INVESTMENT PREFERENCES OF INSTITUTIONAL INVESTORS

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ABSTRACT

This paper examines the determinants of institutional investment. Firm specific characteristics, information asymmetry level and governance mechanisms are the main determinants that are included in this study. Large firms, firms with low book-to-market-ratio, firms with less leverage, firms with high level of past performance, less volatile firms and firms with high liquidity are chosen by institutional investors. They also invest in stocks which have low level of information asymmetry. Institutional investors prefer to invest in countries with high level of investment protection and strong disclosure requirements. Finally, they give importance to country level governance quality. As a result, they invest in countries with high level of governance quality.

Keywords: *Institutional investors, asymmetric information, governance mechanisms*

JEL Classification: *G11, G23, G30*

KURUMSAL YATIRIMCILARIN YATIRIM TERCİHLERİ

ÖZET

Bu çalışmada kurumsal yatırımcıların yatırım kararlarına etki eden unsurlar incelenmektedir. Şirket özellikleri, asimetrik bilgi seviyesi ve yönetim mekanizmaları çalışmada kullanılan başlıca etkenlerdir. Şirket özelliklerine bakıldığında, büyük firmalar, defter değeri/ piyasa değeri oranı düşük olan firmalar, kaldıraç oranı düşük olan firmalar, geçmiş dönem performansı yüksek olan firmalar, düşük riskli firmalar ve likiditesi yüksek olan firmaların kurumsal yatırımcılar tarafından tercih edildiği saptanmaktadır. Ayrıca, asimetrik bilgi seviyesi açısından değerlendirildiğinde, yatırımcıların asimetrik bilgi seviyesi düşük olan firmalara yatırım yaptıkları gözlenmektedir. Yönetim mekanizmaları açısından incelendiğinde ise, kurumsal yatırımcıların, yatırımcı koruması ve açıklığı yüksek seviyede olan ülkeleri tercih ettikleri görülmektedir. Ayrıca, yönetim kalitesi yüksek olan ülkeler kurumsal yatırımcıları çekmektedirler.

Anahtar Kelimeler: *Kurumsal yatırımcılar, asimetrik bilgi, yönetim mekanizmaları*

JEL Sınıflaması: *G11, G23, G30*

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1. INTRODUCTION

Over the last decade, equity ownership by institutional investors has shown a remarkable increase. According to The Conference Board Report (2010), $25.351 trillion worth of capital is in the hands of institutional investors in the United States. This pattern has shown an increase over the years (see Table 1). This substantial level of institutional investment motivates the investigation of the determinants of institutional investment. This paper contributes to the literature by preparing a detailed study that includes the main determinants of institutional investment.

Table 1. Institutional Ownership

This table presents descriptive statistics on institutional ownership by different types of institutional investors for the period 2001 to 2008. BANKS is ownership by banks. INS is insurance companies. IA is investment advisors. PPS is public pension funds. OTHERS includes university and foundation endowments, corporate pension funds and miscellaneous investors.

Variable	2001	2002	2003	2004	2005	2006	2007	2008
BANKS	13%	15%	14%	16%	16%	17%	16%	15%
INS	6%	5%	4%	5%	4%	4%	6%	4%
IA	33%	34%	37%	37%	39%	42%	42%	45%
PPS	3%	3%	3%	4%	3%	3%	4%	2%
OTHERS	1%	2%	3%	3%	4%	3%	4%	4%
TOTAL	56%	59%	61%	65%	66%	69%	72%	70%

Source: Abdioglu, Khurshed, and Stathopoulos (2013).

Institutional investors have to follow 'prudent man rules' (Del Guercio, 1996). According to this rule, they invest in fiduciary assets such as large firms, less leveraged firms, firms with less information asymmetry, stocks with high governance quality, and the like (Badrinath, Gay and Kale, 1989). In this paper, I examine the impact of this rule on the investment preferences of institutional investors by considering three main factors: firm specific characteristics, information asymmetry level and governance mechanisms.

