



## Institutional ownership, volatility and dividends

Amir Rubin\*, Daniel R. Smith

Faculty of Business Administration, Simon Fraser University, Burnaby, BC, Canada V5A 1S6

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### ABSTRACT

We find that the sign of the correlation between institutional ownership and volatility depends on the firm's dividend policy: institutional ownership is negatively (positively) related to volatility among non-dividend (dividend) paying stocks. The empirical results are consistent with an interaction between institutional preference for low volatility and the tendency of higher levels of institutional ownership to increase volatility through their trading behavior. This result is robust to many control variables and possible endogeneity concerns. Supporting our conjecture that institutions herd on dividend signals we find that the correlation between turnover and institutional ownership is higher for dividend paying stocks, and that the positive correlation between turnover and institutional ownership is higher on dividend declaration days. Finally, we also find that the level of institutional ownership drops following an increase in volatility for both dividend payers and non-payers, and that volatility rises following increased institutional ownership for dividend paying stocks.

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### 1. Introduction

We study the relationship between the level of institutional ownership and stock return volatility and find that the sign of this relationship depends crucially on the firm's dividend policy. The general conclusion of the literature is that institutional ownership and volatility are positively related (Sias, 1996; Xu and Malkiel, 2003) and there is some evidence that institutions directly contribute to volatility (Dennis and Strickland, 2002). On the other hand there are some reasons to believe that volatility and the level of institutional ownership may be negatively correlated. Our main contribution is identifying for the first time the central role of dividend policy on the institutional ownership–volatility relation. We argue that a firm's dividend policy impacts on the direction of the relation between the level of institutional ownership and volatility. We demonstrate empirically that higher levels of institutional ownership are associated with higher volatility among dividend paying stocks but lower volatility among non-dividend paying stocks.

There are good reasons to believe that higher levels of institutional ownership could be negatively related to volatility. It

is commonly believed that institutional investors are better informed than individual investors (e.g., Lin et al., 2007). West (1988) shows that an increase in the information content of prices will reduce the variance of stock returns. Therefore, higher levels of institutional ownership will be associated with more informative prices. We label this as the *institutional sophistication* hypothesis. Furthermore, unlike individual investors, institutions are fiduciaries. They invest on behalf of others and may be subjected to agency conflicts. As a result, they are constrained by several rules aimed at preventing them from speculating with other peoples' money. For example, "Prudent-Man" rules direct institution to invest a larger proportion of their holdings in "Prudent Stocks". Age, low volatility, and stable dividends have been used in past studies as indicators of prudence (see, e.g., Del Guercio, 1996). This should further contribute toward a negative correlation between institutional ownership and volatility. We label this effect as the *institutional preference* hypothesis.

We claim that the contribution of institutional sophistication to the efficient processing and gathering of information should be stronger among non-dividend paying stocks than amongst dividend paying stocks because non-dividend paying firms are characterized by more information asymmetry and tend to be younger new-economy firms with more uncertain prospects. With regard to institutional preference, the fiduciary duty to invest prudently should lead to a compounding aversion to

\* Corresponding author. Tel.: +1 778 782 5834; fax: +1 778 782 4920.  
E-mail addresses: [arubin@sfu.ca](mailto:arubin@sfu.ca) (A. Rubin), [drsmith@sfu.ca](mailto:drsmith@sfu.ca) (D.R. Smith).