



Do fund managers herd in frontier markets – and why?



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ARTICLE INFO

Article history:

Received 6 October 2014

Received in revised form 18 March 2015

Accepted 30 March 2015

Available online 3 April 2015

JEL classification:

G02

G10

G15

G23

Keywords:

Herding

Mutual funds

Frontier markets

Intent

ABSTRACT

Frontier markets constitute a category of markets for which very little is known regarding the behavior of their institutional investors. This study attempts to shed light on this issue by investigating whether fund managers herd in frontier markets and whether their herding is intentional or not using data on quarterly portfolio holdings of funds from two such markets (Bulgaria and Montenegro). Results show that fund managers herd significantly in both markets; controlling for the interaction of their herding with different market states, we find that herding is stronger for both markets during periods of positive market performance and high volume, while in the case of Montenegro it also appears significant during periods of low volatility. Our findings are consistent with fund managers herding intentionally, in anticipation of informational and/or professional payoffs. We also find that Bulgarian (Montenegrin) fund managers herd significantly after (before) the outbreak of the 2008 global financial crisis and we attribute this to a volume-effect, since Montenegro (Bulgaria) saw the heaviest trading activity before (after) the crisis' outbreak.

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1. Introduction

Institutional herding has been at the focus of much research conducted in behavioral finance during the past couple of decades with extensive evidence from a series of markets confirming that fund managers herd significantly in their trades internationally. The propensity of fund managers towards imitating each other has been rationalized through several theoretical designs over time. Less skilled fund managers in the acquisition/processing of information, for example, may choose to copy the trades of their better-informed peers in order to extract informational payoffs (Devenow & Welch, 1996). Less able/reputed fund managers may also imitate the trades of their better-able peers with the purpose of improving on their image and protecting their career prospects (Scharfstein & Stein, 1990). Relative homogeneity among fund managers (in terms of their educational background and professional framework) can also lead them to produce correlated trades (De Bondt & Teh, 1997), while a similar argument has been advanced for characteristic trading, given the tendency of fund managers to follow various styles (e.g. momentum/contrarian, value/growth etc) in their investments (Bennett, Sias, & Starks, 2003).

Empirical evidence from a wide cross-section of long-established capital markets, both developed as well as emerging, has identified the sources of herding with both intentional (e.g. fund managers aiming at extracting informational payoffs or improving their professional image) as well as unintentional (e.g. characteristic trading) reasons. It is, however, interesting to note the absence of research on whether – and why – fund managers herd in the specific segment of markets known as *frontier markets*. The term “frontier markets” has been used to describe those emerging markets whose financial systems in general and stock exchanges in particular exhibit a lesser degree of development compared to traditional, long-standing emerging markets (De Groot, Pang, & