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The impact of institutional investors of the performance of companies listed at the PSE

*Murad H. Harasheh and Monther Nijim

Institutional investors have grown substantially in international, mature markets in last two decades parallel with the increase in their impact. They seek to own large proportions of equities; as a result they have become influential on the performance of companies in which they invest. Previous studies show no conclusive evidence on the direction in the role of institutional investors on performance. This research attempts to examine the impact of institutional investors' involvement on performance of investee companies. Performance was measured by using Tobin's q. The study was conducted using cross-sectional regression analysis. And significant statistical relationships were found in this research.

Field of research: Corporate governance

1. Introduction

Institutional investors can be defined as economic entities with large amount of capital to invest; they include mutual funds, brokerages, insurance companies, pension funds, investment banks and endowment funds. Their potential influence as large shareholders was traced back to 1930 in the separation of owners from control of business to be in the hand of directors when was first introduced by (Berle & Means, 1932). This separation of ownership was behind the agency problem, when managers (agents) might look for their own interest rather than on behalf the interest of shareholders. Over time the impact of institutional investors has been increasing, their shareholding in equities have grown dramatically since the middle of the 20th century, we can't underestimate their influential role on the macro & micro levels in the economy especially when we talk about foreign institutional investment in the form of portfolio investment in the equities of emerging financial markets. On the macro level as outlined in (Davis and Steil, 2001), the growth of institutional investors can be traced to various supply and demand factors that have made investing via institutions attractive to households. Literature has found no conclusive evidence about the impact of institutional investors. The increasing importance of the new market engines (institutional investors) makes it valuable to investigate their impact on corporate performance in the Palestinian listed companies.

2. Literature Review

2.1. Institutional investors and corporate performance

Institutional investors as corporate monitors were a focus of many studies and researches. Many studies in that field hypothesized that there is a link between institutional investors & corporate governance in one side and corporate governance

*Murad H. Harasheh, Faculty of Commerce & Economics, Birzeit University, Palestine,
E-mail: mharasheh@birzeit.edu

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& long-term corporate performance, but the findings appear to be fairly mixed. Subsequently, ([Millstein and MacAvoy, 1998](#)) found that corporations with active and independent boards appear to have performed much better in the 1990s than those with passive, non-independent boards in a study covered large US listed companies. Conversely, the work of ([Dalton, Daily, Ellstrand, and Johnson, 1998](#)) concluded that no such relation between board composition and firms' performance, and that there was no relationship between leadership structure (CEO/Chairman) and firm performance. Despite that evidence seems to appear quite mixed, there is a common perception that corporate governance can make a difference to the bottom line. A study by ([McKinsey, 2002](#)) found that investors are most likely willing to pay a premium to invest in a company with good corporate governance.

([Gompers, Ishii & Metrick, 2003](#)) investigated the ways in which shareholder rights vary across firms. They found that firms with stronger shareholder rights had higher firm value, higher profits, higher sales growth, lower capital expenditures, and made fewer corporate acquisitions. ([Deutsche Bank, 2004](#)) studied the impact of corporate governance on portfolio management and concluded that corporate governance standards are an important for equity risk. ([Mallin & Runall, 2006](#)) pointed that shareholders' activism is an important issue for deriving good corporate governance and without this there is less accountability and transparency, and hence management get more opportunities to work for their interest rather than owners' interest (value maximization).

Some studies find that large institutional shareholdings in a firm prohibit managers from declaring pre-determined earnings through managing discretionary accrual choices. In addition, ([Parrino, Sias, and Starks, 2003](#)) show that institutional selling is associated with forced CEO turnover and that these CEOs are more likely to be replaced with an outsider, through effective voting against the dissatisfying CEO. In the same manner ([Cornett, Marcus, Saunders and Terhranian, 2005](#)), ([Navissi & Naiker, 2006](#)), found that there is a positive relation between institutional investor (pressure insensitive) involvement in a firm and its operating cash flow returns.

