Characteristics and performance of institutional and foreign investors in Japanese and Korean stock markets

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This study examines the characteristics of the stock ownership by institutional and foreign investors, as well as their effects on stock price performance in Japan and Korea. The main results of this study are summarized as follows. First, foreign investors have a clearer preference for stocks with large capitalization and low book-to-market ratios than do institutional investors in both Japanese and Korean stock markets. Second, foreign investors prefer stocks with a high return on equity, especially in Korea. Third, average returns have more apparent differentiation among institutional (foreign) ownership portfolios than among foreign (institutional) ownership portfolios in Japan (Korea). Fourth, the stocks that are preferred simultaneously by both institutional and foreign investors show statistically significant positive abnormal returns in both Korea and Japan, whereas those preferred by either institutional or foreign investors show statistically significant positive abnormal returns only in Korea. The institutional investors’ incentive for stock holding, the extent of stock market efficiency, and stock price polarization could be the possible explanations for the different empirical results observed for Japan and Korea.

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1. Introduction

One of the most prominent phenomena in US stock markets over the past two decades has been the rapid increase in the level of stock ownership and trading by institutional investors. Currently, institutional investors own more than 50% of stocks listed on the New York Stock Exchange, which is a common phenomenon observed in stock markets throughout the world today to greater or lesser degrees. As the importance of institutional investors in stock markets increases, both the characteristics of their investment behavior and their impact on stock prices are becoming the subject of intensive discussion and research among academics and practitioners.

A few studies have examined the preferences of institutional investors for their portfolio stocks. As institutional investors are fiduciaries that invest and manage portfolios on behalf of their trustors’ interests, they must always be prepared to meet the demand for redemption. In cases where some restrictions affect their investment decisions, the preferences of institutional investors for stocks might be strikingly different from those of individual investors. Falkenstein (1996) finds that US mutual funds prefer stocks with larger capitalization, higher liquidity, higher prices and more available information. Gompers and Metrick (2001) report that the 100 largest institutional investors are likely to buy stocks with larger capitalization, higher liquidity, higher book-to-market ratio (henceforth B/M), and lower return for the previous year in US stock markets. Regarding the regulatory factor applied to institutional investors, Del Guercio (1996) shows that the so-called “prudent-man rule” affects the portfolio selection of institutional investors. In an intertemporal context, Bennett et al. (2003) report that institutional investors have shifted their preferences toward smaller and riskier stocks over time.

The empirical evidence that institutional investors share common preferences for stocks in their portfolio implies that their trading behavior might show similar patterns. Herd behavior and positive feedback trading are two controversial issues in current institutional trading. While Lakonishok et al. (1992) find some evidence against institutional herd behavior, Nofsinger and Sias (1999) and Wermers (1999) provide supporting evidence in US stock markets. Recently Kim and Nofsinger (2005) show institutional herd behavior in Japan, but not as strong as in the US. Institutional positive feedback trading is also observed by Nofsinger and Sias (1999), Wermers (1999), but not by Lakonishok et al. (1992).

The next issue following the preferences and trading behavior of institutional investors is the effect of their trading on stock prices. Both Lakonishok et al. (1992) and Chan and Lakonishok (1993) fail to provide any significant evidence that institutional trading is either stabilizing or destabilizing stock markets. Gompers and Metrick (2001) find that the premium for small stocks almost completely disappeared in US stock markets as the importance of institutional investors increased. Recently, Chiyachantana et al. (2004) report that the underlying market condition is a major determinant of the price impact and of the asymmetry between price impacts of institutional buy and sell orders.

For stock markets outside the US, especially emerging markets, similar research has been conducted on foreign investors in lieu of institutional investors. Since the late 1980s many countries have allowed foreigners to invest in their stock markets. As a consequence, the importance
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