monks and Minow, 2001). The opposite view is represented by the "passive monitoring" hypothesis, which states that institutional investors do not tend to be active in monitoring management, for example because of free-riding behavior of certain institutional investors that could make it difficult to take collective action.

On the other hand, a study was conducted by David and Kochhar (1996), they argue that various institutional obstacles, such as barriers derived from business relationships, the regulatory environment and information processing limitations, may interrupt institutional investors from exercising their corporate governance role. Leech (2000) argues that many institutional shareholders do not seek control over companies in which they invest for many reasons, which include the fear of obtaining price sensitive information, so institutional investors are more likely to influence rather than complete control. Moreover, it has also been argued, in line

with the “passive monitoring” view, that institutional investors do not tend to “exit” on their investments (sell their equity stakes when the firm is not functioning well), mainly because they hold large portion of equity and not to negatively affect stock prices and further increase any potential loss.

Downes, Houminer & Hubbard (1999), conclude the following important points on the impact of institutional investors on corporate governance,

- All institutional investors have improved their efforts at proxy analysis and voting in recent years by developing in-house proxy-administration departments and employing voting services and consulting firms such as Institutional Shareholder Services (ISS) or the Investor Responsibility Research Center (IRRC).
- And though investors may refer to “corporate governance” in their monitoring and intervention, informal or formal investor actions relate far more frequently to perceptions of poor performance. Except in highly publicized cases involving allegations of excessive executive compensation, dysfunctional boards, or fraud, it is generally only after firms are identified as troubled or as long-term underperformers that governance practices are given more than routine scrutiny.
- Institutional investors view good governance as most valuable when a firm or its industry is in trouble. Despite differing views on the general value of good governance practices.
- While many commentators note that “private mutual-fund” and “pension-fund” institutional investors differ in their assessments about both the

costs and the benefits of shareholder activism, they find that this difference is less clear than it might appear at first glance. Many institutional investors themselves are skeptical of institutional investor activism.

## **2.6 Influence of institutional investors**

Given the size of their shareholdings the power of the institutional investors cannot be doubted. In his influential work, Hirschman (1970) identified the exercise of institutional power within an ‘exit and voice, means that if institutional investors are dissatisfied, they either sell their shares (exit) or exercise their power through effective voting. The former choice is not viable for many institutional investors given the size of their holdings or a policy of holding a balanced portfolio.

Greenbury (1995) report that the main action points that ‘the investor institutions should use their power and influence to ensure the implementation of best practice as set out in the Code. The institutional investors’ potential to exert significant influence on companies has clear implications for corporate governance, especially in terms of the standards of corporate governance and issues concerned with enforcement. In relation to institutional shareholders, the Combined Code (2006) principles of good governance state:

### **Dialogue with companies**

*Institutional shareholders should enter into a dialogue with companies based on the mutual understanding of objectives.*

### **Evaluation of governance disclosures**



*When evaluating companies' governance arrangements, particularly those relating to board structure and composition, institutional investors should give due weight to all relevant factors drawn to their attention.*

### **Shareholder voting**

*Institutional shareholders have a responsibility to make considered use of their votes.*

Some institutional investors formulate their own code and principles of corporate governance.

The Institutional Shareholders' Committee (ISC) which is composed from the Association of British Insurers (ABI) and the National Association of Pension Funds (NAPF), the Association of Investment Trustee Companies (NITC), and the Investment Management Association (IMA) issued a code of practices for institutional investors to exercise their activism procedures in the case of poor-performing investee companies whether to voice or exit, and according to Mallin & Runall (2006), the ISC recommends that institutional investors **should have a clear statement of their policy on activism and on how they will discharge their responsibilities**. The policy would be a public document and would cover the following areas: how investee companies will be monitored; the policy for requiring investee companies' compliance with the Combined Code; the policy for meeting with an investee company's board and senior management; how any conflicts of interest will be dealt with; the strategy on intervention; indication of when and how further action may be taken; and the policy on voting.

They also recommend that institutional investors **should monitor performance**. Monitoring performance should be on regular basis that include important practices for good governance that must be clearly communicable and checked periodically for its effectiveness. It would include reviewing annual reports and accounts, circulars and resolutions; and attending company meetings. In particular, institutional shareholders should try to satisfy themselves that the investee company's board and sub-committee structures are effective; that independent directors provide adequate oversight; and maintain a clear audit trail of their meetings and of votes cast on company resolutions, in particular contentious issues.

The ISC argue that institutional investors **intervene when necessary** for the important company issues including the company's strategy; its operational performance; its acquisition/disposal strategy; independent directors failing to hold executive management properly to account; internal controls failing; inadequate succession planning; an unjustifiable failure to comply with the Combined Code; inappropriate remuneration packages; and the company's approach to corporate social responsibility. Boards should be given the chance to ensure their good reaction but if they do not, and then institutional investors may use their right and actions to change the board in the general or extraordinary meeting by joining with other institution. Finally, institutional investors **should evaluate and report** on the outcomes of their shareholder activism.

Referring to Millin & Runall (2006), corporate governance may be used as a tool for adding value for shareholders from under-valued companies. It has been very

successful for large institutional investors in the world. In addition they added that corporate governance may also be used as an essential factor to help restore investor and improve confidence in markets which have experienced financial troubles. This is proved in the last few years in Malaysia, Japan, and Russia.

Numerous studies have made the point that institutional shareholders may have potential costs (Coffee, Jr., 1991; Bolton and Von Thadden, 1998; Maug, 1998; La Porta et al., 1999), **first**, large shareholders may practice private gains at the expense of small shareholders or of other interested parties such as management, employees and other providers of capital such as bondholders. Thus, for example, high managerial ownership of the firm may lead to the entrenchment of management, as its goal becomes to maximize its own private benefits (“entrenchment” effect). This effect could also occur in case of an entrenched controlling owner, such as an institutional investor, who may deprive minority shareholders of their rights. **Second**, regarding the “entrenchment” effect, the considerable control enjoyed by large shareholders may lead to handle intangible benefits, like status and political influence, which can be defined as “private benefits” of control (Morck et al., 2005). **Third**, large shareholders bear additional risk by putting all their investments in limited number of firms, although, as has been demonstrated, the existence of a liquid stock market reduces the costs of holding large equity stakes (Maug, 1998). Thus, there is a trade-off between liquidity and control, so the liquidity of their investments would be at the expense of the control of the firms in which they invest (Coffee, Jr., 1991; Bolton and von Thadden, 1988). Furthermore, when large shareholders exist, small

shareholders may get out of their monitoring responsibilities that bring them in a “free-riding” problem.

## **2.7 Indirect Monitoring**

Gilson & Kraakman (1991) find that institutional investors’ incentives push against direct involvement in portfolio companies’ management. Therefore, indirect monitoring through the board of directors or trade groups and informal communication between corporate managers and institutional investors are the corner stone of institutional voice. Indirect monitoring can be achieved, inter-alia, by encouraging or funding block-holding funds who will bear the legal risks involved in holding large percentage stakes. An example of this form of indirect monitoring is the emergence of "white squire" funds, funded mainly by institutions, with the stated goal of acquiring large equity stakes that will give them both the incentive and the ability to monitor company managers. Yet another avenue of indirect monitoring is block-holding by a single institution that has developed a reputation for not abusing power and for promoting the interests of shareholders as a group.

Pinto.M (2006) also argues that the need to aggregate power across institutions has led some institutions to rely on trade groups and independent advisors to coordinate governance initiatives. These organizations give voting advice; develop opinion papers on governance issues. Trade groups can also develop lists of director candidates and criteria for assessing director performance. Today, the ISS is the world's leading provider of proxy voting and corporate governance services.

## **2.8 Institutional Investors and Information Asymmetries**

Akerlof (1970) was one of the important researchers who pinpoint the area of information asymmetry and argues that asymmetric information leads to price discounts. Using the example of the used car market, Akerlof shows that rational buyers understand that they are up against sellers that are better informed about the intrinsic quality of the cars put up for sale. As a result, they will only offer to buy at prices reflecting the fact that lower quality owners are most likely to be the ones that are prepared to sell. If asymmetric information is important, the discount may become so large that good quality sellers are driven out of the market and only the lowest quality owners remain willing to trade.

Huyghebaert. N and Hulle. C (2004), argue that adverse selection is one of the out put of asymmetric information and it is a well-known phenomenon in financial markets. When stock prices are low, managers and company insiders often complain that their firm cannot issue new shares to finance its investments because the market cannot be convinced that it underestimates the true value of the firm. Convincing the market is not easy, because outside investors understand that they are up against better informed agents that have an interest in claiming that the share price is too low, even if this is not the case.

Therefore overall, information asymmetries tend to have an inverse effect on the stock price of good performing companies. Consequently, firms may invest in reducing information asymmetries to increase their stock prices.

Different theoretical models show how this may actually arise. These models generally assign a role to institutional investors. Diamond and Verrecchia (1991)

start out from the logic that a reduction in information asymmetries lowers the cost of capital and that companies that can benefit most will invest more strongly in reducing such asymmetries. In their model, the decline in the cost of capital is caused by the fact that better information attracts more large investors (such as institutional owners) as less information asymmetries enhance every-day liquidity. Clearly, there is a relation between information asymmetry and stock liquidity. Similarly, in a capital market with incomplete information, Merton (1987) shows that stock prices are positively affected by the number of institutional investors realizing the firm's stock. This view could explain why larger, hence most of the time also better-known firms attract more investors and institutional investors in particular.

A trend in research is linking the asymmetric information and the book-building; which is a method, through which the selling price of a large block of shares is determined, developed in the US and now is being used in other countries especially in the marketing of the IPOs. In essence, it involves asking professional investors how many shares they are willing to buy and at what price. On the basis of this information, the firm and its investment bankers determine the IPO's offering price. The method uses the fact that compared to small retail investors; professionals generally are better able to evaluate the true worth of a firm. Cohen et al. (2002) find empirical support for this assumption. Based on the fact that institutional investors have more ability to evaluate information & cash flows, then better evaluate the stock. So, comparing to the earlier discussed studies of Diamond and Verrecchia (1991) and Merton (1987), as information asymmetries

reduced, institutional investors are better off and that overall enhance stock liquidity, in this context the literature hypothesizes that the book-building procedure actually contribute in reducing information asymmetries, and then increase the value of the stock.