2.2. Institutional Investors and corporate governance

Corporate governance has recently received much attention due to Adelphia, Enron, WorldCom, and other high profile scandals, serving as the impetus to such recent U.S. regulations as the Sarbanes-Oxley Act of 2002, considered to be the most sweeping corporate governance regulation in the past 70 years, and enhancing the long standing bandwagon for increasing shareholder power, according to ([Huyghebaert & Hulle, 2004](#)), corporate governance concerns the development of performing top structures in corporate organization. One of the important dimensions of corporate governance is the creation of effective monitoring of managers, voting by shareholders is a legal exercise for monitoring and electing the board of directors, these directors are responsible for monitoring management. Recently many questions have been raised if institutional investors should be assigned to an influential role in corporate governance.

During the past decades, institutional investors become increasingly important as shareholders. There are two views about institutional investors activism, the one is active monitoring. The opposite view is represented by the "passive monitoring" hypothesis. On the other hand, a study was conducted by ([David and Kochhar,](#)

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1996), they argue that various institutional obstacles, such as barriers derived from business relationships, the regulatory environment and information processing limitations, may interrupt institutional investors from exercising their corporate governance role. (Leech, 2000) argues that many institutional shareholders do not seek control over companies in which they invest for many reasons, which include the fear of obtaining price sensitive information, so institutional investors are more likely to influence rather than complete control.

Almost no literature was written about the size and impact of institutional investors in Palestine due to the newly established securities market and the new trend in institutional investment especially the foreign one. Very few studies were conducted concerning corporate governance at the PSE, one of them was conducted by (Abdelkarim & Alawneh, 2007), this study relates corporate governance and performance for companies listed at the PSE by considering ownership concentration as one of governance dimensions, they found that financial performance is negatively correlated to ownership concentration that weakens the corporate governance and market efficiency at all, they reported that Palestinian listed companies have ownership concentration that affects information disclosure and transparency that have an inverse impact on governance.

Based on the literature, this paper attempts to answer the following questions,

- 1- Does the involvement by institutional investors have an impact on corporate financial performance?
- 2- Is there a difference between the involvement of whole number of institutional investors and board member institutional investors?

Based on the mentioned questions, this paper will focus on a set of variables that will be tested through empirical testing using regression analysis. The following hypotheses explain the idea more clearly.

H_0 : There is statistically insignificant relationship between number of institutional investors and the corporate performance measured by Tobin's q.

H_1 : There is statistically significant relationship between number of institutional investors and the corporate performance measured by Tobin's q.

3. Methodology and Research Design

In order to test the above mentioned hypotheses, the following regression model was developed to fit the Palestinian context to assess the impact of institutional investors on corporate value for Palestinian companies listed at the Palestine Securities Exchange (PSE).

$$Q = \alpha + \beta_1 \text{debt} + \beta_2 \text{NIG} + \beta_3 \text{IR} + \beta_4 \text{NII} + e$$

Where α is the vertical intercept, β is the regression coefficients and e is the error term.

Debt: is measured as (total debt / total assets). It is a measure of firm's indebtedness, the proportion of the investments financed by debt, finance literature revealed that this variable have some impact on firm's value. we can note here that debt variable in this study is taken as total liabilities over total assets, because almost no long-term debt used by Palestinian companies.

NIG: Net Income Growth = $(NI_t - NI_{t-1}) / NI_{t-1}$ is the growth in net income after tax between the two years.

IR: Institutional investors represented on the board of the investee company.

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NII: The whole number of institutional investors holding a particular stock in a specific year.

Dependent variable: Tobin's Q: is one of the popular measures of corporate financial performance, **Q = market value of firm / corporate net worth**

The sample for the regression model was 18 selected PSE listed companies based on the availability of data during the period of the study, because the PSE contains 37 listed companies, but most of them have been recently listed and have no public data for these years. A cross-sectional regression analysis was used for three consecutive years 2005, 2006, 2007 & 2008 as the majority of companies were listed in the last four years to assess the impact of the existence of institutional investors on corporate financial performance measured by Tobin's q.

