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Institutional Investors and Stock Return Anomalies[#]

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Abstract

We examine institutional demand prior to well-known stock return anomalies and find that institutions have a strong tendency to buy stocks classified as overvalued (short leg of anomaly), and that these stocks have particularly negative ex post abnormal returns. Our results differ from numerous studies documenting a positive relation between institutional demand and future returns. We trace the difference to measurement horizon. We too find a positive relation at a quarterly horizon. However, the relation turns strongly negative at the one-year horizon used in anomaly studies. We consider several explanations for institutions' tendency to trade contrary to anomaly prescriptions. Our evidence largely rules out explanations based on flow and limits-of-arbitrage, but is more consistent with agency-induced preferences for stock characteristics that relate to poor long-run performance.

JEL Classification: G12; G14; G23
Keywords: investor base, limits-of-arbitrage, mispricing, herding, trading strategies

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