

# **INSTITUTIONAL INVESTORS**

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## Introduction and Executive Summary

*"Institutional investors are a permanent feature of the financial landscape, and their growth will continue at a similar, and perhaps faster pace. The factors that underpin their development are far from transitory and in many cases have only just started having an impact. The behavioral characteristics of institutional investors, therefore, will be an increasingly important determinant of domestic and international financial market conditions, and the implications for financial market stability warrant serious consideration"*  
**Bank for International Settlements, Annual Report 1998, p95.**

Undoubtedly one of the most important developments in financial markets in recent years has been the "institutionalization of saving" associated with the growth of pension funds, life insurance companies and mutual funds. This has entailed an increasing proportion of household saving being managed by professional portfolio managers instead of being directly invested in the securities markets, on the one hand, or held in the form of bank deposits, on the other.

Two aspects of institutionalization are covered in this book, namely institutional investment and asset management (also called fund management<sup>1</sup>). Institutional investors may be defined as specialized financial institutions which manage savings collectively on behalf of small investors, towards a specific objective in terms of acceptable risk, return-maximization and maturity of claims. Asset management defines the process whereby assets collected by institutional investors are actually invested in the capital markets. Whereas conceptually these aspects are often bundled together, in fact the asset manager may or may not be a part of the institutional investor in a legal sense. In effect, asset management may be either internal or external to the institution itself.

Given the twin separations between beneficiary and institutional investor and between institutional investor and asset manager, important principal-agent issues may arise. Self interested behavior of agents (such as asset managers) may not always be fully in line with those bearing the risks (such as the corporate sponsors or ultimate beneficiaries). These agency problems give rise in turn to some of the distinctive effects of institutional investors on capital markets. For example, throughout the book, the underlying presumption is that institutional investors operate in efficient capital markets, and indeed their activities may improve market efficiency. However, we also highlight some of the literature on capital market inefficiencies and financial instability more generally, and seek to probe the possible relationship of the behavior of institutional investors - including that linked to principal-agent issues - to such phenomena.

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<sup>1</sup> We use the terms asset management and fund management interchangeably in the text. Other expressions often used broadly for the same function include investment management, money management and portfolio management.

Much of the analysis focuses on the Anglo Saxon countries (notably the US and UK), because institutional investor growth has been most marked there, because regulation is less restrictive and because most academic research has focused on these markets. In a sense, these countries may prove models for the rest of the world. Whereas in the Anglo-Saxon countries the markets for the various types of institutional saving are rather mature, in Continental Europe and to a lesser extent in Japan, there is considerable scope for further development of institutional investment. Both areas are still dominated by pay-as-you-go social security which will ultimately prove unviable. Moreover, Continental Europe is undergoing the structural break of Monetary Union, which by reducing barriers to entry and increasing the integration of markets is providing fertile ground for further development of institutional investors<sup>2</sup>. Emerging market economies also have considerable scope for developing institutional investor sectors, as the example of Chile has shown.

The first three sections of the book, comprising Chapters 1-6, trace the origin, nature and implications of the changes summarized by the term "institutionalization", drawing on experience of the major industrial countries. These changes are considered to be among the key influences on the evolution of financial structure and behavior in recent years. Given that future growth of institutional investors is virtually inevitable in the light of the "aging of the population", the resulting effects are likely to become even more marked in future years. The fourth section of the book, comprising chapters 7 and 8, examines the interrelationship between institutional trading and evolving market structures, focusing in particular on equities.

The text is complemented by a glossary.

In the first chapter, we probe reasons for the **development of institutional investors**. We present data to characterize the growth and size of institutional investors. Then we assess reasons for their growth. Was expansion due to supply-side factors which improved the competitiveness of institutional investors - or were demand factors, which increase the need of the household sector for institutional saving, more prominent? Which was most crucial? Key points raised include:

- *Institutional investors have grown strongly in the past decades, with their claims being valued at 100% of G-7 GDP. They also account for 30% of financial intermediation and 30% of household sector assets. These figures are much higher in countries such as the US and UK, where institutional assets are twice GDP. Convergence of the rest of the G-7 on these levels would accordingly entail massive further expansion of institutional investment.*
- *The evolution of financial systems is appropriately analyzed not only in terms of the traditional view of a shift from banking, through markets to a securitized phase, but also in terms of the functions of*

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<sup>2</sup> See Davis (1998d, 1998g, 1999a and 1999b)

*the financial system. These are functions which the financial system is always called upon to fulfill, regardless of its institutional form. They thus provide a set of constant features underlying both long term developments and more recent trends. Evolution of institutional forms and of financial structure such as the growth of institutional investors may be seen as a form of adaptation and improvement in the ways these functions are fulfilled, under pressure from competitive forces.*