4. Discussion of Findings

In this part, the results of the empirical studies will be discussed and analyzed in relationship to paper hypotheses mentioned earlier. This part will discuss two main ideas; the first is the size of institutional investors in the Palestine Securities Exchange, and the second attempts to answer the question regarding the relationship between institutional investors and corporate performance.

First: that deals with the size of institutional investors in Palestinian market; As of April 27, 2008, the total percentage holding by institutional investors in Palestinian listed companies reached 53 % which represents 1,639.6 millions USD, which can be classified into local institutional investors account for 20.4 % of total market capitalization in that date which represents 630 millions USD, and foreign institutional investors with a total percentage holding reached 32.6 % of total market capitalization that represents 1,063.6 millions USD.

Second: this part tries to answer if there is a relationship between institutional investors and corporate performance. The measures of institutional investor ownership follow those used in (Hartzell and Starks, 2003). I find the total number of institutional investors holding a particular stock and the other is the number of institutional investors represented on Investee company's board for three consecutive years 2005, 2006, and 2007. I estimate a multivariate regression in which Tobin's q in each year is a function of various corporate variables. My particular focus is the impact of the number of institutional investors on performance. I run a regression for the three years 2005, 2006 & 2007 separately for 18 companies in each year. Consistent and significant findings were found in 2005 & 2006 about the relationship between the number of institutional investors and performance.

Table 1: Descriptive Statistics

	Minimum	Maximum	Mean	Std. Deviation
M/B	.48	2.87	1.4134	.67122
Debt	.0	77.0	29.967	21.6167
NII	4	153	42.17	46.795
NIG	-770	1212	53.83	423.570
IR	0	13	6.28	3.982

The above table represents a descriptive statistics. 18 observations for each variable. The market to book value variable ranges from 0.48 to 2.87 times, debt varies from 0

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to 77% with 22 standard deviation, which means there is a variety in the use of debt by firms in Palestine. A large deviation can be noticed in the net income growth variable which ranges from -770% to 1212% with 423% standard deviation which indicates that there is no earning stability for Palestinian firms due to the political and economic instability. Number of institutional investors variable ranges from 4 to 153 with 47 standard deviation, which means that Palestinian firms vary in their ownership structure regarding the involvement of institutional investors. The last one is the number of institutionals represented on board of investee companies, which varies from 0 to 13, from no institutional representation to full representation on board.

Table 2: Summary of regression results

		Regression	NII	IR	NIG	Debt
2005	Adjusted R ²	0.413				
	Sig	0.025	0.002	0.083	0.927	0.813
	B		0.03	-0.157	0	0.003
2006	Adjusted R ²	0.63				
	Sig	0.002	0.001	0.001	0.008	0.501
	B		0.009	-0.115	-0.001	-0.003
2007	Adjusted R ²	0.201				
	Sig	0.144	0.263	0.105	0.686	0.054
	B		0.005	-0.084	0	0.016
2008	Adjusted R ²	0.38				
	Sig	0.188	0.047	0.005	0.374	0.723
	B		0.005	-0.057	0	-0.002

2005 Analysis: looking at the coefficients which shows the importance of each independent variable in the explaining the changes in the dependent variable. The most important influential exploratory variable is the whole number of institutional investors, we can see a positive significant relationship between the whole number of institutional investors holding a particular stock and market to book value as a measure of performance, the regression coefficient is 0.03 and 0.002 significance. These results show the importance of the number of institutional investors holding the stock, and it is enforced by the negative but insignificant relationship between the number of institutional investors represented on board and firm's performance, so it is important to have a large number of institutional investors with diluted ownership (to prevent the concentration of ownership) to positively affect firm's performance. These results can be explained in light of the concentration of ownership, when the representation on board by institutionals increase, this would be at the expense of the whole number of institutional investors, making few institutional investors control the board and they may need to be monitored by other party. These results reveal that most of Palestinian listed companies are controlled by little number of members who are representatives for institutional investors, that they become not caring about monitoring management and board. As a result we accept the alternate hypothesis as long as the regression is significant at 0.05 significance level.