Firstly, I examine the impact of main firm specific characteristics on the institutional investment. These firm specific characteristics are: firm size, book-to-market ratio, performance of the firm, leverage ratio, volatility and liquidity. The main findings of the literature about firm specific characteristics are as follows: Institutional investors prefer to invest in large firms. Because these firms are better known firms (Dahlquist and Robertsson, 2001). Since low book-to-market ratio stocks are accepted as growth stocks, institutional investors prefer to invest in those stocks (Del Guercio, 1996). Del Guercio (1996) finds evidence for 'prudent man' rule which states that investors choose

firms with superior past performance. Institutional investors also avoid investing in high leveraged firms. Because leverage is a measure of long term financial distress. If the financial distress ratio of a firm is high, the firm might be unable to meet its debt obligations in the future (Dahlquist and Robertsson, 2001). Institutional investors choose stocks with low volatility. Because volatility is seen as business risk and investors want to avoid this risk. Finally, if institutional investors want to exit poorly performing firms, they can do it easily in firms with high liquidity. As a result, they prefer to invest in firms with high liquidity (Starks, 2000).

Secondly, information asymmetry level of a firm or a country is another factor that affects the investment decisions of institutional investors. Information asymmetry is one of the barriers that foreign investors encounter when they invest abroad. Since the foreign investors have an informational disadvantage relative to local investors, the cost of investing abroad is high for them. As a result, they invest less in foreign market[1]. Gelos and Wei (2005) find that corporate and country level transparencies have positive effects on the international portfolio flows. Therefore, foreign investors invest in countries where the information asymmetry problem is solved.

The third factor that affects the investment preferences of institutional investors is governance mechanisms. It is well documented in the literature that institutional investors give importance to governance quality in their investment preferences[2]. I divide governance mechanisms into two parts and examine their effect on institutional investment: legal system and country level governance quality. I also investigate legal system into 2 parts: investor protection level and disclosure and liability standards.

Expropriation of shareholder rights is related with agency problem which occurs if the insiders use firm profits for their interest (Jensen and Meckling, 1976). [3] Therefore, investors face a risk while investing in those countries which have weak investor protection because of the risk of expropriation. If there is expropriation, shareholders' rights can be protected by legal system (laws) according to Jensen and Meckling (1976) (contractual framework) and Hart (1995) (the residual control rights framework). It is well known from the literature that investors prefer to invest in countries with a high level of investor protection (Aggarwal et al., 2011; Leuz, Lins and Warnock, 2009). This behaviour is

[1] Brennan and Cao (1997) and Kang and Stulz (1997) report the information disadvantage of foreign investors relative to domestic investors.

[2] If a firm has weak corporate governance quality, institutional investment level in that firm is very low (Giannetti and Simonov, 2006). According to Kho, Stulz and Warnock (2006), US investors prefer to invest in strong corporate governance firms in Korea. Leuz, Lins and Warnock (2008) also find that US investors avoid investing in poorly governed firms.

[3] Managers and controlling shareholders are accepted as insiders by La Porta et al. (2000).

in line with the prudent man rule. Further, in line with the good country bias theory of Giannetti and Koskinen (2010), investors domiciled in countries with weak investor protection should prefer to invest more in countries with higher investor protection than their home country. Besides investor protection, institutional investors give importance to the disclosure of particular information i.e. profitability and ownership structure (La Porta, Lopez-de-Silanes and Shleifer, 2006). If the company discloses information, it will be easier for the investors to value the firm and invest.

Finally, country level governance quality is one of the most important factors that affect the investment preferences of institutional investors. Even if a firm has a high level of governance quality itself, if it is domiciled in a country with low governance quality, it will benefit less from the capital markets (Doidge et al., 2007). Having high firm-level governance quality cannot substitute for the governance quality at the country level (Klapper and Love, 2004). Institutional investors avoid investing in countries with low level of govenrance quality.

The rest of the paper is structured as follows. In Section 2, I provide an overview of the literature on the firm specific investment preferences of institutional investors. Section 3 discusses the importance of information asymmetry level for institutional investment. The importance of country level governance mechanism follows in section 4. Section 5 provides my conclusions.

2.FIRM CHARACTERISTICS

Various firm characteristics affect the investment preferences of institutional investors. A lot of literatures endeavour to determine these firm specific factors[4]. The main factors which are found effective on the investment preferences of institutional investors are past performance of the firms, trading liquidity, share return volatility, leverage, firm size, listing age of the firm, dividend yield, return on equity, idiosyncratic risk and book to market ratio. In this section, I deeply examine how the firm specific characteristics affect the investment preferences of institutional investors.