- *In this context, the phenomenon of institutionalization to date can be traced to various supply and demand factors, often linked directly to a better performance of the functions of the financial system by institutional investors, which have made saving via such institutions attractive to households. These include in particular supply side factors such as ease of diversification, improved corporate control, deregulation, ability to take advantage of technological developments and enhanced competition. Some demand side elements also help explain institutional growth, notably demographic developments, growing wealth, fiscal inducements and the difficulties of social security pensions.*
- *A key factor in a forward looking sense will be demographic change linked to difficulties of social security pension systems, which will undoubtedly lead to a vast expansion of institutional investing in the future. In particular, in many countries (notably in Continental Europe) future demographic pressures on pay-as-you go social security are likely to lead governments to seek to stimulate further growth of private pensions as a substitute for social security.*

The second chapter looks at the **performance of asset managers**. It first outlines the broad influences on portfolio management behavior, both in general and for particular types of institution, before assessing performance successively at a micro level (how well do managers perform relative to each other, and compared to passive "indexation"?) and at a macro level (what influences can be detected affecting average portfolios, and what was their effect on performance?)

- *Portfolio management involves a number of tasks, the most crucial of which are asset allocation (portfolio allocation across instruments) and security selection (choice of specific instruments within a given category). There are a large number of elements in common for all types of asset management, but specialized considerations - based on the nature of liabilities - also apply. The contrasting nature of liabilities may prompt investment behavior which not only differs sharply between institutions but also may appear contrary to the predictions of a paradigm assuming simple optimization of a trade-off between risk and return.*
- *Results of academic studies of both mutual funds and pension funds in the US and UK show that active security selection tends to be value deducting - although there may be positive returns to asset allocation. The implication is that use of index funds is optimal. Internal management - whereby the institutional investor also conducts asset management - is also found to be superior to external. More generally, the results support the argument that principal-agent problems are important in asset management (since internal managers are subject to closer monitoring).*

- *Analysis of asset-holdings and returns to pension fund sectors show that a myriad of influences can be identified affecting portfolios. The outcomes differ markedly across countries in terms of rates of return and risk, in a way which is dependent both on these factors affecting asset allocation and the returns on assets themselves. Conclusions concerning optimality of strategies cannot however be simply derived from data on returns and risks given the additional liability-based constraints (such as the need to hedge against shortfall risk) affecting some sectors.*

The third and fourth chapters examine the **industrial structure and dynamics of asset management**. The third chapter assesses what sort of “industry” asset management is. In this context, we present a framework for assessing the nature of competition for financial institutions, in the light of which we characterize the nature of competition for asset managers. Detailed examinations are undertaken of pricing behavior and the industrial structure of the industry, with a particular focus on the US, UK, and Continental Europe. Reasons for the quite marked differences are suggested.

- *Asset management sectors differ sharply between the major OECD countries. There is a notable divide between the Anglo Saxon countries on the one hand and Continental Europe on the other, in terms of the scope of competition. This is reflected in higher fees and a lesser focus on performance in the latter. There are also marked contrasts between the US and UK in terms of active wholesale asset management. In the former, specialist managers are dominant whereas in the latter it is the balanced managers which have up till now tended to predominate. The retail (mutual fund) and generic (non-discretionary wholesale) sectors in the US and UK are much more comparable.*
- *The generic management sectors in the US and UK, as well as balanced wholesale management in the UK resemble contestable markets - large firms predominate due to economies of scale but potential competition and low sunk costs limit fees to a competitive level. Specialized wholesale management in the US and retail asset management in the US and UK are better characterized as monopolistic competition, with rather few economies of scale or entry barriers, and a proliferation of firms with differentiated products.*
- *Continental systems are typically oligopolies, partly as a consequence of regulatory factors but also due to structural entry barriers entailing significant sunk costs of entry to the market (e.g. owing to control of channels of distribution by incumbent banks). Market power means that the firms concerned obtain higher profits than in a free market. Companies sponsoring pension funds on the one hand and consumers on the other are unlikely to remain content with such structures, given the shortfall in performance. Successful penetration of the market by foreign entrants that appears to be underway in Japan may be a forerunner of similar trends in Continental European countries currently dominated by local banks.*

In the fourth chapter **influences on the future of asset management** are analyzed both in terms of industry analyses and the results of a questionnaire sent to global asset managers.

- *Whereas prospects for institutional asset management are favorable, marked structural change is anticipated by a number of analysts. Indeed, a global merger wave is already underway. There are harbingers of potentially major shifts in the organization and behavior of the industry in the US and UK, under pressure from factors such as the shift to defined contribution pensions. There may be a marked impact of EMU on European sectors. There is potential for globalization of the industry, but owing to the numerous entry barriers to foreign markets, and diseconomies of scale in giant firms, this outcome is by no means certain.*
- *Responses to a questionnaire sent to chief investment officers showed that the key elements of competition in asset management are returns relative to competitors and relationships with customers and advisers. Perceived entry barriers in both domestic and foreign markets include existing firms' distribution channels, relationships and reputations; foreign entry is seen as a tougher hurdle than entry to other domestic sectors. Marked further consolidation and globalization of the industry are foreseen. Benefits of size accrue mainly by way of reputation, with benefits of lower operating costs being offset by costs of the market impact of large trades. The future is seen as being strongly influenced by further mergers, advantages of large firms, and increased participation of commercial and investment banks in asset management.*

In the fifth and sixth chapters, we trace the implications of the growth of institutional investors and asset management for the broader economy. In Chapter 5 we assess **implications for capital markets and for banks**, inter alia addressing the issue as to whether growth of institutional investors may directly or indirectly lead to financial instability.