Actually, there are two stages in the book-building process, the **first** was discussed earlier, and the **second** stage, allow small investors to subscribe at the price determined in stage one. And this price should be reduced for small investors when it reflects the amount that sophisticated investors are willing to pay in that stock. However, for book-building to work in practice, the IPO-firm needs to give professional investors an incentive to invest in information collection and then truthfully reveal their opinion; by reducing the subscription price below the actual value of the firm. So, by doing that, subscribers earn positive returns compared to buying in the after-market which is referred to under pricing that may reach to an average 15%, then the stock will be more demanded. So that practice reflects the irrationality by some institutional investors who bade higher price during the book-building period. This logic has been developed in detail in Benveniste and Spindt (1989), Benveniste and Wilhelm (1990), Welch (1991), Cornelli and Goldreich (2001). It is also supported empirically. Indeed, as predicted by these models, institutional investors collect valuable information and prove to be able to do better than small investors at the time of an IPO (Aggarwal et al. (2002)).

(Ljungqvist and Wilhelm (2002); Keloharju and Torstila (2002) show that professionals intend to collect less information when they do not benefit from

engagement. Ljungqvist and Wilhelm (2002) also show that IPO-firms benefit from the book-building process by reducing the under-pricing.

The above results show how capital markets can benefit from the involvement of institutional investors especially for firms face important information asymmetries, like high growth firms that are hard to value. Arosio et al. (2001) and Huyghebaert and Van Hulle (2002) in fact they find that since the introduction of book-building in Continental Europe in the second half of the nineties, firms with high financing requirements dominate the firms going public, by using book-building, organizing road shows abroad and dealing with high sound foreign investment banks in the marketing of securities. On the other hand, despite the merits of the book-building, we shouldn't forget some adverse effect; the method has been a source of conflicts of interest between firms and small shareholders on the one hand and the advising investment bankers and professional investors on the other hand. Aggarwal et al. (2002) show for IPOs in the U.S. that investment bankers reward their good institutional clients with deeply under-priced issues, significantly in excess of what could be explained by compensation in exchange for the service of information gathering. But investment bankers justify that with other promises by institutional investors not to immediately sell shares in the aftermarket, or even buy shares if selling pressure would occur shortly after the IPO. This conflict of interest may be clearly noticed in Europe as many institutional investors are subsidiaries of financial institutions that are engaged in investment banking services. Consistent with this idea, greater information asymmetry is found in the aftermarket as the commercial



bank acts as underwriter in an IPO, Hebb and MacKinnon (2004). This asymmetry resolves itself over time as the market learns more about each issue so that it becomes clear which ones may have involved a conflict of interest on the part of the commercial bank.

## **2.9 Institutional investors' Impact on Stock liquidity**

Liquidity, how fast assets can be converted into cash or the ability to satisfy short-term obligations, so it is directly related to value. And share price is negatively affected by deficiency in liquidity by three ways. **First** of all, the uncertainty about the true value of stock increases if a stock is not regularly traded (Merton (1987). One of the main features of stock markets is that, when investors receive information regarding a specific share and act upon it, the information becomes reflected into the stock price. Therefore as stock is not regularly traded, the less opportunity for information to be (timely) incorporated into share price, and the more uncertainty about the stock's underlying value. **Furthermore**, investors are not attracted to buy a stock with low liquidity because they are concern about the exit point, so that overall information collection tends to decline. **Finally**, investors holding an illiquid stock find it difficult to get rid of it because there is no other demanding party, so they will be borne a cost in the form of price discounts. Consequently, as uncertainty about the underlying value increases, less investors are interested to buy it and as trading becomes more costly, the share price decreases and that would increase the cost of capital.

Although there is no perfect agreement yet about how the exact impact of the above factors on value, there is a harmony in the literature that liquidity has an

impact on share prices. For example, Eleswarapu and Reingaum (1993), Brennan and Subrahmanyam (1996), Eckbo and Norli (2000) provide evidence that stock market liquidity is reflected in asset returns. Specifically, investors require higher rate of return on illiquid stocks that is reflected in higher cost of equity from the issuer's view. The impact of liquidity on value was a major focus for many researchers, Loderer and Roth (2003) report that the least liquid stocks on Nasdaq and the Swiss Exchange suffer a discount on value of about 30%. And Butler et al. (2002) show in the US, companies with highly liquid shares experience less issuance costs when they raise new share capital and sell these additional shares in the market.

Although, there is a common view that stock liquidity is also affected by the type of investors holding it especially when we talk about companies count for institutional investors in their stockholders' structure, their stock tends to be more liquid than other stocks with no institutional investors in the shareholders' base. Of course, institutional investors have a preference for liquid shares (Gompers and Metrick (1998)). Institutional investors view liquidity as a valuable element when they rebalance their portfolios over time. Conversely, liquidity is improved because institutional investors involve in more information gathering than small retail investors. Supporting this idea, Bennett et al. (2003) report that when institutional investors invest in small firms 'greener pastures', they increase the stock liquidity of these firms by demanding more information. However, when institutional investors trade the company's stock they may affect the price and the

cost of equity by reducing the tax liability on the company and its investors if the company operates under different tax brackets.

Furthermore, Redding (1997) shows in a theoretical model that publicly quoted firms tend to pay more dividends when institutional investors pay low tax on received dividends, higher cash disbursements to investors imply less opportunity for overspending by management, which may positively affect the quality of the firm's governance. On the other side, there is a claim says that trading by institutional investors contribute to greater stock price variability due to the large amounts of stocks traded while these investors rebalancing their portfolios. That such rebalancing indeed may have important effects reflected in the stock prices of firms that are included in an important stock market index. As institutional investors commonly have a preference for index stocks, the entry to or exit from the index may change the ownership structure of the firm included in the index. Shleifer & Vishny (1986) and Denis et al. (2003), among others, prove that this practice significantly affects the company's stock price. Whether or not institutional investors actually cause greater stock price variability is as yet not clear. Other findings by Bushee and Noe (2000) indicate that for the U.S. the existence of these institutionals does not affect return volatility. However, some institutional investors such as momentum traders and hedge funds tend to trade more aggressively, and these professionals may induce more volatility. For Poland, Bohl and Brzeszczyński (2004) prove that when the Polish pension system has been reformed in 1999, and when it was allowed for the privately pension fund to invest in stock market especially index stocks, institutionalism

have become a major investor group. Since then, at least for index stocks, return volatility has decreased. Also, Abarbanell et al. (2003) find that the rebalancing of institutional portfolios after a firm spins off a subsidiary does not create price volatility in the firm's stock. At the same time, the findings of Welker and Sparks (2001) show that at the time public companies disclose information, institutional investors react normally. However, Potter (1992) and Sias (1996) provide evidence that higher institutional ownership is associated with higher stock price volatility. The findings in Badrinath and Wahal (2002) imply that the impact on volatility depends on the type of trading decision: to enter a new stock, institutional investors act as momentum traders, and hence may contribute to volatility, but when they exit or make adjustments to ongoing holdings, they behave as contrarian traders. Overall, most research indicates that institutional investors positively influence liquidity. However, from the findings it is also clear that further work is needed as the type of professional investors and their trading strategies have a diverse impact on the behavior of stock prices.

## **2.10 The Palestinian context**

The Palestine Securities Exchange (PSE), in Nablus, was incorporated as a private shareholding company in early 1995, with the Palestine Development & Investment Company (PADICO) and (SAMED) as its major investors.

After the Palestinian National Authority (PNA) approved a PADICO-sponsored design and work plan in July 1995, a project team was put together by the PSE and entrusted to establish a fully electronic exchange and depository. EFA

Software Services, a Canadian company, provided both the trading and settlement & clearing systems. By August 1996 the Exchange was fully operational, and on November 7th of that year the PSE signed an operating agreement with the PNA, allowing for the licensing and qualification of brokerage firms to take place. On February 18, 1997, the PSE conducted its first trading session.

In 2006 the number of companies increased from 28 to 33, with the addition of six new companies and the de-listing of one company. A plan to offer 40% of the PSE's shares to the public was not successful, but it was not discarded. PADICO attempted to sell 50% of its stake in the PSE, which accounts for 40% of the PSE's total capital, but the attempt failed because of legislative delays. Trading on the Exchange has been volatile, as trading volume witnessed periods of extremely thin and heavy trading. The 2006 Average Daily Trading Volume (ADTV) dropped 37.9% to 0.94 million shares, compared to 1.50 million shares in 2005, and the Average Daily Trading Value (ADTVa) dropped 49.1% to US\$4.48 million, compared to US\$8.52 million for the same period. Over the year 2006, the PSE lost 38.8% of its market capitalization to close at US\$2.73 billion. The Al-Quds Index lost 46.39% to close at 605 points,

Thirty-six shareholding companies have been approved for listing so far, with additional companies expected to be listed in the future. The current list of companies spans a wide range of sectors, including banking, insurance, pharmaceuticals, utilities, telecommunications and investment. There are currently an estimated 40 Palestinian companies eligible to be listed on the Exchange, with

a market capitalization of over \$1 billion USD. Shares of listed companies are mostly traded in Jordanian Dinars, while some are traded in US Dollars.

The Exchange, often known as the Nablus Securities Exchange, fell from a daily turnover of \$12 million in 2005 to about \$6 million "on a good day" in 2007. At the same time the value of the 36 companies traded on the PSE decreased from a combined value of \$4.5 billion to \$2.8 billion over the same period. The year 2005 was a unique year when Al-Quds index reached 1128 points.

The Exchange launched an e-trading portal on April 24, 2007, to allow investors to buy and sell stocks over the internet.

PSE, the Capital Market Authority (CMA), and other regulatory bodies are coordinating efforts to attract foreign institutional investors to Palestine by enforcing effective disclosure, regulations and corporate governance that contribute to developing investment environment in Palestine.