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Table 3: Correlations matrix 2005

		M/B	NII	NIG	REP	Debt
M/B	Pearson Correlation	1	.651(**)	-.133	-.073	.018
	Sig. (2-tailed)	.	.003	.599	.775	.944
	N	18	18	18	18	18
NII	Pearson Correlation	.651(**)	1	-.132	.389	-.046
	Sig. (2-tailed)	.003	.	.600	.110	.856
	N	18	18	18	18	18
NIG	Pearson Correlation	-.133	-.132	1	.047	.191
	Sig. (2-tailed)	.599	.600	.	.852	.447
	N	18	18	18	18	18
REP	Pearson Correlation	-.073	.389	.047	1	-.033
	Sig. (2-tailed)	.775	.110	.852	.	.897
	N	18	18	18	18	18
Debt	Pearson Correlation	.018	-.046	.191	-.033	1
	Sig. (2-tailed)	.944	.856	.447	.897	.
	N	18	18	18	18	18

** Correlation is significant at the 0.01 level (2-tailed).

Table 4: Model Summary 2005

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.742(a)	.551	.413	1.22689

a Predictors: (Constant), Representation on board, Debt, Net income growth, Number of institutionals

Table 5: ANOVA(b)

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	24.022	4	6.005	3.990	.025(a)
	Residual	19.568	13	1.505		
	Total	43.590	17			

a Predictors: (Constant), Representation on board, Debt, Net income growth, # of institutionals

b Dependent Variable: Market to Book

Table 6: Coefficients(a)

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	1.949	.688		2.834	.014
	NIG	.000	.000	-.018	-.093	.927
	NII	.030	.008	.799	3.908	.002
	Debt	.003	.013	.046	.242	.813
	REP	-.157	.084	-.381	-1.878	.083

a Dependent Variable: Market to Book

2006 Analysis: From the coefficients' table we can see that there are three significant relationships between dependent and independent variables, the first significant one is the positive relationship between the number of institutional investors and the firm's performance with 0.009 regression coefficient and 0.001 significance, the second is negative significant relationship between net income growth and firm's performance with -0.001 regression coefficient and 0.008

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significance, the third one is the negative significant relationship between the number of institutional investors on board and performance with -0.115 coefficient and 0.001 significance. These results can be explained in light of the weak efficiency of the Palestine Securities Exchange. Its important to have a large number of institutional investors, but still there is a lack of knowledge among various investors about the good impact of earning growth and the market does not distinguish between growing and non-growing companies. Hence we accept the alternate hypothesis. And the relationship can be expressed as follows.

$$Q = 1.904 - 0.001NIG - 0.115IR + 0.009NII$$

In addition, increasing the number of institutional investors will improve the governance practices and hence will have a positive impact on corporate value by decreasing the conflict that may arise between small and large institutional investors. Increasing the number of institutionals at the expense of the percentage holding (de-concentration of ownership) will have a liquidity effect by buying and selling shares when they believe that the stock is under or over-valued enhancing the stock to be traded on its fair value. The results of 2006 regression seem to be consistent with other studies making this study to add a value to the literature about the field of institutional investors and corporate performance.

