



Valuation uncertainty, market sentiment and the informativeness of institutional trades



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ABSTRACT

Prior studies indicate that institutional investors are informed, in the sense that their trades predict price changes. In this study we show that return predictive ability of institutions arises (after controlling for size, book-to-market, and momentum) mainly from institutional sales of hard-to-value stocks during periods of positive market sentiment. These results support the notion that these stocks tend to be overvalued during periods of bullish market sentiment, and institutions contribute to market efficiency by identifying and trading on these overpriced stocks.

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“Security analysis would be used not to discover undervalued securities about to undergo a rapid price increase (an activity which competition should prevent from yielding appreciable returns over cost), but to avoid purchasing (or to sell if already owned) the occasional overvalued security which less informed investors have bid up”.

— Miller (1977)

In the span of five decades, institutional ownership in the US equity market has increased from 8 to more than 68%, and institutional trades account for more than 96% of NYSE trading volume in the recent data.¹ This has resulted in increased research focusing on the role of institutions in facilitating market liquidity and affecting price formation.

There have been numerous studies providing evidence that institutions are informed. For example, Alexander et al. (2007) find that the stocks purchased by mutual funds earn significantly higher returns than the stocks they sell. Yan and Zhang (2009) re-

port that the trades of institutional investors with short investment horizons exhibit higher levels of return predictive ability. Several studies, including in particular Chordia et al. (2011) and Boehmer and Kelley (2009) present evidence that increased institutional trading has improved market efficiency. Consistent with the reasoning that enhanced competition among institutions has reduced mispricing, Barras et al. (2010) show that the superior predictive ability of institutional trades for future price changes has declined since the 1990s.

In this paper, we assess whether institutional trades continue to display predictive ability, and, if so, whether the predictive ability varies with stock characteristics and across market states. We focus in particular on institutional sales during periods of positive market sentiment. This is because, as Miller (1977) has noted, uninformed investors may occasionally bid up share prices beyond fundamental value, and the overvaluation is most likely to occur for stocks with high valuation uncertainty (VU). Such overvaluation would present profit opportunities. Moreover, as Pontiff (2006) emphasizes, firm specific risk creates costs that impede arbitrage.² Such risk will be particularly pronounced for those securities with high VU, especially during periods when market

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¹ According to the Federal Reserve Board's Flow of Funds (2009) report and Boehmer and Kelley (2009).

² Several studies find evidence that firm specific idiosyncratic volatility makes it risky for risk-averse arbitrageur to take positions. For example, Mendenhall (2004) finds that magnitude of post-earnings-announcement drift is strongly pos-

sentiments are overly optimistic. We therefore assess separately the predictive ability of institutional purchases versus sales of stocks with different levels of VU. In addition, we also distinguish whether the trades are completed during periods of high versus low market sentiment.

Our analysis is also related to the existing literature on valuation uncertainty and market sentiment. Baker and Wurgler (2006) show that the prices of high VU stocks are bid up during periods of optimistic market sentiment, resulting in lower future stock returns. Stambaugh et al. (2012) combine market sentiment with Miller (1977)'s short sale argument and show that the return on the short leg of several long-short strategies is lower during high sentiment periods.

In light of these findings, we hypothesize that well-informed institutional investors should be able to profit from selling high VU stocks during periods of high investor sentiment. In other words, we assess whether institutional traders take advantage of the aforementioned overvaluation.

To test this hypothesis, we obtain institutional trading data from the CDA/Spectrum quarterly institutional holdings database (13F). The 13F dataset contains the universe of all large institutions with greater than \$100 million of securities under management.³ We consider eight VU proxies used in the related literature: firm age (inverse), stock return volatility, idiosyncratic risk, turnover, cash flow volatility, firm size, book-to-market (inverse), and analyst forecast dispersion (Baker and Wurgler (2006), Zhang (2006a,b), and Kumar (2009)). We also derive the first principal component (FCP) of all the eight VU proxies as a combined VU measure. We categorize a trading portfolio formation quarter as a positive or negative sentiment quarter based on the composite investor sentiment index developed by Baker and Wurgler (2006). We then track the performance of the stocks that institutions intensively buy or sell during each quarter, and report subsequent stock returns adjusted by the Daniel et al. (1997) characteristics. We report abnormal returns for stocks sorted by the levels of VU, and during high versus low sentiment periods, respectively.⁴

