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Understanding institutional investors and how they influence the market

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- **An institutional investor is a company or organization that invests pooled assets on behalf of its clients.**
- **Examples of institutional investors include hedge funds, mutual funds, and endowment funds.**
- **Because institutional investors buy and sell large amounts of securities, they can greatly influence price dynamics in the market.**
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All investors are not created equal, and institutional investors are in a league of their own. They're often called the "whales of Wall Street" because of their influence on the market. There are several different types of institutional investors, and you may be wondering what sets them apart from the average investor.

What is an institutional investor?

An institutional investor is a company or organization that invests pooled assets on behalf of its clients. Institutional investors buy and sell much larger quantities of **stocks**, **bonds**, or other securities than the average individual investor. Examples of institutional investors include mutual funds, pensions funds, and insurance companies.

Because institutional investors manage more capital than everyday investors, they often have access to resources the average investor does not.

"Institutional investors have access to a fair amount of databases and analytical tools to help them do their job," says investment banker **James Cassel**, chairman and cofounder of **Cassel Salpeter & Co**. "They also sometimes have access to the management of companies and to individuals with expertise in different fields that can help them in making investment decisions. They try to do proprietary research that individuals may not have access to."

The access they have to the management of companies helps them to have deeper insight into the businesses, explains Jeremy Cohen, senior vice president of Investor Relations at Edelman.

"Institutional investors have more resources to conduct deeper due diligence, whether that is channel checking or having their analyst call on customers to get a better sense of trends," Cohen says.

Quick tip: Institutional investors sometimes use program trading, which is the use of computer-powered algorithms to automatically buy or sell stock based on certain momentum in the market.

Institutional investors employ teams to examine every aspect of the different markets they buy, sell, and trade in. Individuals on these teams must have extensive knowledge of the markets and money management, and may come from a finance or accounting background.

They may be former investment bankers or stock analysts. Many will have a CFA certification on their resume, but Cohen says a liberal arts degree can be just as valuable if research and critical thinking skills were adopted along the way.

How do institutional investors impact the market?

Institutional investors are sometimes called market makers because they can have such huge influence in the financial industry. This is because of the large amounts they trade and how involved they are in important market events.

- **Influence security prices:** Institutional investors routinely trade large amounts in the market and are a driving force of supply and demand. In fact, the proportion of US public equities managed by institutions has risen to about 67% in 2010. These large movements cause stock prices to rise and fall depending on their activities. These changes in prices, although typically short-term, do influence how other investors interact with the market and can have a wider effect on the economy.
- **Report earnings:** Institutional investors are responsible for reporting earnings, usually on a quarterly basis so that clients know how a company is performing financially. This will provide insights into whether investors should buy or sell - which can result in volatility within that quarter.
- **Provide liquidity in the market:** Because institutional investors are often large funds and financial institutions, they're able to provide capital to companies when they need it.
- **Participate in initial public offerings (IPOs):** Institutional investors have the resources to utilize both public and private information to inform how and when to engage in an emerging company IPO. An academic study found that newly public companies with substantial institutional investment significantly outperformed those with less. The same study found that these institutional investors succeeded by making better use of the available public information - focusing on key metrics such as operating history, prior earnings, size, and liquidity.
- **Monitor governance issues:** Institutional investors play an important role in monitoring corporate governance issues, which has previously included: majority voting, focusing on the quality and diversity of Boards of Directors, as well as compensation structures and concerns about the runaway growth in executive pay.

Types of institutional investors

There are several types of institutional investors, and each type is responsible for managing a large number of assets and investing these funds based on their clients' goals. Examples of institutional investors include hedge funds, pension funds, endowment funds, and private equity funds.

Let's break down each type:

- **Hedge funds:** These are pooled investment funds that aggressively invest in a wide array of assets, with the goal of providing the highest return as quickly as possible.
- **Private equity funds:** These types of funds gather money to be invested in companies that likely will have a high return rate. Unlike hedge funds, private equity funds are focused on long-term potential and may not seek a return on investment for four to seven years.
- **Pension funds:** These types of fund accumulates money that will be paid to employees after retirement. These funds gather contributions from employees and employers - or both - to be invested in capital markets such as stock or bond markets. The goal, of course, is to multiply the money for the benefit of retirees.
- **Endowment funds:** These are investment funds established by a foundation with donations made to the organization. Universities, nonprofit organizations, churches, and hospitals often use endowment funds. The foundation typically makes frequent withdrawals from the endowment fund, within the guidelines of the fund's established usage policy. A university, for example, may use an endowment fund to award scholarships.
- **Commercial banks:** These types of financial institutionals invest a portion of the money they hold for customers, but federal regulations restrict how much risk banks can take on to protect your deposits.
- **Insurance companies:** These types of companies make money in part by investing a portion of the premiums received from their customers.
- **Mutual funds:** These investing vehicles allow investors to pool their money for investments that are actively managed. Examples include bond funds, money market funds, stock funds, and target-date funds.

Quick tip: Institutional investors oftentimes have experience in specific industries that helps them make their investment decisions.

Retail investors vs. institutional investors

Institutional investors are not to be confused with retail investors. Understanding the difference is important because institutional investors and retail investors have different resources and regulations and even face different fees. "A retail investor is an individual; an institutional investor is an organization," Cohen explains.

If you're working with a brokerage firm or robo investing app to invest your own money for your own personal goals - such as planning for retirement, paying for kids' education, or buying a beach house - you're a retail investor.

Retail investors are considered less savvy than institutional investors and therefore are subject to more protective regulations from the Securities and Exchange Commission (SEC) to prevent them from making complex, high-risk investments. Retail investors also have considerably smaller purchasing power and thus often pay higher fees.

Institutional investors, on the other hand, invest funds from other entities for the benefit of those clients and on a much larger scale and more frequently. "The biggest difference is size and sophistication," Cohen says. "An institutional investor will have analysts and portfolio managers and they'll have the infrastructure to trade more quickly."

Because of their size and sophistication, institutional investors can typically negotiate better fees and are under fewer restrictions.

Here's an overview of the major differences between the two types of investors:

Institutional investor	Retail investor
• Invests and manages the money of other people and organizations • Trades frequently and works with large amounts of money • Able to negotiate lower fees • Has access to specialized knowledge, research, and resources • Subject to fewer protective regulations	• Invests own money • Trades infrequently and works with a relatively small amount of money • Subject to high brokerage fees • Has limited investing knowledge and resources • Subject to more protective regulations

Quick tip: Individual investors can get access to professional money management. You could, for example, invest in a mutual fund through Fidelity or Berkshire Hathaway and get institutional management with expertise in investing.

The financial takeaway

Institutional investors are companies or organizations that invest on behalf of their clients - usually other companies or organizations. Institutional investors are the big fish of investing because they can greatly impact the market, in part by making much larger and more frequent trades than the average individual investor.

As with nearly all things, when it comes to investing, knowledge is power. Institutional investors have deep pockets and a wealth of information to help them manage the massive amount of funds they're in charge of. While you may not be able to buy, sell, and trade like the market makers, you can empower yourself with a deeper understanding of investing.