Almost no literature was written about the size and impact of institutional investors in Palestine due to the newly established securities market and the new trend in institutional investment especially the foreign one, so this will be an exploratory descriptive research. Very few studies were conducted concerning corporate governance and efficiency at the PSE, one of them was conducted by (Abdelkarim, Alawneh, 2007), this study relates corporate governance and performance for companies listed at the PSE by considering ownership concentration as one of governance dimensions for the years 2005 & 2006, they found that financial performance is negatively correlated to ownership concentration that weakens the corporate governance and market efficiency at all,

they reported that Palestinian listed companies have ownership concentration that affects information disclosure and transparency that have an inverse impact on governance.

Based on the literature, this study will focus on a set of variables that will be tested through empirical testing using regression analysis. The following hypotheses explain the idea more clearly.

## **2.11 Hypotheses**

Based on the literature review questions that the study attempts to address, the following hypotheses were developed. We try to investigate if there is a relationship between the number of institutional investors holding the stock and the financial performance of investee companies measured by Tobin's q.

***H<sub>0</sub>: There is statistically insignificant relationship between number of institutional investors and the corporate performance measured by Tobin's q.***

***H<sub>1</sub>: There is statistically significant relationship between number of institutional investors and the corporate performance measured by Tobin's q.***

### **3 CHAPTER THREE: METHODOLOGY & RESEARCH DESIGN**



### **3.1 Introduction**

This chapter describes the methodologies used to achieve the objectives of the study, and it's important to clarify the overall research approach, since this approach might influence the results of the study. Dependent on different kinds of research issues, various types of research methods can be used. Referring to a source of research procedure, "research methodology can be conceived as a system of rules and procedures. Such rules and procedures are important in research for the purpose of reasoning i.e a specific logic to acquire insights, inter-subjectivity i.e reporting how the research has obtained the findings and communication i.e reporting in a manner to enable others to replicate or criticize..." (Ghauri, Gronhaug, Kristianslund, 1995). We have chosen to use descriptive data analysis and empirical testing using regression model to assess the impact of institutional investors on financial performance based on cross-sectional analysis. To clearly state methodologies used also gives credibility and trustworthiness to the study.

Through investigating the impact of institutional investors on corporate performance, this study should answer the following question

1. Does the involvement by institutional investors have an impact on corporate financial performance?
2. Is there a difference between the involvement of whole number of institutional investors and board member institutional investors?

### 3.2 Study Procedures

This study is composed of three main processes:

1. Preliminary data collection through preliminary readings about the subject and a literature review was made to stand on the previous writings about the impact of institutional investors on investee companies through reviewing different issues of governance and performance.
2. Research design and methodology through using scientific tools to have the study questions been answered, using regression model.
3. The final stage is the discussion of research results to conclude recommendations.

### 3.3 Regression Model and Definition of variable

First of all, we can express the regression model by the following equation,

$$Q = \alpha + \beta_1 \text{debt} + \beta_2 \text{NIG} + \beta_3 \text{IR} + \beta_4 \text{NII} + e$$

Where  $\alpha$  is the vertical intercept,  $\beta$  is the regression coefficients and  $e$  is the error term.

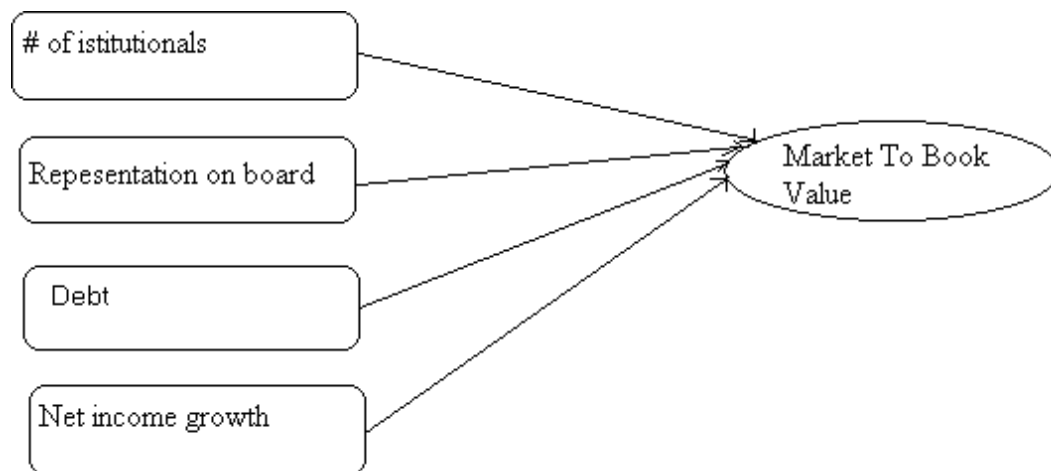
**Dependent variable:** Tobin's  $q$ : is one of the popular measures of corporate financial performance, it is calculated as (market capitalization divided by corporate net worth). A ratio devised by James Tobin of Yale University, Nobel laureate in economics, who hypothesized that the combined market value of all the companies on the stock market should be about equal to their replacement

costs. The Q ratio is calculated as the market value of a company divided by the replacement value or (net worth) of the firm's assets:

$$Q = \text{market value of firm} / \text{corporate net worth}$$

For example, a low Q (between 0 and 1) means that the cost to replace a firm's assets is greater than the value of its stock. This implies that the stock is undervalued. Conversely, a high Q (greater than 1) implies that a firm's stock is more expensive than the replacement cost of its assets, which implies that the stock is overvalued. This measure of stock valuation is the driving factor behind investment decisions in Tobin's model. ([www.investopedia.com](http://www.investopedia.com)).

The following figure is the theoretical framework of the study,



**Figure 1: theoretical framework**

**Independent variables**

**Dependent variable**

### **Independent variables**

**IR:** is the institutional investors represented on the board of the investee company.

**NI:** is the whole number of institutional investors holding a particular stock in specific year.

### **Control variables**

**Debt:** is measured as (total debt / total assets). It is a measure of firm's indebtedness, the proportion of the investments financed by debt, finance literature revealed that this variable have some impact on firm's value. we can note here that debt variable in this study is taken as total liabilities over total assets, because almost no long-term debt used by Palestinian companies.

**NIG:** Net Income Growth =  $(NI_t - NI_{t-1}) / NI_{t-1}$  is the growth in net income after tax between the two years.

## **3.4 Sample of the study**

The sample for the regression model were 22 randomly selected PSE listed companies, four of them were dropped because of the lack of information and newly listed firms, with giving an attention for selecting companies that have available information in the period of the study. A cross-sectional regression analysis is used to asses the impact of the existence of institutional investors on corporate financial performance measured by Tobin;s q. Running the cross-sectional regression in three years 2005, 2006 & 2007. Data for regression variables were obtained from the PSE year book 2006, corporate annual reports for regression variables in 2007, and PSE website.

For the purpose to achieve the research objectives, this study followed scientific approach to assess the impact of institutional investors on corporate performance in the Palestinian listed companies in terms of the number of institutional investors as one of the governance issues. This study is considered a descriptive, exploratory and quantitative based research to describe the characteristics of the variables of interest in a certain situation using empirical testing with regression model.

Regression model is used to as an explanatory tool to establish correlations between a number of variables. In this particular thesis, the explanatory part is presented through the relationship between the involvement by institutional investors and the Tobin's q (M/B as a measure of performance) to answer the question "is there an impact of the existence of institutional investors on corporate financial performance"?

### **3.5 Data Collection**

Data collection is one of the important parts in the research process by which the researcher can accumulate empirical data as a base to formulate his particular research theoretical framework.

Here, in this research we chose to use quantitative approach for collecting primary data using empirical testing by regression analysis. The following is a detail for collecting secondary & primary data.

**Secondary Data**

Secondary data which refers to the literature review is an important part in data collection phase in order to formulate a conceptual view of what has been written about the research problem and it helps to use the appropriate methodology.

Regarding this study, it depended on corporate annual reports for companies under investigation listed on the PSE and also depended on PSE 2006 report for Palestinian listed companies, to get the variables to run the regression.

Articles are important source for literature; it was also used to explain the most important concepts regarding the topic and to accumulate knowledge that helps in developing the theoretical framework.

**Primary Data**

In order to capture the impact of institutional investors on corporate performance, the empirical testing will be used through regression analysis. A cross-sectional analysis for three years will be conducted for 18 selected companies listed on the PSE. This regression is to investigate the correlation between institutional investors and corporate performance measured by Tobin's q as a dependent variable and number of institutional investors holding a particular stock & institutional investors represented on board as independent variables and as corporate governance issues, other independent control variables that seem to affect the dependent variable will be used also, these control variables are debt measured by (total debt / total assets), and the net income growth measured as the percentage change in net income between two years. More details about the variables, justification for use, analysis and results will be discussed in the next chapter (data results & analysis).

It is important to note that not only institutional investors represented on board were considered, but all of them since that there may be institutional investors who are influential but not represented on board.

In this thesis we use two independent variables to investigate the impact of institutional investors' involvement. The first is the whole number of institutionals who are investing in a particular stock. The second is the number of institutionals represented on the board of the investee company. The second one is used to measure the impact of institutional shareholders on performance of investee companies, since they hold significant shares that they can influence management decision and better ability to monitors top management and other board members, then improve performance. It's important to answer the question, who watches the watchers? This is the role of institutional investor set on board to watch other board members and management. Here is to distinguish between the impact of the whole institutional investors and the institutional investors represented on boards, and do the institutional investors represented on board of the investee company really improve performance?

It is important to mention here that large institutional investors are taken as the representation on board rather than investors holding more than 5% of firm's capital or top ten institutional investors for two reasons, the first is that they have better ability to monitor performance and in general they couldn't set on board unless they hold a significant portion of shares, the second is the lack of information about the ownership distribution for the listed companies in Palestine before 2007.

Finally, we were preparing to classify institutional investors as indicated in the finance literature that represents financial institutions which includes mutual funds, pension funds, banks, and insurance companies, but the limitation of small size market of Palestine and the absence of that classification on the PSE database have limited my work in this thesis, as a result we generalized the definition of institutional investors to include financial institutions and other corporate investors.



