Investor Protection, Corporate Investment, and Valuation

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Abstract

Many firms around the world are managed by controlling shareholders who are entrenched with significant wealth exposures to their own illiquid businesses. Lacking investor protection inevitably causes concentrated insiders' equity ownership. Financial under-development induces significant under-diversification costs for the insiders. We analyze the economic consequences of imperfect investor protection and financial under-development for both the firms' diversified outside investors and controlling shareholders by developing a tractable dynamic model. The key mechanism is the insiders' trade-offs between their private benefits and under-diversification costs. We find empirical evidence consistent with the model predictions. In particular, we show that in countries with better investor protection or with more developed financial markets, i) corporations invest more, have higher Tobin's q and have lower expected stock returns; ii) corporate investment is more sensitive to Tobin's q; iii) the effect of firms' insider ownership on investment and Tobin's q is more negative; and iv) Tobin's q predicts expected stock returns less negatively whereas corporate investment predicts expected stock returns more negatively, than countries with weaker investor protection or with less developed financial markets.

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