Since institutional investors' activities are governed by law, it is not conceivable that traditional portfolio selection criteria capture all the preferences of institutional investors. Common Law and Employee Retirement Security Act of 1974 (ERISA) restrict their behaviour (Badrinath, Gay and Kale, 1989). According to these laws, institutional investors should behave in line with 'prudent man' rule which states that institutional investors should invest in fiduciary firms. Firm size is one of the firm characteristics which is taken into consideration while evaluating the reliability of a firm. Dahlquist and Robertsson (2001) link their ideas with Merton (1987) and Huberman (1999) who state that investors prefer firms which are better known and which they are familiar with. Following this argument they assume that firms that are covered by analysts and media are likely the largest firms in

[4] Dahlquist and Robertsson (2001), Kang and Stulz (1997), Gombers and Metrick (2001), Falkenstein (1996) and Ferraira and Matos (2008) are just a few examples of this literature.

financial markets. With accepting this coverage as a determinant of firm recognition Dahlquist and Robertsson (2001) find a significantly positive relationship between firm recognition and investor ownership. Alternatively, Ferraira and Matos (2008) show firm size as an important determinant in international investment and they find a positive relation between firm size and institutional ownership. In addition Gompers and Metrick (2001) show size, per share stock price and share turnover as alternative variables for transaction costs. Therefore, if the institutional investors prefer firms with low transaction costs, they will choose large firms with high share turnover and low per share stock price. The positive relation between size and institutional ownership is also consistent with the results in Badrinath, Gay and Kale (1989), Cready (1994), Falkenstein (1996), and Benett, Sias and Starks (2003) for the US firms, in Dahlquist and Robertsson (2001) for the Swedish firms.

Bardinath et al. (1989) also document that institutional investors prefer firms with superior past performance. In addition, Del Guercio (1996) finds evidence for ‘prudent man’ rule which states that investors choose firms with superior past performance. He concludes that bank managers’ preferences are consistent with prudent man rule. However, mutual funds do not show any consistency for this behaviour. By considering return of assets as a kind of measurement of firm performance, Ferraira and Matos (2008) document that foreign institutions choose stocks with positive stock return performance, however, domestic institutions prefer negative stock return performance.

Book-to-market ratio is another firm level determinant of institutional investment. Del Guercio (1996) finds that banks use their preferences for firms with low book to market ratio. His evidence is consistent with the hypothesis made by Lakonishok, Shleifer and Vishny (1994) and Shefrin and Statman (1995). According to these studies, low book to market ratio is an indicator of growth stocks and investors like to invest in growth stocks. Alternatively, institutional investors take into consideration of the leverage ratio of a firm. The main idea behind the negative relationship between leverage ratio and institutional ownership depends on Jensen and Meckling (1976) who state that debt reduces agency cost by monitoring the management. Therefore, if a firm is highly leveraged, it does not need any other mechanism for monitoring such as institutional ownership. By assuming external monitors such as institutional investors have a role in reducing agency costs, Bathala, Moon and Rao (1994) examine the role of institutional ownership on managerial ownership and debt policy. They find a negative relation between debt and institutional ownership. Dahlquist and Robertsson (2001) accept leverage as a measure of long term financial distress and they conclude that foreign investors avoid investing in firms with high leverage. They state that if the financial distress ratio of a firm is high, the firm might be unable to meet its debt obligations in the future. As a result investors may not be paid in this situation and they want to invest firms with low leverage. Bushee (2001) finds an evidence for this negative relationship, as well.

Roll (1988) and Morck, Yeung and Yu (2000) define idiosyncratic volatility as stock price informativeness and state that institutions prefer stocks with low idiosyncratic volatility which is an

indication of stocks that are informationally efficient. However, Gombers and Metrick (2001) conclude that investors prefer high risk stocks. Also Ferraira and Matos (2008) find a positive relation between idiosyncratic risk and institutional ownership. Alternatively, Falkenstein (1996) conclude that mutual fund holdings are related with volatility. The reason of choosing lower stock volatility is that since volatility is seen as business risk and investors want to avoid this risk, they choose stocks with low volatility (Badrinath, Gay and Kale, 1989; Cready, 1994; Del Guercio, 1996; and Falkenstein, 1996; Gompers and Metrick, 2001).