## **4 CHAPTER FOUR: RESULTS & ANALYSIS**

## 4.1 Introduction

In this chapter, the results of the empirical studies will be discussed and analyzed with the connection of the theoretical framework. I will also add my results with discussion with other studies.

This chapter will be classified into two main parts; the first discusses the size of institutional investors in the Palestine Securities Exchange.

The second attempts to answer the question regarding the relationship between institutional investors and corporate performance measured by Tobin's  $q$  by empirical testing using cross-sectional regression analysis.

Part one: that deals with the size of institutional investors in Palestinian market, a set of data has been collected from the PSE annual report for Palestinian listed companies, these data have been integrated in a meaningful manner that help for better understanding their relative size, and a table has been developed summarizing their percentage holding in the PSE listed companies (see appendix). As of April 27 2008, the total percentage holding by institutional investors in Palestinian listed companies reached 53 % which represents 1162.3 millions JD as indicated in the table (20, appendix)), which can be classified into local institutional investors account for 20.4 % of total market capitalization in that date which represents 446.7 millions JD, and foreign institutional investors with a total percentage holding reached 32.6 % of total market capitalization that represents 715.7 millions JD.

As indicated above, institutional investors hold a significant percentage of total market, so they can have a significant role to affect the investee companies. What

they really do to affect corporate governance and performance; this is what we will see in the next two parts of the analysis.

Part two: the second part tries to answer if there is a relationship between institutional investors and corporate performance. The measures of institutional investor ownership follow those used in Hartzell and Starks (2003). I find the total number of institutional investors holding a particular stock and the other is the number of institutional investors represented on Investee company's board for three consecutive years 2005, 2006, and 2007. Another measure was used which was the percentage holding of a particular stock by institutional investors, but it seemed to be the same as the representation on board, and the correlation matrices revealed a high correlation between them, as a result, the percentage holding variable was omitted. Other control variables were omitted as a result of multicollinearity and immaterial impact on the dependent variable like sales growth, market value of the investee company, and other variables.

I estimate a multivariate regression in which Tobin's q in each year is a function of various corporate variables. My particular focus is the impact of the number of institutional investors on performance. I run a regression for the three years 2005, 2006 & 2007 separately for 18 observations in each year. Consistent and significant findings were found in 2005 & 2006 about the relationship between the number of institutional investors and performance.

## 4.2 Regression Results

### 4.2.1 2005 Analysis

**Table 2: Descriptive Statistics 2005**

	N	Minimum	Maximum	Mean	Std. Deviation
Market to Book	18	.51	6.81	2.2778	1.60129
Debt	18	3.0	85.0	31.611	23.2737
Number of institutionals	18	5	143	38.61	42.932
Net income growth	18	-195	3340	503.83	1020.061
Representation on board	18	0	13	5.78	3.889
Valid N (list wise)	18				

**Table 3: Correlations matrix 2005**

		Market to Book	Number of institutionals	Net income growth	Representation on board	Debt
Market to Book	Pearson Correlation	1	.651(**)	-.133	-.073	.018
	Sig. (2-tailed)	.	.003	.599	.775	.944
	N	18	18	18	18	18
Number of institutionals	Pearson Correlation	.651(**)	1	-.132	.389	-.046
	Sig. (2-tailed)	.003	.	.600	.110	.856
	N	18	18	18	18	18
Net income growth	Pearson Correlation	-.133	-.132	1	.047	.191
	Sig. (2-tailed)	.599	.600	.	.852	.447
	N	18	18	18	18	18
Representation on board	Pearson Correlation	-.073	.389	.047	1	-.033
	Sig. (2-tailed)	.775	.110	.852	.	.897
	N	18	18	18	18	18
Debt	Pearson Correlation	.018	-.046	.191	-.033	1
	Sig. (2-tailed)	.944	.856	.447	.897	.
	N	18	18	18	18	18

\*\* Correlation is significant at the 0.01 level (2-tailed).

For the correlation matrix shown in table (3) for 2005, we can say that the only significant correlation is between number of institutional investors and corporate performance measured by Tobin's q, this relationship shows a correlation coefficient 0.65 with 0.003 significance at 1% significance level. These results are enforced by 2006 results. So in the two years 2005 & 2006, there is a significance correlation between the whole number of institutional investors and corporate performance.

**Table 4: Model Summary 2005**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.742(a)	.551	.413	1.22689

a Predictors: (Constant), Representation on board, Debt, Net income growth, Number of institutionals

**Table 5: ANOVA(b)**

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	24.022	4	6.005	3.990	.025(a)
	Residual	19.568	13	1.505		
	Total	43.590	17			

a Predictors: (Constant), Representation on board, Debt, Net income growth, # of institutionals

b Dependent Variable: Market to Book

**Table 6: Coefficients(a)**

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	1.949	.688		2.834	.014
	Net income growth	.000	.000	-.018	-.093	.927
	Number of institutionalism	.030	.008	.799	3.908	.002
	Debt	.003	.013	.046	.242	.813
	Representation on board	-.157	.084	-.381	-1.878	.083

a Dependent Variable: Market to Book

Looking to 2005 regression results, We can say that there is a moderate exploratory power for the whole regression, but still significant. Adjusted  $R^2 = 41\%$ , means that only 41% of changes in the market value of Palestinian listed companies are due to changes in all exploratory variables (debt, whole number of institutional investors, number of institutionals represented on board, and net income growth). So we can accept the exploratory power of the whole regression as long as F-statistics is below 0.05, and it is 0.025. as a result we reject the null hypothesis (H0) and accept the alternate one (H1) that says: ***There is statistically significant relationship between number of institutional investors and the corporate performance measured by Tobin's q.***

Moving to the coefficients table which shows the importance of each independent variable in the explaining the changes in the dependent variable. The most important influential exploratory variable is the whole number of institutional investors, we can see a positive significant relationship between the whole number of institutional invertors holding a particular stock and market to book value as a measure of performance, the regression coefficient is 0.03 and 0.002 significance. These consecutive results shows the importance of the number of institutional investors holding the stock, and it is enforced by the negative but insignificant relationship between the number of institutional investors represented on board and firm's performance, so it is important to have a large number of institutional investors with diluted ownership (to prevent the concentration of ownership) to positively affect firm's performance. Number of institutional investors represented on board is insignificant; it shows a negative relationship between representation

on board and firm's performance with  $-0.157$  regression coefficient with  $0,083$  significance. These results can be explained in light of the concentration of ownership, when the representation on board by institutionals increase, this would be at the expense of the whole number of institutional investors, making one or two institutional investors control the board and they may need to be monitored by other party. These results reveal that most of Palestinian listed companies are controlled by little number of members who are representatives for institutional investors, that they become not caring about monitoring management and board.

The following graph shows the clear relationship between the whole number of institutional investors and corporate performance measured by Tobin's  $q$ . this relationship is significant on both logarithmic and linear calculations, this relationship is significant in 2005 and 2006.

## Curve Fit 2005

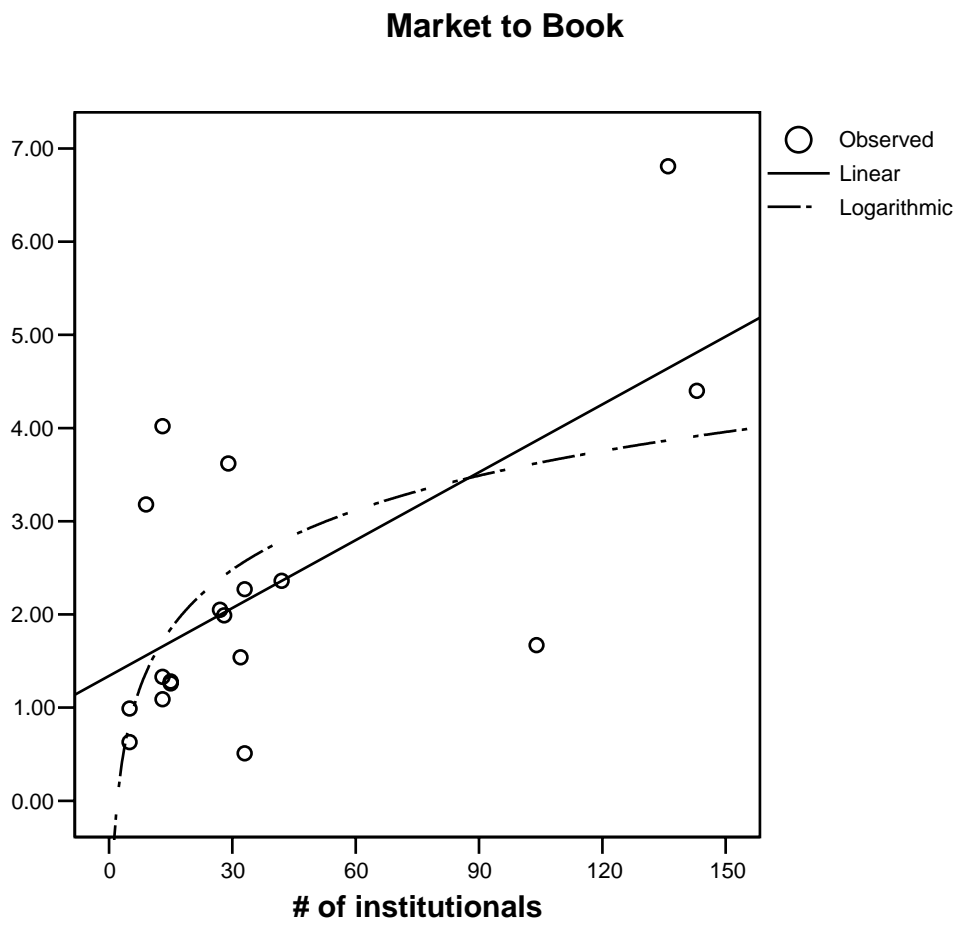


Figure 2: 2005 regression graph



#### 4.2.2 2006 Analysis

**Table 7: Descriptive Statistics 2006**

	N	Minimum	Maximum	Mean	Std. Deviation
Market to Book	18	.48	2.87	1.4134	.67122
Debt	18	.0	77.0	29.967	21.6167
Numberof institutionals	18	4	153	42.17	46.795
Net income growth	18	-770	1212	53.83	423.570
Representation on board	18	0	13	6.28	3.982
Valid N (listwise)	18				

The above table represents a descriptive statistics for 2006 variables. 18 observations for each variable. The market to book value variables ranges from 0.48 to 2.87 times, debt varies from 0 to 77% with 22 standard deviation, which means there is a variety in the use of debt by firms in Palestine. A large deviation can be noticed in the net income growth variable which ranges from -770% to 1212% with 423% standard deviation which indicates that there is no earning stability for Palestinian firms due to the political and economic instability. Number of institutional investors variable ranges from 4 to 153 with 47 standard deviation, which means that Palestinian firms vary in there ownership structure regarding the involvement of institutional investors. The last one is the number of institutionals represented on board of investee companies, which varies from 0 to 13, from no institutional representation to full representation on board.