Table 7: ANOVA(b)

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	5.484	4	1.371	8.194	.002(a)
	Residual	2.175	13	.167		
	Total	7.659	17			

a Predictors: (Constant), Representation on board, Debt, Number of institutionals, Net income growth

b Dependent Variable: Market to Book

Table 8: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.846(a)	.716	.629	.40904

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Table 9: Correlation Matrix 2006

		M/B	NII	NIG	REP	Debt
M/B	Pearson Correlation	1	.514(*)	-.345	-.329	.044
	Sig. (2-tailed)	.	.029	.161	.182	.862
	N	18	18	18	18	18
NII	Pearson Correlation	.514(*)	1	-.185	.277	.112
	Sig. (2-tailed)	.029	.	.462	.267	.657
	N	18	18	18	18	18
NIG	Pearson Correlation	-.345	-.185	1	-.372	-.227
	Sig. (2-tailed)	.161	.462	.	.129	.366
	N	18	18	18	18	18
REP	Pearson Correlation	-.329	.277	-.372	1	.052
	Sig. (2-tailed)	.182	.267	.129	.	.838
	N	18	18	18	18	18
Debt	Pearson Correlation	.044	.112	-.227	.052	1
	Sig. (2-tailed)	.862	.657	.366	.838	.
	N	18	18	18	18	18

* Correlation is significant at the 0.05 level (2-tailed).

Table 10: Coefficients(a)

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	1.904	.253		7.523	.000
	NIG	-.001	.000	-.508	-3.104	.008
	NII	.009	.002	.622	4.010	.001
	Debt	-.003	.005	-.105	-.692	.501
	REP	-.115	.028	-.685	-4.182	.001

2007 analysis: the regression results do not support the exploratory power; the overall regression was insignificant at 5% significance level.

Table 11: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.624(a)	.389	.201	.74003

a Predictors: (Constant), Representation on board, Debt, Number of institutionals, Net income growth

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Table 12: Correlation Matrix 2007

		M/B	NII	NIG	REP	Debt
M/B	Pearson Correlation	1	.115	-.085	-.338	.466
	Sig. (2-tailed)	.	.650	.736	.170	.051
	N	18	18	18	18	18
NII	Pearson Correlation	.115	1	-.189	.323	-.020
	Sig. (2-tailed)	.650	.	.453	.191	.939
	N	18	18	18	18	18
NIG	Pearson Correlation	-.085	-.189	1	-.120	-.364
	Sig. (2-tailed)	.736	.453	.	.636	.137
	N	18	18	18	18	18
REP	Pearson Correlation	-.338	.323	-.120	1	-.029
	Sig. (2-tailed)	.170	.191	.636	.	.910
	N	18	18	18	18	18
Debt	Pearson Correlation	.466	-.020	-.364	-.029	1
	Sig. (2-tailed)	.051	.939	.137	.910	.
	N	18	18	18	18	18

Table 13: ANOVA(b)

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	4.529	4	1.132	2.068	.144(a)
	Residual	7.119	13	.548		
	Total	11.649	17			

a Predictors: (Constant), Representation on board, Debt, Number of institutionals, Net income growth

b Dependent Variable: Market to Book

Table 14: Coefficients(a)

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	1.019	.471		2.167	.049
	NIG	.000	.000	.099	.413	.686
	NII	.005	.004	.272	1.170	.263
	Debt	.016	.008	.495	2.115	.054
	REP	-.084	.048	-.400	-1.741	.105

a Dependent Variable: Market to Book

2008 analysis: only 17 companies out of 18 were regretted, and one company was excluded due to the insufficient data and became unlisted company during the year 2008.

Table 15: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.616(a)	.379	.172	.400797

a Predictors: (Constant), NIG, NI, Debt, REP

Almost weak exploratory power for the whole regression for the year 2008 as indicated in $R^2 = 61\%$ and adjusted $R^2 = 38\%$, and as shown in the table below the whole regression is almost insignificant as the standard error is greater than 5%.

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Table 16: ANOVA

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	1.177	4	.294	1.831	.188(a)
	Residual	1.928	12	.161		
	Total	3.104	16			

a Predictors: (Constant), NIG, NI, Debt, REP

b Dependent Variable: Q

Table 17: Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	1.020	.248		4.108	.001
	Debt	-.002	.005	-.084	-.363	.723
	NII	.005	.002	.530	2.215	.047
	REP	-.057	.027	-.559	-2.146	.0501
	NIG	.000	.000	-.232	-.924	.374

a Dependent Variable: Q

The tables of coefficients shows that only the whole number of institutional investors and the institutional investors represented on board are significant with 0.005 regression coefficients for NII and -0.057 for the IR, but the whole regression is insignificant in explaining the performance of the companies as measured by M/B Here we can say that the direction of impact for each variable is consistent for all years of study.

