<u>Job Market Paper:</u>

Institutional Ownership and CEO Turnover: Evidence from Index Switching

The past thirty years has seen the share of publicly traded corporations held by Institutional Investors rise by twenty percentage points. Over this period, the annual CEO turnover rate increased by twenty-seven percent. This has led some to argue that Institutional Investors are more likely to fire poor performing CEOs. I construct a dataset using CEO information found in ExecuComp for 1992 to 2017 on over 3000 companies listed in the Russell 1000 and Russell 2000 indices which I link with CRSP data on firm fundamentals and Institutional Ownership share reported in Bloomberg. To isolate the effect of a change in Institutional Ownership on CEO tenure, I use a regression discontinuity approach to exploit the large difference in Institutional Ownership share that exists between the smallest firms in the Russell 1000 and the largest firms in the Russell 2000 by comparing companies that move between the two indices with those that do not. I find that a one percent increase in Institutional Ownership share of a company after the yearly reconstruction of the Russell indices leads to a twenty percent increase in the probability of its CEO leaving over the following year. To interpret these results, I examine a stylized model of CEO monitoring by Institutional Investors which make portfolio allocation decisions based on the minimization of tracking error and portfolio management costs. The model's prediction that Institutional Investors are more likely to identify and replace low-quality CEOs is consistent with the empirical evidence on future firm performance, CEO departure rates, changes in CEO salary and the career path of exiting CEOs. The persistence of high-quality CEOs across exclusion/inclusion events may account for the puzzle of why firms that move from the Russell 1000 to the Russell 2000 exhibit higher performance but there is no inverse effect when they move back to the Russell 1000.

<u>Work In Progress</u>

Why Do Institutional Investors Avoid Some Firms? The Role of Index Tracking Funds

The share of publicly traded corporations held by Institutional Investors within an index usually increases with the market capitalization of the firm. However, firms located near the top of market weighted indexes have a much higher level of Institutional Ownership than expected and firms near the bottom have a much lower level. For example, the Institutional Investors share of the bottom 100 firms of the Russell 1000 is fifty-five percent, roughly 10 percentage points lower than the institutional ownership share of the 100 largest firms in the Russell 2000. To establish that this pattern is due to the investment decisions of passive firms which track these indices, I examine the top 3000 US publicly traded corporations' Institutional Ownership levels and their yearly movements between the Russell 1000 & 2000 based on market capitalization changes. In a model of passive index tracking funds and small investors investing in firms which move between two indices based on idiosyncratic shocks, I show that index tracking funds constructing index portfolios to minimize index tracking error and management costs create similar patterns in Institutional Ownership as is seen in the data.