**Table 8: Correlation Matrix 2006**

		Market to Book	Number of institution als	Net income growth	Representat ion on board	Debt
Market to Book	Pearson Correlation	1	.514(*)	-.345	-.329	.044
	Sig. (2-tailed)	.	.029	.161	.182	.862
	N	18	18	18	18	18
Number of institution als	Pearson Correlation	.514(*)	1	-.185	.277	.112
	Sig. (2-tailed)	.029	.	.462	.267	.657
	N	18	18	18	18	18
Net income growth	Pearson Correlation	-.345	-.185	1	-.372	-.227
	Sig. (2-tailed)	.161	.462	.	.129	.366
	N	18	18	18	18	18
Representation on board	Pearson Correlation	-.329	.277	-.372	1	.052
	Sig. (2-tailed)	.182	.267	.129	.	.838
	N	18	18	18	18	18
Debt	Pearson Correlation	.044	.112	-.227	.052	1
	Sig. (2-tailed)	.862	.657	.366	.838	.
	N	18	18	18	18	18

\* Correlation is significant at the 0.05 level (2-tailed).

First of all, a preliminary statistics were conducted for the three data sets. For the year 2006 running the correlation matrix shown in table (8) reveals the interrelations among all variables. There is only one significant correlation among variables. It is between the number of institutional investors in a particular stock and the corporate performance measured by Tobin's q, the matrix shows a positive significant correlation between the two variables, Pearson correlation coefficient is 0.51 with 0.029 significance confident at 5% significance level. This can have a

reasonable explanation which implies that the increase in the whole number of institutional investors with dilution of ownership reduces the probability that large institutional shareholders could collaborate with each other to inversely affect governance issues that are negatively reflected on performance, and then leads to negative impact on share price. When there is a large number of institutional investors, it becomes hard for institutional investors and top management to control the activities of all other institutionals. So when there is a large number of institutionals with de-concentrated ownership, each one would monitor the governance and performance in the investee company separately and objectively from others.

This can be ensured by the negative correlation between the number of institutional investors represented on board in a particular stock and corporate performance. The increase of the number of institutionals represented on the board of a particular company would be at the expense of the whole number of institutional investors, because they can't set on board unless they hold a significant percentage of shares. In general, their holdings are non-tradable shares, and this may affect the fair pricing of shares. If one of the institutional investors represented on board wants to sell his shares, they most likely be sold for existing representative institutional investors without selling on exchange, this act increases the ownership concentration that leads to less disclosure, less governance, and then weak financial performance. Some finance literature indicates that active institutional investors do not set on board and it is not necessarily that each institutional set on board must be active in monitoring.

Sometimes, the increase in the number of institutionals represented on board would be representing the same institutional investor that may change the form of ownership to a subsidiary or affiliate of the investor's company, means that less monitoring and oversight to top management and to the board of directors of the investee company, which would have a negative impact on performance.

Another perspective to analyze and explain the positive impact of the number of institutional investor on performance is the liquidity impact and information asymmetries, the large number of institutionals with de-concentrated ownership makes the stock more actively traded in the stock market, and the increase of the number of sophisticated & well-informed investors would force the stock to be traded on its fair value, because no single one institutional can affect the price significantly without the existence of the fundamental based information. So, the existence of institutional investors will lead to less information asymmetries that lead to better and fair pricing of traded securities. In addition, the increase in the number of institutional investors minimizes the high prices volatility (which results from the concentrated ownership by institutionals), therefore they contribute in price stability rather than high volatility.

The matrix also shows other insignificant relationships among variables, debt has a positive insignificant relationship with M/B value with correlation coefficient 0.044 and 0.86 significance, means that financing with more debt have a weak positive impact on performance.

**Table 9: step-wise regression, 2006**

Model	Variables Entered	Variables Removed	Method
1	Representation on board, Debt, Number of institutionals, Net income growth(a)		Enter

a All requested variables entered.

b Dependent Variable: Market to Book

**Table 10: Model Summary**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.846(a)	.716	.629	.40904

a Predictors: (Constant), Representation on board, Debt, Number of institutionals, Net income growth

**Table 11: ANOVA(b)**

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	5.484	4	1.371	8.194	.002(a)
	Residual	2.175	13	.167		
	Total	7.659	17			

a Predictors: (Constant), Representation on board, Debt, Number of institutionals, Net income growth

b Dependent Variable: Market to Book

**Table 12: Coefficients(a)**

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	1.904	.253		7.523	.000
	Net income growth	-.001	.000	-.508	-3.104	.008
	Number of institutionalism	.009	.002	.622	4.010	.001
	Debt	-.003	.005	-.105	-.692	.501
	Representation on board	-.115	.028	-.685	-4.182	.001

Further more, going to the exploratory power of the regression as whole as shown in table (10), for the year 2006, a diagnostic statistics are found by the regression, the adjusted  $R^2$  is 0.63, this acceptable exploratory power is enforced by the F-test with 0.002 significance, so we can say that the model explains 63% of changes in dependent variable or 63% of changes in Tobin's q are due to the changes in the above independent variables. From the coefficient we can see that there are three significant relationships between dependent and independent variables, the first significant one is the positive relationship between the number of institutional investors and the firm's performance measured by Tobin's q with 0.009 regression coefficient and 0.001 significance, the second is negative significant relationship between net income growth and firm's performance with -0.001 regression coefficient and 0.008 significance, the third one is the negative significant relationship between the number of institutional investors on board and performance with -0.115 coefficient and 0.001 significance. These results are accepted as long as their significance is below 0.05. These results can be explained in light of the weak efficiency of the Palestine Securities Exchange. Its important to have a large number of institutional investors, but still there is a lack of knowledge among various investors about the good impact of earning growth and the market does not distinguish between growing and non-growing companies.

As a result of the above findings for the 2006 regression, we reject the null hypothesis (H0) and accept the alternate one (H1) which states that *There is*

*statistically significant relationship between number of institutional investors and the corporate performance measured by Tobin's q.*

So we can conclude that there a relationship between these significant independent variables (number of institutionals, net income growth, and institutionals on board) and the market value of Palestinian listed firms, and we can express the relationship by the following equation

$$\mathbf{Q = 1.904 - 0.001NIG - 0.115IR + 0.009NII}$$

The following graph represents the relationship between the number of institutional investors and corporate performance for 2006; we can see that there is a clear positive relationship between the two variables using linear and logarithmic math, and the relationship is significant in both curves.

## Curve fit 2006

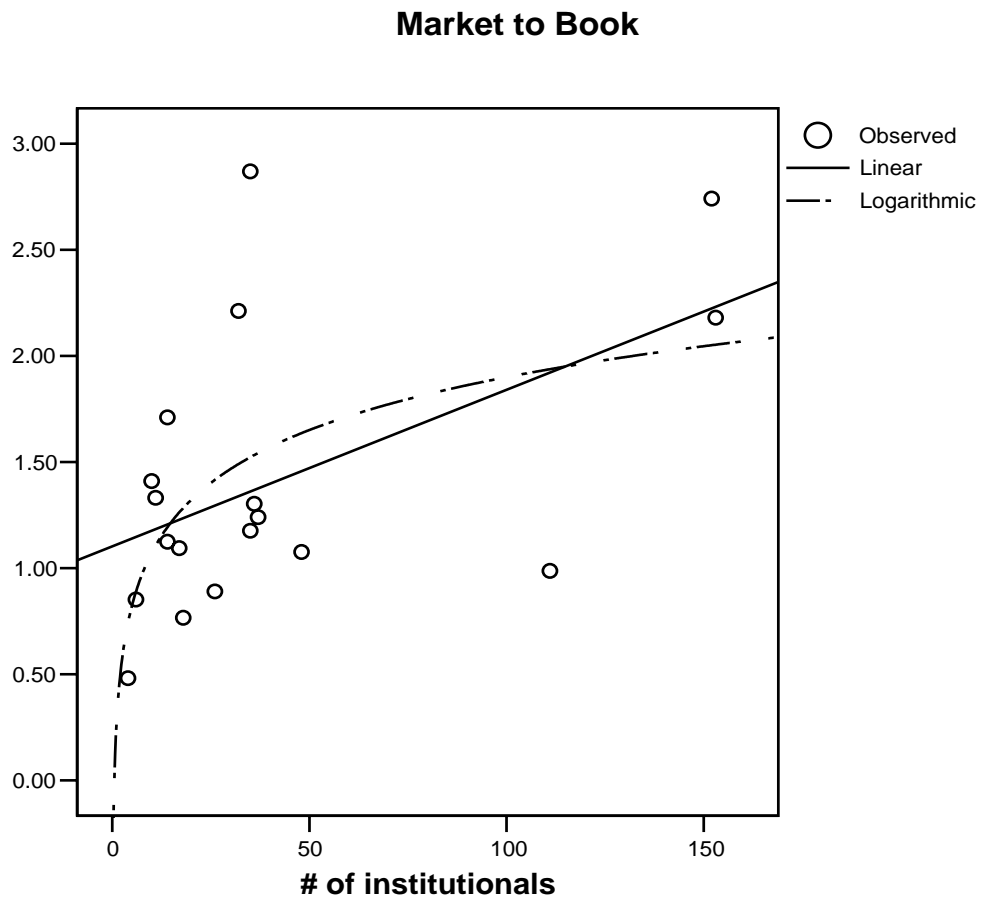


Figure 3: 2006 regression graph



### 4.2.3 2007 Analysis

**Table 13: Correlation Matrix 2007**

		Market to Book	Number of institutionals	Net income growth	Representation on board	Debt
Market to Book	Pearson Correlation	1	.115	-.085	-.338	.466
	Sig. (2-tailed)	.	.650	.736	.170	.051
	N	18	18	18	18	18
Number of institutionalism	Pearson Correlation	.115	1	-.189	.323	-.020
	Sig. (2-tailed)	.650	.	.453	.191	.939
	N	18	18	18	18	18
Net income growth	Pearson Correlation	-.085	-.189	1	-.120	-.364
	Sig. (2-tailed)	.736	.453	.	.636	.137
	N	18	18	18	18	18
Representation on board	Pearson Correlation	-.338	.323	-.120	1	-.029
	Sig. (2-tailed)	.170	.191	.636	.	.910
	N	18	18	18	18	18
Debt	Pearson Correlation	.466	-.020	-.364	-.029	1
	Sig. (2-tailed)	.051	.939	.137	.910	.
	N	18	18	18	18	18

