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Do Institutional Investors Influence Capital Structure Decisions?*

by

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Abstract

This paper empirically investigates the relationship between institutional holdings and capital structure. We find that institutional holdings are a significant determinant of firms' capital structure. Specifically, we find that a change in institutional holdings causes an opposite change in leverage. Higher leverage, on the other hand, does not unequivocally cause institutions to decrease their holdings. We also find that firms lower their leverage in response to increased institutional holdings by becoming more likely to issue equity and less likely to issue debt. These findings are consistent with both asymmetric information and agency models where institutions, who monitor and reduce information asymmetry problems, substitute for debt. However, since our findings are most pronounced for small, high-growth firms, where adverse selection and information asymmetry problems are most severe, we suggest that the evidence supports theories that imply institutional holdings substitute for debt primarily in the role of reducing asymmetric information between management and outside shareholders.

*** Joint work with Christopher Vincent.**

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