Finally, Gombers and Metrick (2001) use liquidity as a determinant of institutional investment and conclude a positive relation between institutional holding and liquidity. Kang and Stulz (1997) define turnover as volume divided by number of shares outstanding and state that firms with lowest turnover have lower foreign ownership. In addition, Starks (2000) assumes that liquidity is an important determinant of institutional investment. Because, if they want to exit poorly performing firms, they can do it easily in firms with high liquidity.

3. THE ROLE OF ASYMMETRIC INFORMATION

In theory, institutional investors prefer to get the benefits of diversification by investing abroad. Increased welfare gain of investors can be shown as one of the benefits of diversification of portfolios (Grubel, 1968)[5]. Despite the benefits of international diversification, domestic securities form the great part of the investors' portfolios (French and Poterba, 1991; Coval and Maskowitz, 1999; Ahearne, Griever and Warnock, 2004). This behaviour is called 'home bias puzzle' and the reason of it is the information asymmetry problem between foreign investors (uninformed investors) and local investors (informed investors) (Brennan and Cao, 1997; Kang and Stulz, 1997). As a result of the information asymmetry problem, foreign investors are more likely to buy lemons than domestic investor and to acquire greater monitoring costs than locals (Giner, Tahoun and Walker, 2008). Thus, when the foreign investors take into account this asymmetric information problem, their investment at home becomes more than the investment they make abroad.

Foreign investment literature shows several examples for the reason of home bias puzzle: barriers to the international investment such as capital control, foreign taxes, high transaction costs (Stulz, 1981; Giner, Tahoun and Walker, 2008); departures from purchasing power parity (Cooper and Kaplanis (1994); hedging of human capital or other non traded assets (Baxter and Jermann, 1997). These barriers cause large costs for foreign investors who invest in domestic equities and for domestic investors who invest in foreign equities. If the cost that the foreign investors face when investing in local market is higher than the cost domestic investors face when investing in foreign market, there will be less investment by foreigners and more investment by domestic investors (Chan, Covrig and

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[5] Sharpe (1964), Lintner (1965), Levy and Sarnat (1970), Solnik (1974), Grauer and Hakansson (1987) are the other examples which find evidence about the benefits of international diversification for the investors.

Ng, 2005). Chan, Covrig and Ng (2005) examine whether changes in foreign and domestic bias can be explained by the same factors.[6] They conclude that while stock market development and familiarity variables have important role in domestic bias, these factors have asymmetric effects on foreign bias.

In sum, the information asymmetry between foreigners and domestic investors is a possible explanation for the home bias (Stulz, 1981; Ahearne, Griever and Warnock, 2001). According to Diamond and Verrechia (1991), if there is a reduction in information asymmetry between foreigners and domestic investors at corporate level, this can increase the investment by foreigners and reduces the cost of capital of the firm. Also according to Ausubel (1990), outsiders do not invest in the firms in which they think the insiders will take the advantage of this investment. With taking into account information asymmetry problem, Gelos and Wei (2005) examine the role of both corporate level and country level transparency on the investment decisions of foreign investors. They find evidence about the hypothesis that the corporate and country level transparencies have positive effects on the international portfolio flows. Therefore, foreign investors invest in countries where the information asymmetry problem is solved. Leuz, Lins and Warnock (2009) show that the typical US investor invests less in countries with poor information frameworks. Kang and Stulz (1997) demonstrate that foreign investors invest in firms which they have better information.

4. GOVERNANCE MECHANISMS

Denis and McConnell (2003, p. 2) define corporate governance as: “the set of mechanisms - both institutional and market based- that induce the self-interested controllers of a company (those that make decisions regarding how the company will be operated) to make decisions that maximize the value of the company to its owners (the suppliers of capital)”. Alternatively, Shleifer and Vishny (1997, p.737) state that “Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment.” Besides this, the quality of corporate governance is defined as the extent to which companies are able to avoid the extraction of private benefits by potential investors (Gianetti and Simonov, 2006).

According to Gianetti and Simonov (2006), corporate governance of a firm affects how the firm value is divided between security benefits and private benefits. Security benefits accrue to all shareholders. However, private benefits accrue to a group of shareholders who have management connections. Thus, if a company has weak corporate governance, potential investors who have connections with management may be able to obtain private information and use it to trade at favourable prices. If different types of investors have different returns depending on the quality of corporate governance, those investors may have different preferences while making their investment

[6] Sources of home bias are thought as economic development, capital control, stock market development, familiarity and investor protection.

decisions. For example, if they encounter with a company which has good corporate governance, they want to invest in this firm (Gianetti and Simonov, 2006).

