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The trading behavior of institutions and individuals in Chinese equity markets

Lilian Ng [a,1], Fei Wu [b,*]

[a] *University of Wisconsin-Milwaukee, Sheldon B. Lubar School of Business, P.O. Box 0742, WI 53201-0742, United States*
[b] *Massey University, Department of Finance, Banking and Property, Palmerston North, New Zealand*

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Abstract

This paper employs a unique data set to analyze the trading behavior of 4.74 million individual and institutional investors across Mainland China. Results show that groups of individual investors with varying trade values (as proxies for wealth levels) engage in different trading strategies. Chinese institutions are momentum investors, while less wealthy Chinese individual investors at large are contrarian investors. The results also indicate that a small group of wealthiest Chinese individuals tend to behave like institutions when they buy stocks, and behave like less wealthy individuals when they sell. Furthermore, only the trading activities of institutions and of wealthiest individuals can affect future stock volatility, but those of Chinese individual investors at large have no predictive power for future stock returns.

JEL classification: G11; G15

Keywords: Trading behavior; Momentum and contrarian strategies; Stock volatility

* Corresponding author. Tel.: +64 6 350 5799x4744; fax: +64 6 350 5651.
E-mail addresses: lng@uwm.edu (L. Ng), f.wu@massey.ac.nz (F. Wu).
[1] Tel.: +1 414 229 5925; fax: +1 414 229 6957.

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1. Introduction

Financial economists are often intrigued by the trading behavior of institutional and individual investors in financial markets. The recent availability of more proprietary data has afforded researchers the opportunity to empirically examine the issue. Much of the evidence shows that past price performance significantly influences how institutions and individuals trade. Existing findings indicate that institutions and individuals differ systematically in their reactions to past price performance and in the degree to which they follow momentum and contrarian strategies.

A number of empirical studies examine the behavior of institutions, but produce somewhat mixed results. Grinblatt et al. (1995), while not Lakonishok et al. (1992) and Gompers and Metrick (2001), find evidence of positive feedback trading by US institutions. Other studies, on the other hand, investigate the behavior of individual investors and provide evidence that individual investment choices are also affected by past stock performance. Odean (1998, 1999) and Barber and Odean (2000) find that on average individual investors are "antimomentum" investors. Griffin et al. (2003) examine the trading behavior of of both US individuals and institutions, and show that institutional buying, while individual selling, reveals strong momentum investing.

Some researchers look at the trading behavior of investors in foreign markets. Choe et al. (1999) find daily positive-feedback trading by Korean institutional investors but short-run contrarian trading by Korean individual investors. Grinblatt and Keloharju (2001) document that Finnish domestic investors, generally, tend to be contrarian investors, while foreign investors tend to be momentum traders. Shapira and Venezia (2006) focus on the trading behavior of Israeli investors and find that individuals increase, while institutions transact fewer, sells and buys after the weekend.

While the existing results offer important insights into the differential trading behaviors of institutional and individual investors, they focus mainly on developed markets. Except for Korea and Israel, there is little research on emerging markets, possibly due to the difficulty of obtaining similar data on these markets. In this study, we employ a new unique data set that allows us to examine the equity trading behaviors of individual and institutional investors in Mainland China. There are two key reasons why studying Chinese equity markets is important and how this study contributes to the existing literature.

First, China has the largest and one of the fast growing economies in the world. Its two domestic stock exchanges, the Shanghai Stock Exchange (SHSE) and the Shenzhen Stock Exchange (SZSE), were only established in December 1990 and July 1991, respectively. With robust developments over the last decade, the combined market capitalization of the two exchanges has grown from Renminbi (RMB) 104 billion in 1992 to RMB 3.83 trillion in 2002,[2] with corresponding increase in annual market turnover from RMB 68.1 billion to RMB 2.8 trillion. Also, the number of domestic investor accounts has increased from 2.2 millions to 68.8 millions; 99.5% of the latter are individual accounts and 0.5% are institutional accounts (Chinese Securities Depository & Clearing Co. Ltd, 2002). The Chinese equity markets are clearly dominated by individual investors, compared to developed equity markets where a form of polarization between individual and institu-

[2] During our sample period, the Chinese currency Renminbi was pegged to the US dollar at 8.28. On 21 July of 2005, China relaxed its currency's peg to the dollar by revaluing it against a basket of currencies.