Table 18: Correlations

		M/B	Debt	NII	REP	NIG
M/B	Pearson Correlation	1	.012	.375	-.327	.006
	Sig. (2-tailed)	.	.963	.139	.200	.982
	N	17	17	17	17	17
Debt	Pearson Correlation	.012	1	.084	-.121	.072
	Sig. (2-tailed)	.963	.	.747	.643	.784
	N	17	17	17	17	17
NII	Pearson Correlation	.375	.084	1	.247	.045
	Sig. (2-tailed)	.139	.747	.	.339	.864
	N	17	17	17	17	17
REP	Pearson Correlation	-.327	-.121	.247	1	-.393
	Sig. (2-tailed)	.200	.643	.339	.	.118
	N	17	17	17	17	17
NIG	Pearson Correlation	.006	.072	.045	-.393	1
	Sig. (2-tailed)	.982	.784	.864	.118	.
	N	17	17	17	17	17

5. Conclusion

From the previous analysis, institutional investors are the majority owners of most corporations listed on Palestine Securities Exchange. The results presented in this paper show contradiction findings. In one hand, it revealed a significant positive relationship between the whole number of institutional investors and corporate performance measured by Tobin's q, this result was found in 2005, 2006 & 2008, but not in 2007. On the other hand, a significant negative relationship was found between the number of institutional investors represented on the board of investee companies and firms performance in 2006 & 2008 only. These results can be explained in light of some dimensions; liquidity & information asymmetries, ownership concentration, results show also that net income growth has a negative relationship to corporate performance. The results are somewhat consistent with other studies but are inconclusive findings, results for the number of institutional investors are consistent with existing evidence, and other variables' results are somewhat consistent or less consistent due the weak efficiency in the securities market in Palestine.

It was found that there is an ownership concentration by some institutional investors in Palestine that may lead to a conflict of interest between large and small shareholders, it was found that one or two institutional investors control the board of investee companies, or it may increase its holding making the investee company a subsidiary or affiliate. And then "who watches who?" and "who watches the watchers" in which previous studies revealed that active institutional investors always do not set on boards. The inconclusive findings in this paper are not surprising, also in this field did not generate conclusive evidence about the true relationship between institutional investors and corporate performance, so further research is needed using other methodologies like time series analysis or considering more companies and years in the sample. Given the limited scope of the research in this topic, taking into consideration the weak efficiency of Palestine Securities Exchange & the lack of knowledge about institutional investors involvement, and small size of Palestine Securities Exchange that make it easy to be controlled by few number of large institutional investors.

During conducting the research, many limitations were encountered. First of all, the lack of data about corporate governance in Palestine and the lack of data and literature about institutional investors & ownership structure in Palestine. The use of other measure of financial performance, other than Tobin's q may show different results. Another important limitation is that the lack of sufficient years that limits the use of time series analysis before & after the involvement of institutional investors, since that the PSE was established in 1997, and the majority of companies were listed in the last four years.

6. Recommendations

- Give more attention to the large institutional holding, since that there is a positive relationship between the whole number of institutional investors and corporate performance. And a negative one between institutionals represented on board and performance.

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- The Capital Market Authority and Palestine Securities Exchange should set regulations that prevent a percentage holding of share in investee companies to protect the control by few institutional investors.
- To have better monitoring by large institutional investors, they should not set on board of investee companies in order to have wider bird's view image.
- It is important to work on knowledge and informative programs about the good impact of the large number of institutional investors and the bad impact of few large institutional investors who controls boards of investee company, enhancing low governance practices.

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