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Herding behavior in institutional investors: Evidence from China's stock market



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ABSTRACT

This paper tests how institutional herding affects future excess stock returns in China's stock market. By employing a hand-collected institutional holding database, we create the herding measure following Lakonishok et al. (1992). The results suggest that both short-term and long-term future excess stock returns are positively correlated with the herding measure. The results hold true for next-day, next-quarter, and next-year excess stock returns. Furthermore, herding effect is found mostly significant on buy side herd and herding affects excess stock returns more significantly during the crisis period. By testing the herding effect for different stock portfolios, we find that when institutional investors herd on larger, value or liquid stocks, the price effect is stronger and short lived, but when institutional investors herd on smaller, growth, or illiquid stocks, the price effect lasts much longer. Finally, persistent herd activities are positively associated with excess stock returns for short to medium time periods (one month and one quarter), but are negatively associated with excess stock returns for a long run.

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1. Introduction

Investors may herd on actively traded stocks, especially when they are less informed or less educated. Bikhchandani et al. (1992) explain this behavior by informational cascades: investors who herd tend to follow the trading pattern of more sophisticated investors to trade towards the same direction rather than process the financial information by themselves. Therefore, herd behavior can cause stock prices to deviate from their fundamentals and destabilize the stock market (Lakonishok et al., 1992).

Existing literature studies the effect of herd behavior on stock market from two perspectives. One strand of research investigates how investors herd around the market. Christie and Huang (1995) introduce a model to use cross-sectional standard deviation (CSSD) to proxy for market herd behavior and test investor herd behavior in the U.S. market. Chang et al. (2000) further develop the model to use cross-sectional absolute deviation of returns (CSAD) to proxy for herd behavior

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and apply the model in several Asian markets (Hong Kong, Japan, South Korea, and Taiwan).¹ They find evidence of herding in South Korea and Taiwan, but only partial evidence of herding in Japan and no evidence in the U.S. Following this line, Demirer and Kutan (2006), Tan et al. (2008) and Chiang and Zheng (2010) among others also confirm the existence of herding in Asian markets.

The other strand of research focuses on herd behavior among institutional investors. Lakonishok et al. (1992) find a positive-feedback trading strategy among pension fund managers. Grinblatt et al. (1995) find evidence of herding activities among mutual fund managers. Welch (2000) documents that investment recommendations from earlier financial analysts have positive influence on later analysts' revision.

More recent research starts to investigate how herd behavior affects stock returns. The results from Wermers (1999) suggest that stocks that investors herd on buy side outperform those with sell herds by 4 percent in the following six months; this return difference is stronger among small stocks.² On the other hand, Sias (2004) documents that institutional investors' demand for a security this quarter is positively correlated with their demand for the security last quarter, but there is no evidence indicating that institutional herding drives stock prices from fundamental values. By looking at how herd behavior affects long-term stock returns, Dasgupta et al. (2011) find that persistent institutional trading is negatively associated with long-term returns, i.e., persistently bought stocks underperform persistently sold stocks at long horizons. The effect is stronger for smaller stocks. These results again indicate that herd behavior may cause price anomalies and the anomalies tend to adjust back to fundamentals in a long run. In this strand of research, herding is generally proxied by the imbalance between buy and sell trading orders.³

The first strand of research indicates that less advanced markets tend to exhibit stronger herd behavior. However, most studies on institutional herding only focus on the U.S. market and some other advanced markets. Research on emerging market herding is mostly at the market level. Furthermore, studies that investigate institutional herding on stock returns are mainly focused on long-term stock returns (Sias, 2004; Wermers, 1999); effect on short-term stock returns is little discussed. Along with other questions, large gaps in literature are left for further investigations.

This research tends to fill in the gaps and contribute to literature from the following aspects. First, we study institutional herding behavior in China, which is one of the largest and most rapidly growing markets,⁴ but the research on institutional herding in China is not thorough. In existing literatures, Schuppli and Bohl (2010) find foreign institutions have a stabilizing effect on China's stock markets and contribute to market efficiency. Li et al. (2009) suggest that institutional investors are more likely to herd than individual investors. Frijns et al. (2014) use daily data to investigate the stock return behavior of institutional holding stocks and find strong evidence of price pressure, informed trading, and momentum trading for institutional investors. The above findings provide important insight in studying institutional investor behavior in China. However, these studies all have limitations in that only stock trading information (return and trading volume) is used in conducting the research, but the importance of institutional investor trading imbalance is ignored. Our research takes another perspective by adopting institutional investor holding data to analyze how investor herding affect stock returns in China.

Second, due to data unavailability or unreliability, institutional herding research is mainly undertaken for developed markets,⁵ with only a few studies examining the institutional herding in emerging economies such as Taiwan (Chen et al., 2008; Hung et al., 2010; Chiao et al., 2011), Korea (Kim and Wei, 2002; Choe et al., 1999), and Poland (Voronkova and Bohl, 2005). These studies find that in general institutional herding exists in those markets. For example, Kim and Wei (2002) and Choe et al. (1999) find foreign investor herding in Korea; Voronkova and Bohl (2005) find pension fund herding in Poland; Chen et al. (2008) find foreign investor herding in Taiwan and Hung et al. (2010) find mutual fund' herding in Taiwan. China's stock market was established and developed later than advanced markets and also many emerging economies. However, it has been playing a more and more important role in global portfolio management, especially in the emerging market context.⁶ This study employs a unique database⁷ in which investor holding information at firm level is collected for most major types of institutional investors in China's stock market.⁸ Therefore, we could implement a comprehensive study on institutional herding and its effect on stock returns in China's stock market. Furthermore, the results from this study could shed light on studying institutional herding in other emerging markets.

¹ Followings are the expression of CSSD and CSAD:
$$CSSD_t = \sqrt{\frac{\sum_{i=1}^N (R_{i,t} - R_{m,t})^2}{(N-1)}}, CSAD_t = \frac{1}{N} \sum_{i=1}^N |R_{i,t} - R_{m,t}|$$
 where N is the number of firms in the portfolio,

$R_{i,t}$ is the observed stock return of industry i at time t , and $R_{m,t}$ is the cross-sectional average stock of N returns in the portfolio at time t .

² The positive correlation between institutional investor demand and future returns also can be found in Nofsinger and Sias (1999), Grinblatt et al. (1995), Cohen et al. (2002), and Chen et al. (2002), among others.

³ The detailed description on models can be found in Section 3.

⁴ See Section 2 for more details about China's stock market and institutional investors.

⁵ For example, Kremer and Nautz (2013) document that institutional herding activities affect short-term stock returns in German stock market.

⁶ As of 2015, China market weighs 25.07% in MSCI emerging market index, one of the most tracked emerging market index: https://www.msci.com/resources/factsheets/index_fact_sheet/msci-emerging-markets-index-usd-net.pdf.

⁷ The data is hand collected by GTA information technology from CSRC (China Securities Regulatory Commission) under our special request.

⁸ Please see data description in Section 4.

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