2007 correlation matrix shows no significant correlations among all dependent and independent variables. The relationships and correlations in the above correlation matrix are in the same direction of 2005 & 2006 impact but are insignificant. Number of institutional investors has a positive but insignificant correlation with market to book value with 0.115 correlation coefficient and 0.65 significance. Number of institutionals represented on board also has the same direction of impact as in 2005 & 2006; it has a negative but insignificant

correlation with corporate performance with -0.338 correlation coefficient and 0.17 significance.

**Table 14: Model Summary**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.624(a)	.389	.201	.74003

a Predictors: (Constant), Representation on board, Debt, Number of institutionals, Net income growth

**Table 15: ANOVA(b)**

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	4.529	4	1.132	2.068	.144(a)
	Residual	7.119	13	.548		
	Total	11.649	17			

a Predictors: (Constant), Representation on board, Debt, Number of institutionals, Net income growth

b Dependent Variable: Market to Book

**Table 16: Coefficients(a)**

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	1.019	.471		2.167	.049
	Net income growth	.000	.000	.099	.413	.686
	Number of institutionalism	.005	.004	.272	1.170	.263
	Debt	.016	.008	.495	2.115	.054
	Representation on board	-.084	.048	-.400	-1.741	.105

a Dependent Variable: Market to Book

The results for 2007 regression reveal a weak exploratory power. The adjusted  $R^2 = 0.201$  with 0.144 significance and F statistics 2.209 at 5% significance level, this indicates that there is a weak relationship between all independent variables and the dependent variable, and a small portion (0.201) of performance in Palestinian listed companies can be explained by the changes in the independent variables. The coefficients table for 2007 shows no single significant variable, no

single on has a material impact to explain the changes in market value for Palestinian listed companies. Net income growth shows no relationship with zero regression coefficient and 0.69 significance. The whole number of institutional investors and institutionals represented on board are with insignificant relationship with performance but in the same direction with 2006 & 2005 regression results. Debt is also unable to explain changes in the dependent variable; its regression coefficient is 0.016 with 0.054 significance.

Based on the above findings, we can see that there is no relationship between dependent and independent variables, and thus we accept the null hypothesis (H<sub>0</sub>) that states *there is statistically insignificant relationship between number of institutional investors and the corporate performance measured by Tobin's q*. this result can be explained that the Palestine Stock Market does not distinguish listed companies on the bases of the number of institutional investors holding the stock, means that a lack of knowledge in Palestine about the true impact of institutional investors in how they positively affect governance issues and that would be reflected corporate performance.

The following graph shows the weak relationship between the whole number of institutional investors investing in a particular stock and the performance of investee companies. This relationship is weak and insignificant for both logarithmic and linear calculations. It shows no difference in performance between small and large number of institutional investors.

## Curve Fit 2007

## Market to Book

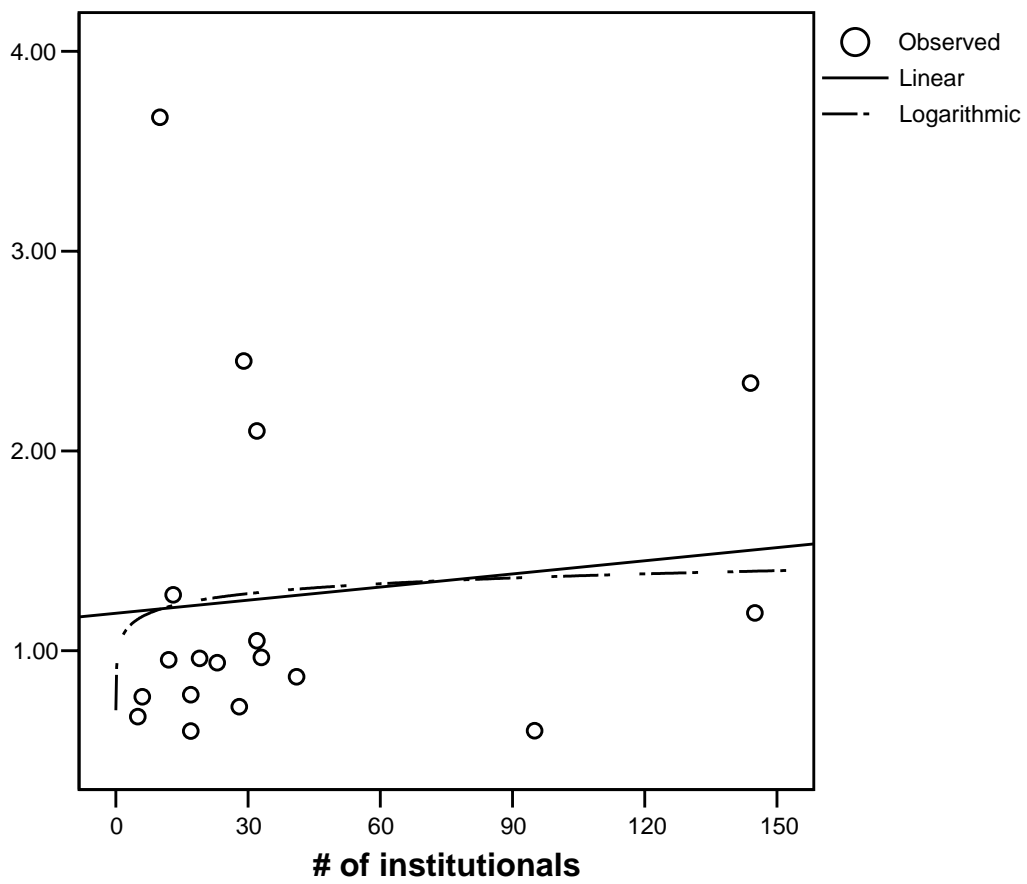


Figure 4: 2007 regression graph

**Table 17: Summary of regression results**

		<b>Regression</b>	<b>NII</b>	<b>IR</b>	<b>NIG</b>	<b>Debt</b>
<b>2005</b>	<b>Adjust R<sup>2</sup></b>	0.413				
	<b>Sig</b>	0.025	0.002	0.083	0.927	0.813
	<b>B</b>		0.03	-0.157	0	0.003
<b>2006</b>	<b>Adjust R<sup>2</sup></b>	0.63				
	<b>Sig</b>	0.002	0.001	0.001	0.008	0.501
	<b>B</b>		0.009	-0.115	-0.001	-0.003
<b>2007</b>	<b>Adjust R<sup>2</sup></b>	0.201				
	<b>Sig</b>	0.144	0.263	0.105	0.686	0.054
	<b>B</b>		0.005	-0.084	0	0.016

In sum, as discussed earlier the regressions for 2006 & 2005 show a significant relationship between the dependent and independent variables, the significant positive relationship is between the number of institutional investors in a particular stock and firm's performance was ensured in 2005 & 2006, number of institutionals represented on board is also with significant but negative relationship with performance in 2006 only, therefore we reject the null hypothesis and accept the alternate one.

Number of institutionals as a one of the corporate governance issues was tested in this research, increasing the number of institutional investors will improve the governance practices and hence will have a positive impact on corporate value by decreasing the conflict that may arise between small and large institutional investors. Increasing the number of institutionals at the expense of the percentage holding (de-concentration of ownership) will have a liquidity effect by buying and selling shares when they believe that the stock is under or over-valued enhancing

the stock to be traded on its fair value. The results of 2006 regression seem to be consistent with other studies making this study to add a value to the literature about the field of institutional investors and corporate performance.

For 2007 regression analysis, its results does not support the exploratory power, the overall regression was insignificant at 5% significance level.

Overall, this study did not generate consistent findings, also in this field did not generate conclusive evidence about the true relationship between institutional investors and corporate performance, so further research is needed using other methodologies like time series analysis or considering more companies and years in the sample.

## **5 CHAPTER FIVE: CONCLUSIONS & RECOMMENDATIONS**

## **5.1 Introduction**

The purpose of this chapter is to try to answer the research issues: what is the size of institutional investors in Palestine Securities Exchange? Does involvement by institutional investors have an impact on corporate financial performance? Is there a difference between the involvement of whole number of institutional investors and board member institutional investors? And then recommend some suggestions to be taken on the regard of the study.

## **5.2 Conclusions**

It concludes the previous chapters' discussions regarding the role of institutional investors to influence corporate performance in investee companies.

From the previous analysis, institutional investors are the majority owners of most corporations listed on Palestine Securities Exchange. The results presented in this thesis show contradiction findings. In one hand, it revealed a significant positive relationship between the whole number of institutional investors and corporate performance measured by Tobin's q, this result was found in 2005 & 2006, but not in 2007. On the other hand, a significant negative relationship was found between the number of institutional investors represented on the board of investee companies and firms performance in 2006 only. These results can be explained in light of some dimensions; liquidity & information asymmetries, ownership concentration, results show also that net income growth has a negative relationship to corporate performance. The results are somewhat consistent with



other studies but are inconclusive findings, results for the number of institutional investors are consistent with existing evidence, other variables' results are somewhat consistent or less consistent due the weak efficiency in the securities market in Palestine.

