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Do institutional investors destabilize stock prices? evidence from an emerging market☆

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Abstract

In this paper, we provide empirical evidence on the impact of institutional investors on stock market returns dynamics in Poland. The Polish pension system reform in 1999 and the associated increase in institutional ownership due to the investment activities of pension funds are used as a unique institutional characteristic. We find robust empirical evidence that the increase of institutional ownership has changed the autocorrelation and volatility structure of aggregate stock returns. However, the findings do not support the hypothesis that institutional investors have destabilized stock prices. The results are interpretable in favor of a stabilizing effect on index stock returns induced by institutional trading.

JEL classification: G14; G23

Keywords: Institutional traders; Polish pension fund investors; Stock market volatility

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1. Introduction

The increase in the number of institutional investors trading on stock markets world-wide since the end of the 1980s has been associated with a rise in the financial economists' interest in institutions' impact on stock prices. In particular, there is a popular belief that institutional traders destabilize stock prices. Due to their specific investment behavior institutions are supposed to move stock prices away from fundamentals and thereby induce stock returns autocorrelation and increase returns volatility. Herding and positive feedback trading are the two main arguments put forward for the destabilizing impact on stock prices induced by institutional investors. Consequently, empirical investigations in the existing literature have been focused on the question of whether institutional traders exhibit these types of investment behavior.[1]

However, evidence in favor of herding and positive feedback trading does not necessarily imply that institutional traders destabilize stock prices. If institutions herd and all react to the same fundamental information in a timely manner, then institutional investors will speed up the adjustment of stock prices to new information and thereby make the stock market more efficient. Moreover, institutional investors may stabilize stock prices, if they collectively counter irrational behavior in individual investors' sentiment. If institutional investors are better informed than individual investors, institutions are likely to herd to undervalued stocks and away from overvalued stocks. Such herding can move stock prices towards rather than away from fundamental values. Similarly, positive feedback trading has been shown to be stabilizing, if institutional traders underreact to news (Lakonishok et al., 1992).

Cohen et al. (2002) provide empirical evidence on the stabilizing impact of institutions for US data. Institutions respond to positive cash-flow news by buying stocks from individual investors, thus exploiting the less than one-for-one response of stock prices to cash-flow reports. Moreover, in case of a price increase in the absence of any cash-flow news institutions sell stocks to individuals. The findings by Cohen et al. indicate that institutional investors push stock prices to fundamental values and, hence, stabilize rather than destabilize stock prices. Barber and Odean (2003) find for the US that individual investors display attention-based buying behavior on days of abnormally high trading volume, extremely negative and positive 1 day returns and when stocks are in the news. In contrast, institutional investors do not exhibit attention-based buying. While the behavior of individual investors may contribute to stock returns autocorrelation and volatility, institutions may induce a stabilizing effect on stock price dynamics.[2]

We can conclude from the short discussion above that empirical findings on institutional investors' herding and positive feedback trading behavior are not necessarily evidence in favor of the destabilizing effect on stock prices. However, these results provide us with only indirect empirical evidence on the destabilizing effects of institutional investors' trading behavior on stock prices. The existing literature on institutional trading behavior is pre-

[1] Evidence on institutions' trading behavior can be found in, for example, Lakonishok et al. (1992), Grinblatt et al. (1995), Nofsinger and Sias (1999), Wermers (1999), Badrinath and Wahal (2002) and Griffin et al. (2003).

[2] These findings are in contrast to the empirical results in, for example, Sias and Starks (1997), Sias et al. (2001) and Dennis and Strickland (2002) which come to the conclusion that institutional investors trading has a destabilizing effect on stock returns.