Corporate governance mechanisms are thought as a proxy for governance quality and these mechanisms are considered while making investment decisions. Corporate governance mechanisms are characterized as being internal or external to the firm (Denis and McConnell, 2003). Monitoring by a board of directors, directors' ownership and board characteristics (i.e. separation of Ceo and chairman, board size, etc.) are examples of internal mechanisms. The takeover market and the legal system are examples of external control mechanisms. Chou et al. (2007) examine Investor Responsibility Research Center (IRRC) governance index (G-index) and the Bebchuk E-index of the stocks that mutual funds hold in order to understand if corporate governance mechanisms affect their investment decisions. They conclude that mutual funds, especially the ones who practice good governance themselves prefer the stock of firms whose corporate governance mechanisms are good. This shows that corporate governance has an impact on the voting decisions of well governed mutual funds. Chou et al. (2007, p. 24) explain this relation as follows: "For both management -and shareholder-sponsored proposals, poorly-governed funds strongly vote in favour of management on issues of antitakeover, board quality, director elections, and executive incentives. On the other hand, well-governed mutual funds focus more on protecting shareholders' rights." Furthermore, with referring to the Swedish market, Giannetti and Simonov (2006) conclude that the probability of investment in firms with weak corporate governance by both foreign and domestic investors is very low. Kho et al. (2006) show that US investors prefer to invest in strong corporate governance firms in Korea. Finally, Leuz, Lins and Warnock (2009) conclude that US investors avoid investing in poorly governed firms.

In sections 4.1, I divide governance mechanisms into several categories. The effect of the legal system is explained in the first part. In the second part, I examine the role of governance quality measure of the countries on institutional investment.

4.1. Legal System

In 'Law and Finance', La Porta et al. (1998) accept legal system as an important corporate governance mechanism. They suggest that if a country's laws protect investor rights and if these laws are enforced, corporate governance and corporate finance are developed in that country. They divide the countries according to their laws and form four groups which are common law countries, Scandinavian civil law countries, French civil law countries and German civil law countries. They conclude that while common law countries have the strongest investor protection for investors, French civil law countries have the lowest investor protection. The intuition behind the study is that with providing relevant investor protection, countries with right legal system are more financially protected.

It is commonly accepted in the corporate governance literature that the extent to which a country's legal system protects the investor rights has an effect on the structures of markets in that country and on the governance structures of companies in that country (Denis and Connell, 2003). Strong investor protection results in improved corporate governance and economic development. Therefore, the extent to which a country enforce the laws and protects the investor rights will be a determinant of the preferences of investors. The role of investor protection on institutional investment is provided in the next section.

4.1.1 Investor Protection

According to Modigliani and Miller (1958), firms are the combination of investment projects and cash flows these projects create. They consider debt and equity as claims to these cash flows. However, they do not consider the reason of why managers should return the cash flows to the investors. Jensen and Meckling (1976) hypotheses that return to cash flows might be used by insiders for their own benefit. Expropriation of shareholder rights is related with agency problem which occurs if the insiders use firm profits for their interest (Jensen and Meckling, 1976). [7] Therefore, investors face a risk while investing in those countries which have weak investor protection because of the risk of expropriation. If there is expropriation, shareholders' rights can be protected by legal system (laws) according to Jensen and Meckling (1976) (contractual framework) and Hart (1995) (the residual control rights framework). It is well known from the literature that investors prefer to invest in countries with a high level of investor protection (Aggarwal et al., 2011; Leuz, Lins and Warnock , 2009). This behaviour is in line with the prudent man rule. Further, in line with the good country bias theory of Giannetti and Koskinen (2010), investors domiciled in countries with weak investor protection should prefer to invest more in countries with higher investor protection than their home country.