- *Institutional-investor development has had a major impact on capital market size, microstructure and innovation. Institutionalization by this route makes a contribution to the broader efficiency of the economy, by ensuring that the functions of the financial system are carried out in an effective manner.*
- *The banking sector has experienced heightened competition on both the asset and liability side of the balance sheet, owing to the growth of institutional investors. Loss of traditional business has at times been followed by increases in balance-sheet risk on the part of banks, leading to banking crises. We note, however, that heightened risk taking is not the only feasible response, and many banks have taken the more profitable and sustainable route of shifting to non-interest earning activities. These include offering services such as custody and passive asset management to institutional investors themselves.*
- *An increase in average capital market volatility is not detectable with institutionalization, and indeed there is evidence of increased market efficiency. Institutions have matched assets and liabilities which*

*are usually marked-to-market and are generally well-diversified. Accordingly, their development should help improve financial stability relative to a system dominated by banks. On the other hand, institutionalization does seem to be linked to a rise in volatility for stocks held by institutions. Moreover, one-way selling of assets by institutions occurs occasionally, usually following a longer wave of buying and price increases. In liquid markets this may lead to sharp price fluctuations, while in less liquid markets liquidity failure may be the consequence. Such patterns may be linked in turn to sporadic herding behavior by institutions, induced by the types of incentives that portfolio managers face.*

In Chapter 6 we consider the **effects of growth of institutional investors for the non financial sectors**, notably in terms of saving behavior, international capital flows and corporate governance. In this context, we also focus on implications for policy-makers - fiscal authorities, regulators and central banks of the development of institutional investors.

- *It appears that institutional investors have had an impact on the portfolio behavior of the household sector, entailing increasing holdings of longer term instruments - although they have probably had less of an effect on saving itself. One can also identify a sea change in the pattern and locus of international portfolio flows, as banking flows have given way to portfolio flows undertaken by institutional investors.*
- *In corporate finance, major changes are in prospect as institutions impact on bank-based systems of corporate governance. It is suggested that European and Japanese financial systems are likely to shift to an Anglo Saxon paradigm under pressure from institutionalization, although the process will be slow.*
- *On balance, these effects are favorable, as they tend in the direction of greater economic efficiency at a national and - for international investment - at a global level. Some question marks arise in some countries, for example in relation to the lack of institutional investment in small firms. This is, for example, an important aspect of a current UK government investigation into institutional investors (Myners 2000). The effect of “corporate governance activity” on returns is also disputed.*
- *As regards public policy, institutionalization may make fiscal deficits easier to finance, and institutions are also vigilant against “excesses” of fiscal expansionism that generate default risk. Monetary policy makers benefit from this vigilance, but also need to revise their own views of how markets work and regarding indicator properties of yields. Regulatory policy must learn to cope with the potential for instability generated by an institutionalized financial system, while also ensuring by appropriate regulation that the benefits of institutions for financial stability are safeguarded and consumer protection is maintained.*

In chapter 7 we examine the rapidly changing **trading environment** in which institutional investors transact securitized products – in particular, equities. Widespread automation of the trading process over the course of the past decade has had a significant impact on the natural industrial structure of the securities trading industry. Applying a combination of network economics and contestability theory, we explain why and how automation is changing the industry, focusing in particular on the pricing of trading services, changing competitive strategies, trading system architecture, cross-border access, exchange alliances and mergers, exchange governance, and the cost of institutional trading. We illustrate the impact of trading automation on institutional trading costs through a study of five years of trading data from a large US mutual fund operator. We document significant cost savings from the use of nonintermediated electronic trading vehicles, which impact directly on the performance of the operator's funds.

In chapter 8 we examine **institutional trading** in much greater depth. After discussing the significance of trading costs to investment returns, we analyze in detail the components of such costs and how they are measured. We then consider the impact of both the portfolio management function (investment style) and trading function (order handling) on the cost of trading, highlighting the impact of a number of common market practices which limit the incentive for cost minimization in fund management firms. Fiduciary problems and regulatory implications are discussed. We then examine how trading costs are affected by different market structures, such as auction and dealer markets, and highlight the causes of the proliferation of “electronic communications networks” (ECNs) in the United States. We conclude with an analysis of how institutional trading is likely to change in the coming years, drawing out the implications for public policy.