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# Investor biases in Japan: Another pathology of *Keiretsu*

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**Abstract**

We examine how *keiretsu*-related institutional investors behave in the Japanese stock market relative to other investor categories for the period from 1985–1998. Based on the agency problem hypothesis for the general bias of institutional investors and the relational distance hypothesis for the unusual bias of *keiretsu*-affiliated money managers, this paper finds that *keiretsu*-affiliated money managers over-invest not only in large firms, but also in *imprudent* firms. The group affiliation of Japanese domestic money managers may drive their portfolio decisions towards financially weak group member firms at the expense of their client investors. Identifying the conditions for this rescue type of investment, we illustrate a rather weak corporate governance foundation of institutional money management in Japan.


*JEL classification:* G1; G15
*Keywords:* Institutional investors; *Keiretsu*; Agency problems; Information asymmetries; Japanese corporate governance

## 1. Introduction

This paper investigates an interesting question: Under what condition do *keiretsu*-affiliated domestic institutional money management agents change their investment style? The possible spectrum of their investment ranges from the style of a purely prudent money manager like a foreign portfolio investor to that of a corporate cross-holding shareholder. We first compare the behavior of Japanese money managers with that of foreign investors using the market portfolio as an unbiased benchmark. Next, similar to the study by Bennet, Sias, and Starks (2003) for U.S. institutions, we break down the domestic institutional investor group into three sub-categories: pension funds, investment trust (mutual) funds, and others.[1] The third sub-category represents the

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[1] Bennet, Sias and Starks (2003) differently classify the U.S. institutional investor group into five sub-categories.

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least transparent out of the three. The Japanese institutional management practice may be different internationally because of the existence of *keiretsu*-affiliated money managers and because of less transparent funds managed by them. We also compare investment bias among the three sub-categories and identify any condition in which *keiretsu*-affiliated agents change from a prudent manager to a cross-holding shareholder.

The ownership percentage of the domestic institutional investor group ranged between 23% and 31%, peaking in 1989 (Table 1) during the bubble and the post-bubble periods in Japan. The total percentage ownership of more professionally managed groups (i.e., pension and mutual funds) was relatively small in Japan, at 2.4% in 1985 and 7.2% in 1999. The remaining "others" consist of the special trust accounts managed by trust banks, mostly with a Japanese brand. Our analysis focuses on corporate governance of institutional money management and finds that the others sub-category over-invests in *keiretsu*-affiliated firms in trouble.

While the behavior of foreign investors is interesting to study, we mainly use it as the most prudent benchmark against which the investment bias of the domestic institutional investor categories is compared. Foreign investors have substantially increased their presence in Japan.[2] The group was the third largest consisting mostly of large global investors with full money management capacities in their home countries (Froot et al., 2001).[3]

Bennet, Sias and Starks (2003) and Sias, Starks and Titman (2006), among many, investigate the relationship between institutional ownership and stock returns. In an international context, Kamesaka, Nofsinger and Kawakita (2003) find that foreign investors use information-based positive-feedback trading for higher returns than other classes of investors in Japan. Kim and Nofsinger (2005) document that Japanese institutional investors herd less than the U.S. counterpart does, but the impact of institutional herding is much stronger on stock prices than found in the U.S., especially for *keiretsu*-affiliated firms. Karolyi (2002) find evidence of positive-feedback trading by foreign investors in Japan, while domestic institutional investors were aggressive contrarians during the Asian financial crisis. These institutional herding patterns are also supported by Iihara, Kato and Tokunaga (2001) for other periods than the crisis. Thus, there is some evidence that Japanese institutional investors increase their investment when firms decrease the market value. Unfortunately, these previous studies on Japanese institutions do not distinguish flows caused by relational investments and those caused by pure portfolio reformation, with much limited use of firm characteristics for herding. As a result, few corporate governance implications are drawn from their results.

The behavior of institutional investors in a (U.S.) domestic context is well studied, including Gompers and Metrick (2001), Falkenstein (1996), and Del Guercio (1996). Kang and Stulz (1997) document that foreign investors in Japan prefer large firms with greater international exposure and a low risk profile. These studies show that U.S. institutional investors prefer large and prudent firms at home as well as overseas.[4] Using Swedish data, Dahlquist and Robertson (2001) show that foreign investors, mostly from the U.S., prefer local firms with large capitalization, low dividend

[2] In 1999, for example, the group traded 102.9 trillion yen (38.6%) of the total transaction of 266.6 trillion yen on the major stock exchanges in Japan. Their ownership share is the third largest at 18.6%, which is higher than that of the individual investor group, at 18.0% in 1999.

[3] The data reveal that, within the class of foreign investors in Japan, institutional investors accounted for 99.5 percent (vs. 0.5% individuals) of equity transactions in 1999 on the TSE (http://www.tes.or.jp/ as of December 31, 2000). These global investors usually employ global custodian banks, such as State Street Bank & Trust, for their international equity transactions.

[4] However, Bennet, Sias and Starks (2003) show that the preferences of sub-classified institutional investors in the U.S. change over time.