Institutional Ownership and Firm Cash Holdings

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Abstract

The precautionary theory of firm cash holdings argues that firms hold cash to protect themselves against adverse cash flow shocks or external financial constraints that might force them to default on payments or forgo valuable investment opportunities. The aggressive trading of a group of institutional investors magnifies the firm’s stock price volatility and makes its external financing costly. This may induce the firm’s precautionary demand for cash. Consistent with the hypothesis, I find that firms with greater institutional ownership have more cash holdings. The relationship is purely driven by the ownership of short-term institutions (i.e., institutions that trade frequently for short-term trading profits). The ownership of long-term institutions (i.e., institutions that trade infrequently for long-term holding profits) is negatively associated with firm cash holdings. Further tests show that the effect of both types of institutional ownership on firm cash holdings is more significant for growth firms that rely more on external financing and suffer more from cash shortages.

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