Following the existing literature, Giannetti and Simonov (2006) show that the investors who consider only security benefits do not prefer to invest in companies in which the extraction of private benefits is high. In line with this study, it can be assumed that when investor rights are enforced by legal system, investors want to finance the firms. La Porta et al (2000) give the voting rights of shareholders and the reorganization and liquidation rights of creditors as examples of investor rights. They examine the results of investor protection through low to high levels. They demonstrate that if the investor protection is too low, the firm's profit can be stolen. As a result, investors avoid investing in that firm. "As investor protection improves, the expropriation of their rights becomes more difficult and the insiders must engage in more distorted practices such as setting up intermediary companies

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[7] Managers and controlling shareholders are accepted as insiders by La Porta et al. (2000).

into which they channel profits." (La Porta et al., 2000, p.6). If the investor protection is very high, the insiders expropriate less. They can expropriate by overpaying themselves or undertake some wasteful projects. However, after a point paying dividends might be better. Therefore, as the law avoid expropriation, outside finance increases.

La Porta et al. (1998) show ownership concentration as a reason of lack of investor protection. If the laws do not protect owners from the controllers, owners become controllers. They assume that countries with high ownership concentration have lowest investor protection. As an evidence they find that US has the lowest ownership concentration among 49 countries and therefore it has the highest investor protection. In addition, Shleifer and Vishny (1997) express that the quality of a country's corporate governance is the result of its quality of legal system and form of concentrated ownership. While the US and the UK corporate governance systems have high investor protection and low concentrated ownership, German and Japanese systems have low investor protection and high ownership concentration. And they characterise four countries as having good corporate governance systems.

As an another result of investor protection, existing literature finds a positive relation between investor protection and financial market development which means that in countries with high investor protection, financial markets become developed (La Porta et al, 1997,1998,2000). Because, as the investor protection in countries increases, investors want to invest in the firms in those countries since they know that they will encounter with less expropriation. When investors are well protected, they may pay more for the securities and issuing those securities becomes more attractive for the entrepreneurs. Therefore, more investors finance those countries and financial markets in those countries expand. The increase in the level of external finance can be shown as an indicator of increasing in economic development. La Porta et al. (1997) find that using external finance is positively related with investor protection. They find that the usage of the external finance is highest in the common law countries, and lowest in French civil law countries. They explain the reason of the positive relation between these two variables as the fact that if investor protection is high, investors demand low expected rates of return and therefore those companies where the investors invest in can use external finance easily.

4.1.2. Standardization

Disclosure and liability standards

Mahoney (1995) shows promoter's problem as the determinant of the security issue and defines it as the risk that the issuers of the securities sell bad securities to the public. Countries with developed securities laws can avoid this problem with various tools. Standardization of the private contracting framework is one of them. La Porta, Lopez-de-Silanes and Shleifer, (2006) accept two types of standardization: disclosure and liability standards.

According to La Porta, Lopez-de-Silanes and Shleifer (2006), investors' decisions to invest depend on the necessity of the disclosure of particular information i.e. profitability and ownership structure. If the company discloses information, it will be easier for the investors to value the firm and invest. Landis (1938) and Seligman (1995) demonstrate that the lowest cost providers of information about a security such as issuers, distributers and accountants, should collect and present the information. If the cost provider omits or misleads, he is seen as responsible for the misleading (Grossman and Hart, 1980; La Porta, Lopez-de-Silanes and Shleifer, 2006). If information is wrong or omitted, with the help of disclosure requirements and liability standards, investors can recover the damages. Grossman and Hart (1980) determine laws against lying as antifraud laws and state that thanks to those laws, the companies make true disclosures if there is not any transaction costs. As a result, they conclude that since government could make the enforcement of laws with no cost, it can force the firms with the lowest cost of disclosure to make disclosures. And social transaction costs of disclosure decrease.

La Porta, Lopez-de-Silanes and Shleifer (2006) shows 6 proxies for the power of the disclosure requirements. Firstly, a prospectus should contain the information about the security for the investors and this prospectus must be required by the countries. Delivering the prospectus to investors is seen as the first step in making disclosure requirements to them. The next five proxies of disclosure requirements are showed by La Porta, Lopez-de-Silanes and Shleifer (2006) as follows: insiders' compensation, ownership by large shareholders, insider ownership, contracts outside the normal course of business and the transactions with related parties. They use the average of these 6 proxies and named them as the index of disclosure requirements.

