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The informational role of individual investors in stock pricing: Evidence from large individual and small retail investors[☆]



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ABSTRACT

Using a unique data set, we find that large individual investors are successful at picking stocks. Large individual investors' correlated trades can not only move synchronous stock prices but also positively predict future returns. More importantly, they tend to trade before major earnings announcements and large price changes. By contrast, small retail investors' correlated trades are inversely associated with synchronous and future stock returns, indicating that small retails are uninformed. The differential information content between large individuals and small retails highlights the need to classify individual investors according to their investment amount when examining their role in stock pricing.

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1. Introduction

This paper examines the informational role of individual investors in stock pricing. Past literature has documented that institutional investors tend to trade the same stocks on the same side during a

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short-term period and that their correlated trades can not only move stock prices but also predict future returns.³ In contrast to institutional investors, despite a growing body of literature devoted to examining the trading of individual investors, questions on whether individual investors herd and how their trading affects synchronous and future stock returns are still being debated.⁴ In this paper, we explore these issues by analyzing the transactions of all investors in an emerging market.

Our unique dataset consists of the complete historical order, trade records, and the identities of the investors in the Taiwan stock market from January 2001 to December 2006, allowing us to perform a detailed analysis of investors' trading behavior and its impact on stock prices. According to their identity, we group all investors as individuals, local institutions, or foreigners.⁵ We then further categorize the investors in each group into large-size and small-size traders based on their annual trading dollar value. We are particularly interested in examining whether the effect of stock trading on synchronous and future stock returns is different among large individual and small retail investors.⁶ We hypothesize that large individual investors have more precise information regarding the fundamental value of stocks than small retail investors. The rationale of our hypothesis is based on the assumption that large individual investors are in a better position to access private information or they can better interpret a firm's public information.⁷ To test our hypothesis, we examine the relationship between investors' correlated trades and concurrent and future stock returns. The relationship of a concurrent return with the herds in a group of investors is related to whether the investors' trades can move stock prices, while the future return predictability is the measure that is most likely to reflect differential information among investors.

Interestingly, although large individual investors are "small" in terms of the number of accounts and trading dollar volume, our empirical result demonstrates that the correlated trades of large individual investors can move concurrent stock prices and positively predict the cross-section of stock returns over the subsequent 20-day period. In contrast, despite that small retail investors account for 99% of total accounts and nearly 60% of the market trading dollar volume, the trades of small retail investors are oppositely related to synchronous and future stock returns. This finding is crucial in understanding and interpreting the mixed results of literature on the informational role of individual investors.

We begin our analyses by investigating whether individual and institutional investors herd. Using the Lakonishok et al. (1992) herding measure, we find a mean herding level of 4.64% when at least five large individual investors trade one stock during any given day. The measure increases monotonically to 5.68% if at least 20 investors trade. For local institutions and foreigners, the mean herding levels are 4.16% and 5.14%, respectively, when at least five institutions trade. These results show that our average levels of investors' herding are larger than that reported by Lakonishok et al. (1992) for their sample of pension funds (2.0%) and by Wermers (1999) for his sample of mutual funds (3.61%).⁸ We also examine the association between

³ Please refer to Lakonishok et al. (1992), Nofsinger and Sias (1999), and Wermers (1999).

⁴ Existing studies have different views on the informational role of individual investors. The noise trader theory argues that individual investors are uninformed investors (see Black (1986); Barber et al. (2009a); Seasholes and Zhu (2010)). This strand of literature asserts that individual investors with little investment knowledge may trade on noise, thus resulting in pushing stock prices away from their fundamental value (Hvidkjaer, 2008; Dorn et al., 2008; Barber et al., 2009b). Moreover, naive individual investors provide immediacy to informed traders and are compensated for price reversals, which are caused by the price pressure of heavily informed trades (Kaniel et al., 2008). Another strand of literature, called the informed trader hypothesis, argues that some groups of individual investors can exploit private information and trade for profit. The informed trades by individuals are helpful to speed up the process of incorporating private information into stock prices, thus improving market efficiency (Kaniel et al., 2012; Kelley and Tetlock, 2013). In addition to rational models, behavioral finance literature demonstrates that individual investors tend to suffer from behavioral biases and thus have lower investment returns than the benchmark (Odean, 1998; Barber and Odean, 2000, 2001).

⁵ Several studies examining U.S. data separate investors and stocks into locals and non-locals (e.g., Coval and Moskowitz, 2001; Baik et al., 2010; Seasholes and Zhu, 2010) using geographic distance or state identifiers. In comparison to the 50 states, the area of Taiwan is 13,974 mile² and is smaller than West Virginia (24,231 mile², the 41st largest state in the U.S. by area) but larger than Maryland (12,407 mile², the 42nd largest state). If we use a similar standard as a measure of geographic proximity, it is suitable to regard domestic investors as local investors while foreigners as non-local investors.

⁶ We also conduct empirical analyses for local institutions and foreigners and present the results as a reference.

⁷ Large individual investors are better at developing close relationships with corporate insiders and employees than small retail investors. Furthermore, large individual investors can buy financial analysts' reports, hire financial analysts as investment advisors, or mandate their investments to professional managers. Therefore, large individual investors have advantages in analyzing the information regarding future cash flows. This is not surprising because the benefits from higher returns on large amount of investments can offset the costs spent on gathering information.

⁸ We note that our herding measures are calculated using the daily transaction data rather than the changes of quarterly holding data used by Lakonishok et al. (1992) and Wermers (1999).

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