Largely consistent with our main hypothesis, our results indicate that the predictive ability of institutional trades is mainly found in stocks with high VU and more so during periods of positive market-wide investor sentiment. Specifically, high VU stocks that institutions intensively sell significantly underperform stocks with similar firm sizes, book-to-market values, and past returns. In contrast, there are no consistently significant positive abnormal returns following institutional buys. We further find that the predictive ability is usually confined to institutional sales of high VU stocks during periods of high market sentiment. In contrast, there is little consistent predictive ability in institutional sales of high VU stock during low sentiment periods. This finding is consistent with the notion that market sentiment is the key driver of the overvaluation of high VU stocks. Interestingly, institutional sales in the high VU stocks during high sentiment periods predict significantly negative subsequent quarter's earnings surprise. We do not observe this for sales of low VU stocks or for sales completed during low sentiment periods. These results indicate that it is possible that institutions' informational advantage may be due to their ability to forecast earnings-related fundamentals.

In light of the evidence reported by Barras et al. (2010) that institutional trading performance declines since the mid-1990s, we

partition our sample into pre-1996 and post-1996 periods to examine whether our main findings remain robust post mid-1990s. We find equally strong predictive power of institutional trades for both subsamples. In the post-1996 sample, we find that institutional selling in high VU stocks during optimistic market sentiment periods continues to predict statistically significant negative future returns.

This paper extends and refines the literature on the informational content of institutional trades. Our paper is the first to show evidence that institutional trades' significant predictive power is largely confined to sell trades. This evidence is consistent with the reasoning of Miller (1977) that potentially successful security analysis should be derived from selling or avoiding buying overvalued stocks, especially for stocks with high VU. Further, by documenting that the predictive ability of institutions usually comes from the trading of high VU stocks during periods of optimistic market sentiment, our results support and extends the findings of Baker and Wurgler (2006).⁵

In our opinion, this study is most closely related to Stambaugh et al. (2012), who argue that impediments to short selling are the major obstacle to eliminating overpricing in the presence of market-wide sentiment. They examine a broad set of well-documented anomalies relative to the Fama and French three-factor model. And they document that adjusted profits from a long-short strategy are confined to months following high investor sentiment periods, and that the profit from exploiting the anomalies are attributable to the short-leg portfolio. A key difference between our study and theirs is that we focus on institutional trades. Specifically, we focus on assessing whether institutional investors are able to exploit and correct the overpricing. To the extent that institutional investors are dominant players in today's stock market, our results on the informativeness of institutional investors' trades will also shed light on the stock market efficiency. In this regard, our paper compliments that of Stambaugh et al. (2012).

The remainder of the paper is structured as follows. Section 1 develops the hypothesis; Section 2 describes the data and variables constructed. In Section 3 we present our empirical findings, and Section 4, robustness checks. Section 5 concludes the paper.

1. Related literature and hypothesis development

Existing research findings on the informativeness of institutional trades are mixed. Proponents of efficient markets argue that given the fierce competitiveness of institutions in the equity market, any mispricing will be arbitrated away instantaneously. Studies supporting this notion include Gompers and Metrick (2001), Barras et al. (2010), and Lewellen (2011).

However, there are numerous studies that find evidence suggesting that market may not be efficient, as there are occasionally mispriced stocks in the market. One particular explanation for mispricing is by Miller (1977), who proposes that if pessimists face binding short-sales constraints, then the price of an asset will reflect the valuation of optimists and as a result, he predicts that stocks with higher uncertainty will tend to be overpriced. Empirical evidence supporting Miller's (1977) assertions include Chen et al. (2002), Diether et al. (2002), and Zhang (2006a,b). These studies documented empirical evidence suggesting that young, volatile, stocks with higher analyst dispersion, and other "valuation uncertainty" (VU) stocks are subjected to overvaluation.⁶

ively related to the idiosyncratic risk. Mashruwala et al. (2006) find accrual anomaly is concentrated in firms with high idiosyncratic stock return volatility.

³ Using quarterly institutional holding data from 13F may underestimate institutional investors' stock selection skills and therefore will bias against the tests of our hypothesis.

⁴ For the sake of brevity, we report results for firm age (inverse), stock return volatility, analyst forecast dispersion and the first principal component in the main tables and the rest of the results are available in the online appendix.

⁵ Our finding is also consistent with Yan and Zhang (2009), and Schultz (2010), who suggest that profitable trading opportunities are more likely to arise for small and growth (which are highly uncertain) stocks in general.

⁶ Valuation uncertainty refers to information *sparsity* or *ambiguity*. The concept of valuation uncertainty dates to the revolutionary work by Knight (1921). Uncertainty is distinguished from risk in that risk reflects randomness with known probability while uncertainty is randomness with unknown probabilities.

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