Alternatively, Mitton (2002) considers disclosure requirements at firm level as a determinant of legal protection. Better stock performance is related to higher disclosure quality in this study. Besides disclosure quality, ownership structure and corporate diversification have role in stock market performance. Furthermore, Aggarwal et al. (2005) examine the role of financial disclosures and laws on the investment allocation of US mutual funds. This study is a complement of two kind of studies. First one is by La Porta et al (1997, 1998, 2000) who find a positive relation between market development and strong investor protection laws, high enforcement and high quality accounting disclosures. Second one is by Johnson et al. (2000), Milton (2002) and Joh (2003) who find that disclosure and governance are related with performance during the East Asian financial crisis. Also, this study is different than the prior literature because of the reason that it both considers firm level and country level policies that are effective on the preferences of mutual funds. Aggarwal et al. (2005) conclude that country level policies, accounting disclosures, strong shareholder rights, legal framework have roles in the investment preferences of US mutual funds and this relation is significantly positive. These results assume that disclosure requirements might have a larger role in countries with weak institutions.

Besides the disclosure requirements, the law determines liability standards that the issuers and intermediaries face when the companies fail to reveal possible information (La Porta, Lopez-de-Silanes and Shleifer, 2006). In this way the laws can benefit market and uncertainties can be reduced with these laws according to La Porta, Lopez-de-Silanes and Shleifer (2006). According to several authors such as Black (2001) and Coffee (2002), liability standards are necessary in order to cope with omission of the relevant information to assess the value of the securities. In addition, La Porta, Lopez-de-Silanes and Shleifer (2006) demonstrate that the law should have liability standards facing issuers and intermediaries in order to recover damages when companies do not reveal the potential material information.

4.2. Country Level Governance Quality

The effect of quality of a country's legal system on aggregate equity investments of institutional investors are examined by several studies in the literature (La Porta et al, 1997,1998; Aggarwal et al., 2005; Chan, Covrig and Ng, 2005 and Gelos and Wei, 2005). It is concluded that strong macro governance factors affects the shareholdings of institutional investors. Even if a firm has a high level of governance quality itself, if it is domiciled in a country with low governance quality, it will benefit less from the capital markets (Doidge, Karolyi and Stulz, 2007). Having high firm-level governance quality cannot substitute for the governance quality at the country level (Klapper and Love, 2004). McKinsey and Company (2002) Global Investor Opinion Survey finds that investors give nearly the equal importance to corporate governance quality and financial issues in their investment decisions. According to this survey, as a result of poor corporate governance quality, investors avoid investing in certain countries and firms. Table 2 shows some of the results of this report.

Table 2. McKinsey Report

Investors identify clear issues at all levels that impact on their investment decisions
Percentage of investors who think that factor is very important for investment decision; top ten factors listed

Corporate Factors	Accounting disclosure	71%
	Shareholder equality	47%
Capital Market Factors	Market regulation and infrastructure	43%
	International accounting standards	42%
	Market liquidity	37%
Broad Country Level Factors	Property rights	46%
	Pressure on corruption	32%
	Insolvency and bankruptcy regulation	32%
	Fiscal environment	31%
	Banking system	30%

Source: McKinsey Global Investor Opinion Survey on Corporate Governance, 2002

Several indicators can be used to measure the quality of governance in a country. The worldwide governance indicators (WGI), which are determined by Kaufmann, Kraay and Mastruzzi (2007) can be shown as an example for these indicators. The WGI report examines six different indicators for 200 countries and for the period 1996-2006 in order to determine these governance indicators. This report is based on responses from citizens, enterprise managers and experts. While constructing governance indicators, individual sources of data on perception of governance are related with those six governance indicators. Then, aggregate indicators from these individual measures are obtained (Kaufmann, Kraay and Mastruzzi, 2007). Six dimensions of governance indicators are used which are as follow: Voice and Accountability (VA), Political Stability and Absence of Violence (PV), Government Effectiveness (GE), Regulatory Quality (RQ), Rule of law (RL) and Control of Corruption (CC)[8]. Table 3 shows the time series change in average governance quality for some of the selected countries.

[8] 'Voice and Accountability' measures if a country's citizens can select their government. Besides this, it measures the citizens' ability in selecting their freedom of expression, freedom of association and a free media. 'Political Stability and Absence of Violence' is a measure of perceptions about likelihood of the destabilization of government by violent means, including domestic violence and terrorism. 'Government Effectiveness' is defined by Kaufmann, Kraay and Mastruzzi, (2007, p.3) as follows: "Government Effectiveness measures the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies."The ability of the government to make and implement policies and regulations which include permission and promotion of private sector development is measured by 'Regulatory Quality'. The fifth measure of the governance which is 'Rule of Law' is defined as a measure of the extent to which firms have confidence in and feel compulsory to abide the rules of society. Their confidence to the quality of contract enforcement, to the police and to the courts is taken into consideration. Finally, 'Control of Corruption' measures the extent to which public power is used for private gain.