It was found that there is an ownership concentration by some institutional investors in Palestine that may lead to a conflict of interest between large and small shareholders, it was found that one or two institutional investors control the board of investee companies, or it may increase its holding making the investee company a subsidiary or affiliate and then "who watches who?" and "who watches the watchers" , in which previous studies revealed that active institutional investors always do not set on boards

The inconclusive findings in this thesis are not surprising, given the limited scope of the research in this topic, taking into consideration the weak efficiency of Palestine Securities Exchange & the lack of knowledge about the true impact of institutional investors involvement, and the newly born & small size of Palestine Securities Exchange that make it easy to be controlled by few number of large institutional investors.

### **5.3 Recommendations**

**Based on the above findings, we recommend the following,**

- Give more attention to the large institutional holding, since that there is a positive relationship between the whole number of institutional investors

and corporate performance. And a negative one between institutionals represented on board and performance.

- The Capital Market Authority and Palestine Securities Exchange management should set regulations that prevent a percentage holding of share in investee companies to protect the control by few institutional investors.
- To have better monitoring by large institutional investors, they should not set on board of investee companies in order to have wider bird's view image.
- It is important to work on knowledge and informative programs about the good impact of the large number of institutional investors and the bad impact of few large institutional investors who controls boards of investee company, enhancing low governance practices.

#### **5.4 Suggestions for further research**

This thesis deals with the role of institutional investors on the performance of companies in which they invest. In order to have a wider picture about the true impact of institutional, further researches are needed to be conducted using other methodologies like using time series analysis before and after the institutional investors involvement, or using the same methodology by considering more companies or more years in the sample. Other studies are needed to relate institutional investors' involvement and ownership concentration. It is important

to conduct studies about the impact of institutional investor on the take over process of investee companies, do they really protect from the hostile take over?

Another important area of research is needed to answer the questions, who leads to who? Institutional investors lead to better performance, or better performing company attracts more institutional investors and who watches the watcher? And conduct studies about the difference between the impact of local and foreign institutional investors.

## 5.5 References

- Abarbanell, J., Bushee, B. And Ready, J., 2003, Institutional Investor Preferences and Price Pressure: the Case of Corporate Spin-Offs, *Journal of Business* 76. 233-261.
- Abdelkarim, N. Alawneh, S, 2007, The Relationship between Ownership Concentration and Corporate Performance in Palestine: Empirical Evidence in Supporting of Change, working paper, P4-15.
- Aggarwal, R., Prabhala, N. And Puri, M., 2002, Institutional Allocation in Initial Public Offerings: Empirical Evidence, *Journal of Finance* 57. 1421-1442.
- Agrawal, A., and C.R. Knoeber, 1996. Firm performance and mechanisms to control agency problems between managers and shareholders. *Journal of Financial and Quantitative Analysis* 31. 337-397.
- Akerlof, G., 1970, The Market for Lemons: Qualitative Uncertainty and the Market Mechanism, *Quarterly Journal of Economics* 84.228-300.
- Almazan, A., J. Hartzell, and L.T. Starks, 2005. Active institutional shareholders and cost of monitoring: Evidence from managerial compensation. Working paper, University of Texas at Austin.
- Arosio, R., Giudici, G. And Paleari, S., 2001, The Market Performance of Italian ipos in the Long-Run, unpublished working paper.
- Azzam, H, 2007, The Importance of Attracting More Institutional Investments to Arab Stock Markets, *Al-Khaleej Newspaper*, UAE.

- Badrinath, S. And Wahal, S., 2002, Momentum Trading by Institutions, *Journal of Finance* 57. 2449-2478.
- Benveniste, L. And Spindt, P., 1989, How Investment Banks Determine the Offer Price and Allocation of New Issues, *Journal of Financial Economics* 24. 343-362.
- Benveniste, L. And Wilhelm, W., 1990, A Comparative Analysis of IPO Proceeds under Alternative Regulatory Environments, *Journal of Financial Economics* 28. 173-207.
- Berle, A.A and Means, G.C, 1932, *The Modern Corporations and Private Property*, Macmillan, New York. Macmillan.
- Bernard Black, 1998, Shareholder Activism and Corporate Governance in the United States. *The New Palgrave Dictionary of Economics and the Law* 459.
- Bohl, M. And Brzeszczyński, J., 2004, Do Institutional Investors Destabilize Stock Prices? Emerging Market's Evidence against a Popular Belief, working paper.
- Bolton, P., and E. Von Thadden, 1998, "block, liquidity, and corporate control", *Journal of finance* 53. 314-330.
- Borkovich, K., K. Brunarski, and R Parrino, 2000. Variation in the monitoring incentives of outside blockholders. Cleveland State University, Miami University, and University of Texas Working Paper.

- Brennan, M. And Subrahmanyam, A., 1996, Market Micro Structure and Asset Pricing: on the Compensation for Illiquidity in Stock Returns, *Journal of Financial Economics* 41. 441-461.
- Brickley, J., R. Lease, and C. Smith, 1988. Ownership structure and voting on antitakeover amendments. *Journal of Financial Economics* 20, 267-292.
- Bushee, B. And Noe, C., 2000, Corporate Disclosure Practices, Institutional Investors and Stock Return Volatility, *Journal of Accounting Research* 38. 171-202.
- Butler, A., Grullon, G. And Weston, J., 2002, Stock Market Liquidity and the Cost of Raising Capital, working paper.
- Chen, X., J Harford, and K. Li, 2005. Monitoring: Which Institutions Matter? University of British Columbia Working Paper.
- Cohen, R., Gompers, P. And Vuolteenaho, T., 2002, Who Under Reacts to Cash Flow News? Evidence from Trading between Individuals and Institutions, *Journal of Financial Economics* 66. 409-462.
- Combined Code, 2006, The Combined Code on Corporate Governance, Financial Reporting Council, London.
- Cornelli, F. And Goldreich, D., 2001, Bookbuilding and Strategic Allocation, *Journal of Finance* 56. 2337-2369.
- Cornett, M.M, Marcus, J.A, Saunders, A & Tehrania, H, 2005, The Impact of Institutional Ownership on Corporate operating Performance, *Journal of finance* 41. 215-231.

- Corporate annual reports for companies listed on the PSE, 2005, 2006 & 2007.
- Dalton, D.R., Daily, C.M., Ellstrand, A.E. and Johnson, J.L, 1998, ‘Meta-Analytic Reviews of Board Composition, Leadership Structure, and Financial Performance’, *Strategic Management Journal* 19, No. 24. 64-80.
- David, P., and R. Kochhar, 1996, “Barriers to effective corporate governance by institutional investors: Implications for theory and practice”, *European Management Journal*, 14. 157-165.
- Davis E P & Steil B (2001) "institutional investors" MIT press.
- Deutsche Bank, 2004a, Global Corporate Governance Research, ‘Beyond the Numbers – Corporate Governance in the UK’, February 2004.
- Diamond, D. And Verrecchia, R.E., 1991, Disclosure, Liquidity and Cost of Capital, *Journal of Finance* 46. 1325-1359.
- Dobson, G.R., 1994, The Global Investor, Opportunities, Risks and Realities for Institutional Investors in the World’s markets, Probus Publishing Company, Cambridge.
- Downes, JR, Houminer, E and Hubbard, G.R, 1999, Institutional Investors and Corporate Behavior, AEI press, Washington.
- Eckbo, E. And Norli, O., 2000, Debt, Liquidity, and Long-Run IPO Returns, working Paper.
- Eleswarapu, V. And Reingaum, M., 1993, The Seasonal Behaviour of the Liquidity Premium in Asset Pricing, *Journal of Financial Economics* 34. 373-386.

- Fabozzi, F.J. & Modigliani, F., (1992) Capital markets: institutions and instruments, Prentice-Hall, Inc., New York.
- Ghuari, Pervez, Gronhuag, Kjell, and Kristianslund, Ivar. (1995). Research methods in business studies, a practical guide. Great Britain. Prentice Hall. P77-83.
- Gilson & Kraakman, 1991, Reinventing the Outside Director: An Agenda for Institutional Investors, 43 Stan. L. Rev. 863-906.
- Gompers P.A., Ishii, J.L., and Metrick, A, 2003, 'Corporate Governance and Equity Prices', *Quarterly Journal of Economics*, Vol. 118. 312-341.
- Gompers, P. And Metrick, A., 1998, How are Large Institutions Different from Other Investors? Why do these Differences Matter?, working paper, (Harvard Institute of Economic Research).
- Gompers, P., and A. Metrick, 2001, "Institutional investors and equity prices", *Quarterly Journal of Economics* 116. 503-515.
- Greenbury, Sir Richard, 1995, Directors' Remuneration, Gee & Co. Ltd., London.
- Hebb, G.M., mackinnon, G.H., 2004, Valuation Uncertainty and ipos: Investment Bank versus Commercial Bank Underwriters, *Journal of Economics and Finance* 28. 68-87.
- Hirschman, A.O, 1970, Exit, Voice, and Loyalty, Harvard University Press, Cambridge, Massachusetts.
- Huyghebaert, N& Hulle, C. 2004, The Role of Institutional Investors in Corporate Finance, *Journal of economics & management*, Vol 4. 334-360.



- Huyghebaert, N. And Van Hulle, C., 2002, Structuring the IPO: Empirical Evidence on the Portions of Primary and Secondary Shares, working paper.
- Keloharju, M. And Torstila, S., 2002, The Distribution of Information Among Institutional and Retail Investors in ipos, *European Financial Management* 8. 357-372.
- La porta, R., F. Lopez-de-Silanes and A. Shleifer, 1999, “Corporate ownership around the world”, *Journal of finance* 54. 98-111.
- Leech, D, 2000, Shareholder power and corporate governance, University of Warwick, Warwick Economics Research.
- Ljungqvist, A. And Wilhelm, W., 2002, IPO Allocation: Discriminatory or Discretionary?, *Journal of Financial Economics* 65.167-201.
- Loderer, C. And Roth, L., 2003, The Pricing Discount for Limited Liquidity: Evidence from the SWX Swiss Exchange and the NASDAQ, working paper.
- Mallin, C & Runall, T, 2006, The Role of Institutional Investors in Corporate Governance.
- Maug, E., 1998. Large Shareholders as Monitors: Is there a trade-off between liquidity and control? *Journal of Finance* 53, 65-98.
- Mckinsey & Co, 2002, Global Investor Opinion Survey: Key Findings, Mckinsey & Co., London.
- Merton, R., 1987, A Simple Model of Capital Market Equilibrium with Incomplete Information, *Journal of Finance* 42.483-510.

