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Anchoring effect on foreign institutional investors' momentum trading behavior: Evidence from the Taiwan stock market[☆]

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ABSTRACT

On Taiwan's stock market, foreign institutional investors hold over one-third of the total market value and have enjoyed remarkable returns on their investments. Hence, it is important to investigate the trading behavior of foreign institutional investors. Previous studies have found that foreign institutional investors are momentum traders. This study documents a cognitive bias – anchoring effect – on foreign institutional investors' trading decisions. Moreover, we document that foreign institutional investors' momentum behavior is influenced (anchored) by prior foreign ownership (anchor). We also show that foreign investors' momentum behavior is strengthened when prior foreign ownership is high. However, the anchoring effect cannot improve momentum profitability. In some cases, momentum profitability suffers because of the anchoring effect.

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1. Introduction

In financial literature, institutional investors are generally deemed to be informed traders. Hence, the behavior of institutional investors has attracted much interest from researchers; their decisions have become important indicators for retail investors in practice. Therefore, institutional trading has become a significant research issue over the past few decades. This issue is more noticeable in Taiwan's equity market since the proportion of trading by institutional investors (including foreign and local investors) in total trading volumes increased three fold between 1994 (10.2%) and 2011 (37.3%).

This paper investigates the trading behavior of foreign institutional investors in Taiwan. There are two reasons why the analysis is focused on foreign institutional investors. First, among all types of institutional investors, trading volumes for foreign institutional investors have dominated local institutional investors. More specifically, as at the end of 2011, foreign institutional investors held about one-third, by market value, of the listed equities in Taiwan, whereas local institutional investors held only about 2% of the market value. This implies that foreign institutional investors' trading behavior may have a larger impact on the stock market than the behavior of others. Second, as well as dominance in terms of trading volumes, foreign institutional investors' profits have also been remarkable. Barber, Lee, Liu, and Odean (2009) found that nearly half of the individual investors in Taiwan's stock market had suffered losses from trading, and a huge sum (about 2.2% of Taiwan's GDP), has been garnered by foreign institutional investors.¹ Therefore, it is important to look further into the trading behavior of foreign institutional investors in Taiwan.

A large number of research studies have investigated the behavior of institutional investors. Related literature can easily fall into two groups. Some researchers have examined the holdings of foreign investors in the local market (e.g. Białkowski & Otten, 2011; Dahlquist & Robertsson, 2001; Ferreira & Matos, 2008; Kang & Stulz, 1997; Lin & Swanson, 2003). These papers aimed to identify the characteristics of the stock holdings of foreign institutional investors. In general, their firm-level findings indicate that foreign institutional investors prefer to invest in stocks with high turnover rates and larger firm size. This disproportional holding of stocks reveals that global investors have particular preferences in terms of stock selection when forming their foreign asset combinations (Lin & Shiu, 2003).

The other group of researchers is interested in investigating the dynamic trading pattern of institutional investors, especially how they incorporate past stock returns into their trading strategies (Badrinath & Wahal, 2002; Griffin, Harris, & Topaloglu, 2003; Grinblatt, Titman, & Wermers, 1995; Ng & Wu, 2007). More specifically, these papers try to examine whether institutional investors are momentum traders or not. Most researchers have found that institutional investors are momentum traders (also referred to as positive feedback traders and trend followers), although the conclusions are still mixed. With respect to the related issue of foreign institutional investors, Grinblatt and Keloharju (2001) indicated that foreign investors tended to be momentum traders in the Finnish stock market.

Our study follows the later stream of literature in order to examine the trading behavior of foreign institutional investors in the Taiwan stock market. Specifically, this paper contributes to the literature by examining whether the behavior of foreign institutional investors is influenced by their ownership, a form of anchoring effect. From the viewpoint of traditional financial theory, investors act rationally and consider all available information in their decision-making process. Accordingly, this implies that investors should act consistently on receipt of similar information. However, considerable evidence indicates that human psychology leads investors to irrational behavior and causes market anomalies (e.g. Kahneman & Tversky, 1979; Maymin, 2012; Shleifer, 2000). Therefore, this paper uses a cognitive bias – 'anchoring effect' – to investigate whether foreign institutional investors act irrationally when they trade stocks that have similar attributes.

This question is raised because of the debate, in prior researches, over investors' investment behavior. For example, De Bondt (1993) suggested that investors expect a recent trend to continue and tend to

¹ The research covered the period from 1995 to 1999. During this period, the trading values of foreign institutional investors were only about 2% of all trades. To date, it is reasonable that foreign institutional investors have gained much more because their impact has increased in recent years.

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