Table 3. Time Series Changes in Governance Quality by Country

Country	2001	2002	2003	2004	2005	2006	2007	2008
AUSTRALIA	1.63	1.54	1.57	1.67	1.56	1.55	1.58	1.62
BELGIUM	1.36	1.44	1.4	1.36	1.28	1.27	1.27	1.21
CANADA	1.62	1.64	1.63	1.61	1.53	1.59	1.57	1.6
DENMARK	1.75	1.81	1.8	1.85	1.77	1.82	1.84	1.82
FRANCE	1.22	1.22	1.23	1.31	1.26	1.25	1.22	1.24
GERMANY	1.6	1.56	1.44	1.45	1.46	1.5	1.49	1.43
JAPAN	1.06	0.96	1.12	1.17	1.16	1.24	1.18	1.16
NETHERLANDS	1.82	1.74	1.69	1.7	1.63	1.6	1.62	1.61
NORWAY	1.61	1.69	1.65	1.72	1.64	1.66	1.64	1.64
SINGAPORE	1.44	1.44	1.41	1.49	1.43	1.4	1.45	1.51
SWITZERLAND	1.75	1.75	1.69	1.74	1.64	1.68	1.71	1.7
TAIWAN	0.8	0.84	0.88	0.91	0.88	0.78	0.73	0.79
UNITED KINGDOM	1.6	1.55	1.48	1.52	1.42	1.5	1.45	1.4
UNITED STATES	1.52	1.4	1.34	1.33	1.24	1.25	1.22	1.28

This table reports the time series changes in GQ for all countries examined in this study. GQ is the average of the six KKM governance indicators. The six governance indicators are scaled from -2.5 to 2.5, with higher values corresponding to better governance outcomes

Li et al. (2006) use control of corruption as a measure of enforcement of the shareholder rights and examine the effect of enforcement of shareholder rights on investment preferences of institutional investors. They measure enforcement of shareholder rights because they state that while shareholder rights is an important feature of the governance rights, its effect can be made weak if they are not enforced. With using these measures, they conclude that countries with high legal enforcement have high level of institutional investment. But in countries with weak legal enforcements, shareholding of institutional investors is too low. Li et al. (2006) use Rule of Law and Regulatory Quality as a measure of governance quality, as well. They accept degree of enforcement of shareholder rights as a determinant of the governance quality of a country. They define rule of law as the extent to which the firms have confidence to rules of society and the extent to they abide these rules. They also determine regulatory quality as the ability of government to make and implement the effective policies for the regulation of markets. Finally, it is found that the higher the degree of enforcement of the shareholder rights, the higher the quality of a country's governance and as a result the higher the institutional investment.

5.CONCLUSIONS

In this paper, I deeply examine the institutional investment literature and focus on three main factors that are effective on the investment preferences of institutional investors: firm characteristics, information asymmetry level and governance mechanisms. Institutional investors determine their investment decisions in line with prudent man rule. According to this rule they have to invest in

reliable assets. Large firms, low book-to-market ratio, firms with low leverage ratio, firms with high level of liquidity, less volatile firms and firms with high performance are accepted as reliable assets and investors prefer to invest in those assets.

Information asymmetry level is another factor that affects the investment decisions of institutional investors. In order to avoid bearing the information asymmetry cost, institutional investors prefer to invest in stocks which they are familiar with. Alternatively, since the foreign investors have an informational disadvantage relative to local investors, the cost of investing abroad is high for them. They prefer to invest more at home than foreign countries.

Finally, governance mechanisms are effective on the investment preferences of institutional investors. It is well known from the literature that investors prefer to invest in countries with a high level of investor protection (Aggarwal et al., 2011; Leuz, Lins and Warnock, 2009). This behaviour is in line with the prudent man rule. Besides investor protection, institutional investors give importance to the disclosure of particular information i.e. profitability and ownership structure (La Porta, Lopez-de-Silanes and Shleifer, 2006). They also invest in countries with high level of governance quality. In sum, I contribute to the institutional investment literature by showing detailed preferences of institutional investors. This research might be helpful for the firms which wants to attract institutional investors.

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