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Institutional trading and attention bias☆

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ABSTRACT

Share repurchase announcements with higher turnover ratio attract more attention from institutions than events with lower turnover ratio. The stock price behavior is associated with the institutional trading behavior around share repurchase announcements. The higher exposure to the attention bias, the worse the post-trade performance the institution earns. Because of the agency problem and lack of sophistication, domestic mutual funds suffer from attention bias in Taiwan.

1. Introduction

The connection between information and price changes is an important issue of market efficiency. Thus, exploring how market participants react to public firm-specific information can provide new insights into market efficiency, particularly, when the market participants have the ability to move prices (Nofsinger, 2001). Several studies have shown that institutional investors have the ability to move prices directly through their own trading, as well as indirectly, by influencing the trading decisions of other market participants who may follow their actions (Chakravarty, 2001; Nofsinger and Sias, 1999; Wermers, 1999; Griffin et al., 2003; Sias et al., 2001; Chiao et al., 2011; Bennett et al., 2003; Gompers and Metrick, 2001). We contribute to this line of research by testing the trading behavior of institutional investors around share repurchase announcements (SRAs, thereafter). Specifically, we argue that if a certain institution's attention is attracted by SRAs, their attention will be reflected in their post-event trading relative to their pre-event trading, leading to a higher magnitude of reversal in their trade imbalance during the post-SRA period. We believe that an understanding of whether SRAs

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attract institutions, the characteristics of SRAs that attract institutions, and whether post-SRA returns relate to institutional trading is of great importance for academics, practitioners, and regulators.

Most recent studies focus on developed markets, which are usually dominated by institutional investors, and little research has been carried out regarding this issue in emerging stock markets, which are usually dominated by retail investors. For example, Schwartz and Shapiro (1992) reveal that on the NYSE, a 70% share of all dollar trading volume was held by institutional investors in 1989; by contrast, in the same year only 3% of all dollar trading volume in Taiwan was held by institutional investors.[1] As a result, it is reasonable to examine whether the price impact around SRAs by institutional investors, which comprise a small proportion of the trading volume in the Taiwan stock market, still exists.

Since daily institutional trading data is not easily assessed, most prior empirical studies of institutional trading have focused on quarterly or annual data (e.g., Grinstein and Michaely, 2005).[2] Few studies have explored the relationship between institutional daily trading behavior and SRAs. Puckett and Yan (2011) show that institutional investors are able to earn significant abnormal returns on their trades within the trading quarter, and that interim trading skill is persistent. They suggest that the trading performance shown by prior studies using quarterly data are biased downward because of the inability of researchers to publicly access interim trades. We argue that quarterly holdings data cannot capture interim institutional trading within a quarter, such as the exact timing of institutional trading surrounding SRAs. In particular, we show that institutional trading occurs very near the SRA date – about a month before and a month after – which is less than a quarter. As a result, daily institutional trading data in Taiwan allows us, for the first time, to contribute to the literature by examining institutional trading in response to SRAs.

We find that SRAs attract institutions, switching their trading behavior from net selling to net buying (or less net selling), i.e., trading behavior displays a reversal pattern, particularly for domestic institutions. This finding is consistent with the argument that SRAs attract institutions (Grinstein and Michaely, 2005; Shleifer and Vishny, 1986; Allen et al., 2000). If institutional investors do have informational advantages, we can expect that institutions are able to trade SRAs with better post-trade performance. That is, the portfolio with the largest reversal in trade imbalance should earn higher returns subsequent to their trading, and the portfolio with the lowest reversal in trade imbalance should have lower returns following their trading (DeLong et al., 1990; Choe et al., 1999; Nofsinger and Sias, 1999; Wermers, 1999; Sias, 2004). Inconsistent with the information-based trading hypothesis, we document that institutions do not have the superior ability in identifying SRA stocks. In particular, for domestic money managers (mutual funds), the presence of return reversals following reversals in trade imbalance suggests that their trading is non-information-based and drives asset prices away from fundamental values.

Furthermore, we use post-trade performance to measure the informativeness of the institutional investor, and use reversal index to measure the level of attention bias. Lee et al. (2010) show that the less-informed investors are heavily influenced by attention-grabbing news. If reversal trading behavior does reflect institutional attention bias, then we might see that the higher exposure to the attention bias (the higher reversal tendency), the worse the post-trade performance the institution earns. Consistent with the argument, we find that local mutual funds not only exhibit the strongest reversal tendency, but also experience the worst post-trade performance, supporting that reversal trading behavior is the effect of attention bias.

We document that prior turnover ratio is mostly related to reversal in trade imbalance. Several studies have used turnover ratio (or trading volume) as a proxy for investor attention. For example,

[1] The percentages of institutional trading in terms of trading value are 13.9%, 22.5%, and 27.9% in 2000, 2004, and 2009, respectively.

[2] In most previous studies of the US stock market, data on the number of shares held by institutional investors is collected from CDA Spectrum, Morningstar or Standard and Poors' Security Owners' Stock Guides. In particular, many studies on institutional ownership use CDA Spectrum. (All institutional investors with more than $100 million in equity ownership have to report their holdings to the Securities and Exchange Commission in quarterly 13F filings.) Although CDA Spectrum provides the type of the institutional investor and the number of shares held by each institution for all publicly traded companies, it is available only on a quarterly basis. As a result, it is impossible to examine immediate institutional trading in response to daily events (Chen and Hong, 2006). For example, Nofsinger and Sias (1999) infer the trading behavior of various types of investors by using trade size or institutional ownership as a proxy.