- Millstein, I.M. and Macavoy, P.W, 1998, 'The Active Board of Directors and Performance of the Large Publicly Traded Corporation', *Columbia Law Review* 98, No. 21. 412-425.
- Monks, R., and N. Minow, 2001, *Corporate governance*, Oxford: Blackwell.
- Morck, R., A. Shleifer and R. W. Vishny 1988, "Managerial ownership and market valuation: An empirical analysis", *Journal of Financial Economics* 20. 319-339..
- OECD, *Institutional Investors in the New Financial Landscape*, Paris, 1998.
- Parrino, R., R.W. Sias, and L.T. Starks, 2003. Voting with their feet: Institutional ownership changes around forced CEO turnover. *Journal of Financial Economics* 68. 3-46.
- Patterson, D.J, 2000, *The Link Between Corporate Governance and Performance*, year 2000 Update, Conference Board, New York.
- Pinto,M, 2006, *The Role of institutional Investors in the Corporate Governance*, German Working Papers in Law and Economics.
- Potter, G., 1992, Accounting Earnings Announcements, Institutional Investor Concentration and Common Stock Returns, *Journal of Accounting Research* 30. 146-155.
- Redding, L., 1997, Firm Size and Dividend Payouts, *Journal of Financial Intermediation* 6. 224-248.

- Shleifer, A. And R. Vishny, 1986. Large shareholders and corporate control. *Journal of Political Economy* 94, 461-448.
- Sias, R.W., 1996, Volatility and the Institutional Investor, *Financial Analysts Journal* 52. 13-20.
- Tobin, James. 1969. "A General Equilibrium Approach to Monetary Theory." *Journal of Money, Credit, and Banking* 1.15-29.
- Welch, I., 1991, An Empirical Examination of Models of Contract Choice in Initial Public Offerings, *Journal of Financial and Quantitative Analysis* 26. 497-518.
- Welker, M. And Sparks, H., 2001, Individual, Institutional and Specialist Trade Patterns Before and After Disclosure, *Journal of Financial Research* 24. 261-287.

**Websites**

[www.investword.com](http://www.investword.com)

[www.investopedia.com](http://www.investopedia.com)

[www.p-s-e.com](http://www.p-s-e.com)

## **6 APPENDIX**

**Table 18: 2006 regression variables**

Company	Q	Debt	Number of institutionals	Rep on board	NI growth
ACPC	1.41	77	10	4	-28
AHC	1.24	2.4	37	9	296
APC	0.852	25.3	6	1	867
ARAB	1.331	0	11	5	-58
ARE	0.481	21.2	4	3	1212
AZIZA	1.124	26.1	14	10	-80
BPC	2.869	16.8	35	0	-76
GMC	1.176	17.7	35	7	47
JPH	1.71	13	14	0	18
LADAEN	1.094	30.7	17	11	-770
PADICO	2.18	23.8	153	4	-62
PALTEL	2.741	36.9	152	9	-20
PEC	0.987	56.6	111	13	-4
PIIC	0.89	21.8	26	11	-123
PLAZA	0.766	43.5	18	7	144
PRICO	1.076	7.3	48	10	60
QUDS	1.303	63.3	36	5	-360
VOIC	2.212	56	32	4	-94

Source: [www.p-s-e.com](http://www.p-s-e.com), & corporate annual reports

**Table 19: 2005 regression variables**

Company	Q	Debt	Number of institutionals	rep on board	NI growth
ACPC	3.18	85	9	4	11.99
AHC	0.51	6	33	9	11
APC	0.99	25	5	1	-11
ARAB	1.09	3	13	4	-121
ARE	0.63	40	5	3	319
AZIZA	1.33	21	13	10	2735
BPC	3.62	15	29	0	107
GMC	1.54	16	32	8	1000
JPH	4.02	19	13	0	-15
LADAEN	1.26	26	15	6	-189
PADICO	4.4	15	143	4	277
PALTEL	6.81	29	136	10	84
PEC	1.67	59	104	13	-18
PIIC	2.05	12	27	9	1503
PLAZA	1.28	53	15	7	-44
PRICO	2.36	28	42	10	-195
QUDS	1.99	76	28	2	3340
VOIC	2.27	41	33	4	274

Source: [www.p-s-e.com](http://www.p-s-e.com), & corporate annual reports

**Table 20: 2007 regression variables**

Company	Q	Debt	Number of institutionals	rep on board	NI growth
ACPC	3.67	90.8	10	4	-89
AHC	1.05	5.4	32	7	696
APC	0.77	22	6	0	227
ARAB	0.955	4.8	12	5	2096
ARE	0.67	35.6	5	4	-107
AZIZA	0.78	28.2	17	10	327
BPC	2.45	21	29	0	138
GMC	0.967	29.8	33	7	-37
JPH	1.28	13	13	0	-6
LADAEN	0.598	13.5	17	10	-5
PADICO	1.19	23	145	4	-18
PALTEL	2.34	34.2	144	10	17
PEC	0.6	52.7	95	13	-41
PIIC	0.72	19.3	28	11	-133
PLAZA	0.962	55	19	7	-34
PRICO	0.87	6.7	41	10	-70
QUDS	0.94	80.7	23	5	-49
VOIC	2.1	57.6	32	4	322

Source: [www.p-s-e.com](http://www.p-s-e.com), & corporate annual reports

Table 21: Investment distribution in the PSE

					Local institutionalism		Foreign institutionals	
Company	No.of shares	Share price	Market Cap(JD)	%of market cap	%Holding	Amount (JD)	%Holding	Amount (JD)
ACPC	660,000	1.25	825,000	0.0004	35.53	293,123	1.52	12,540
AHC	20,000,000	0.89	17,800,000	0.0081	38.58	6,867,240	29.78	5,300,840
AIB	35,000,000	1.66	58,100,000	0.0265	20.76	12,061,560	39.34	22,856,540
AIE	1,000,000	1.25	1,250,000	0.0006	23.49	293,625	0	0
AIG \$	30,000,000	1.32	2,803,680	0.0013	19.78	554,568	13.1	367,282
AMB \$	30,000,000	1	21,240,000	0.0097	34.86	7,404,264	2.44	518,256
APC	1,500,000	0.93	1,395,000	0.0006	4.58	63,891	0	0
ARAB	9,452,328	0.75	7,089,246	0.0032	74.26	5,264,474	0	0
ARE	948,890	0.51	483,934	0.0002	8.89	43,022	0	0
AZIZA	9,392,330	0.92	8,640,944	0.0039	89.08	7,697,353	4.33	374,153
BOP \$	59,769,737	3.41	144,300,880	0.0658	7.23	10,432,954	11.76	16,969,783
BPC	12,100,000	4.6	55,660,000	0.0254	3.39	1,886,874	2.98	1,658,668
CBP \$	20,000,000	0.8	11,328,000	0.0052	2.86	323,981	1.25	141,600
GMC	15,000,000	0.8	12,000,000	0.0055	31.12	3,734,400	23.7	2,844,000
HOTEL	1,150,000	1.94	2,231,000	0.0010	94.8	2,114,988	0	0
IID	4,000,000	0.47	1,880,000	0.0009	2.42	45,496	0	0
JCC	7,000,000	3.63	25,410,000	0.0116	28.07	7,132,587	1.03	261,723
JPH	5,000,000	5.79	28,950,000	0.0132	15.07	4,362,765	5.34	1,545,930
JREI \$	10,000,000	1.05	7,434,000	0.0034	9.27	689,132	54.65	4,062,681



Company	No.of shares	Share price	Market Cap(JD)	%of market cap	Local institutionals		Foreign institutionals	
					%Holding	Amount (JD)	%Holding	Amount (JD)
LADAEN	7,000,000	0.58	4,060,000	0.0018	84.13	3,415,678	5.56	225,736
MIC \$	6,214,690	0.85	5,282,487	0.0024	29.24	1,544,599	6.82	360,266
NCI	5,000,000	0.4	2,000,000	0.0009	16.6	332,000	22.79	455,800
NIC \$	8,000,000	4.56	25,827,840	0.0118	10.62	2,742,917	1.97	508,808
PADICO \$	250,000,000	2.85	504,450,000	0.2299	9.93	50,091,885	28.43	143,415,135
PALTEL	131,625,000	7.68	1,010,880,000	0.4606	26.26	265,457,088	43.21	436,801,248
PEC \$	60,000,000	1.02	43,329,600	0.0197	70.56	30,573,366	3.81	1,650,858
PIBC \$	40,000,000	1.65	46,728,000	0.0213	6.44	3,009,283	23.17	10,826,878
PID	4,840,419	0.9	4,356,377	0.0020	15.14	659,555	0	0
PIIC	18,750,000	0.81	15,187,500	0.0069	9.06	1,375,988	59.7	9,066,938
PLAZA	5,220,000	0.61	3,184,200	0.0015	82.12	2,614,865	2.56	81,516
PRICO	48,750,000	1.02	49,725,000	0.0227	8.37	4,161,983	69.06	34,340,085
QUDS \$	50,000,000	1	35,400,000	0.0161	6.64	2,350,560	34.74	12,297,960
UCI \$	40,000,000	0.78	22,089,600	0.0101	19.42	4,289,800	25.95	5,732,251
VOIC	3,000,000	2.5	7,500,000	0.0034	15.11	1,133,250	28.97	2,172,750
WASSEL	6,500,000	0.89	5,785,000	0.0026	28.26	1,634,841	13.92	805,272
			<b>2,194,607,287</b>			<b>446,653,952</b>		<b>715,655,496</b>
						<b>0.204</b>		<b>0.326</b>
							<b>0.530</b>	

Source: www.p-s-e .com, & corporate annual reports