



Daily institutional trades and stock price volatility in a retail investor dominated emerging market[☆]

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Abstract

We examine the short-run dynamic relation between daily institutional trading and stock price volatility in a retail investor-dominated emerging market. We find a significantly negative relation between volatility and institutional net trading that is mainly due to the unexpected institutional trading. The price volatility–institutional trade relation differs for institutional buys and institutional sells, and for small and large stocks. Institutional investors herd-trade in large stocks, but do not systematically engage in positive-feedback trading. We argue that the net impact of informational and noninformational institutional trades determines the relation between volatility and institutional trading, and that the relation is negative when informational trading by institutions prevails.

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0. Introduction

The volatility of securities is a central and fundamental issue to finance, and how trading in general and institutional trading in particular impact the stock price volatility has been the focus of many studies. In this study, we focus on the short-run dynamic relation between daily institutional trading and stock price volatility in a retail investor dominated emerging market. We conjecture that the net effect of informational and noninformational trading by institutions determines the relation between volatility and institutional trading, in that the relation tends to be negative if informational trading by institutions prevails, and non-negative otherwise.

This study examines the theoretical prediction on the different impacts of informational and noninformational trading on price volatility (e.g., Hellwig, 1980; Wang, 1993, 1994). In a market with asymmetrically informed investors, trades are signals of private information (Hasbrouck, 1991a). Informed traders trade based on private information, whereas liquidity traders trade for reasons not directly related to the future payoffs of assets (Admati and Pfleiderer, 1988). Informed trading, especially private information-driven trading, generally reduces volatility, whereas non-informed or liquidity-driven trading increases volatility (French and Roll, 1986).

Relative to retail investors, institutions are generally viewed as better-informed, rational, and prudential investors who have better access to market information and a better ability to time stock price volatility (Aggarwal and Rao, 1990; Busse, 1999). Institutional trading reflects information and speeds up the daily stock price adjustments (Sias and Starks, 1997), especially in the short run (Yan and Zhang, 2009). Some researchers view individual investors as less-informed noise traders who have a short-term speculative investment perspective and are more vulnerable to the influence of psychological biases (Chopra, Lakonishok, and Ritter, 1992; Brennan, 1995; Kaniel, Saar, and Titman, 2008). In a market with heterogeneously informed investors, trades of better-informed investors partially reveal their private information on the market and move the price towards its fundamentals. Thus, an increase in informed investors can reduce the price variability (De Long, Shleifer, Summers, and Waldmann, 1990; Wang, 1993).

Institutional investors are also constrained by other considerations, such as liquidity (Hodrick and Moulton, 2007; Coval and Stafford, 2007). As the percentage of institutional investors in a market reaches a certain level, the effect of noninformational institutional trading may prevail and prices may become more volatile. Over a specific period, or for a particular market, this volatility–institutional trading relation can be either negative or non-negative, depending on the net effect of the informational and noninformational trading of institutions.

Based on these arguments, we hypothesize that institutional trading is negatively associated with stock price volatility in a retail investor dominated market when the informational effect of institutional trading prevails.

We also examine whether the volatility–institutional trading relation is different for institutional buys and sells. A number of previous studies find that the buy orders of informed investors convey more information than the sell orders, and that institutional buys and sells have asymmetric price impacts (Scholes, 1972; Kraus and Stoll, 1972). Although an institution's decision to buy a particular stock from a group of unlimited choices can convey favorable firm-specific information, its decision to sell a particular stock from the limited number in its portfolio does not necessarily convey negative information.

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