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The effect of fiduciary standards on institutions' preference for dividend-paying stocks

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Many researchers apparently believe that some institutional investors prefer dividend-paying stocks because they are subject to the "prudent man" (PM) standard of fiduciary responsibility, under which dividend payments provide prima facie evidence that an investment is prudent. Although this was once accurate for many institutions, during the 1990s most states replaced the PM standard with the less-stringent "prudent investor" (PI) rule, which evaluates the appropriateness of each investment in a portfolio context. Controlling for the general decline in dividend-paying stocks, we find that institutions reduced their holdings of dividend-paying stocks by 2% to 3% as the PI standard spread during the 1990s. Studies of asset pricing and corporate governance should no longer consider dividend payments when evaluating the actions of institutional investors.

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Institutional investors play a prominent role in US equity markets by making investment choices on behalf of many savers. These institutions' share of US equity ownership has risen from 11% in 1960 to more than 50% in 2000, and they account for an even larger proportion of equity trading volume (Griffin, Harris, and Topaloglu, 2003). Historically, a "prudent man" (PM) standard of fiduciary care caused some institutional investors to avoid holding shares that did not pay cash dividends. The PM standard judged the appropriateness of each security position on a stand-alone basis, and the payment of regular dividends became a "safe harbor" indicator of a stock's "prudence." The literature contains clear evidence that the PM standard caused bank trust departments to shun non-dividend-paying stocks (Del Guercio, 1996; Schanzenbach and Sitkoff, 2007). Moreover, PM restrictions probably had effects far beyond their narrow applicability to trusts. Legal precedents encouraged other fiduciaries to make similar choices as protection against judicial review of their investment decisions. Yet during the 1990s, most states replaced the PM standard of fiduciary care with the less-stringent "prudent investor" (PI) standard, which evaluates the appropriateness of each investment in a portfolio context. These changes should have weakened or eliminated a restriction on many institutional investors' opportunity sets.

Given the importance of institutional investors to the equity market, researchers must understand the extent to which their behavior was (is) subject to special restrictions. Institutions are typically viewed as rational, informed, and profit-oriented investors. They can provide important monitoring (governance) services to firms whose stock they hold (Shleifer and Vishny, 1986; Allen, Bernardo, and Welch, 2000). Institutions are also viewed as arbitrageurs who will seek profits by offsetting "irrational" asset price movements. Researchers have suggested that constraints on institutional holdings of nondividend-paying shares limited their ability to arbitrage apparent market inefficiencies (Badrinath, Kale, and Noe, 1995). Mauer and Senbet (1992) indicated that institutional preferences for dividend-paying shares limited their ability to speculate against IPOs' high initial returns. Kamara (1997) asserted that investing constraints limited the ability of well-informed institutions to correct the "Monday effect" in stock returns caused by the irrational behavior of smaller investors. Chung (2000) noted that institutions exhibit a preference for high-quality companies because of prudence concerns.

Corporate finance issues are also interwoven with constraints on institutional investing. Allen et al. (2000) speculated that the PM restriction might be turned to the firms' advantage if introducing dividend payments serves to attract additional institutional investors, which provide valuable monitoring services. In their 2002 survey, Brav, Graham, Harvey, and Michaely (2005) asked 166 executives at dividend-paying firms whether institutional preferences affected their dividend decisions, and reported,

> The CFOs do not indicate that institutions as a class prefer dividends over repurchases, except perhaps the existence of a small dividend payout that is needed to attract certain types of institutions. (p. 509, emphasis added)

Grinstein and Michaely (2005, p. 1390) examined the institutional ownership proportions of traded stocks from 1980 to 1996 and presented "clear evidence that institutions prefer dividend-paying firms." They further concluded that "institutions do not show any preference for firms that pay high dividends.... In fact, we find some evidence that institutions prefer low-dividend stocks to high-dividend stocks." Gompers and Metrick (2001) and Bennett, Sias, and Starks (2003) also concluded that a stock's institutional holdings varied inversely with its dividend yield over 1980-1996 and 1983-1997, respectively.

Although the PM standard of fiduciary care once applied to many institutional investors, that standard has been largely replaced in state statutes and Employee Retirement Income Security Act (ERISA). Since 1992, 43 states have substituted the less-restrictive PI standard of

fiduciary responsibility, which uses modern portfolio theory to assess an investment's prudence in the context of the overall portfolio. If PM biased institutions toward dividend-paying stocks, the change to PI removed this constraint and should have increased their appetite for non-dividend-paying shares. We present evidence here that the states' removal of PM restrictions led institutional investors to expand their holdings of non-dividend-paying stocks during the 1990s.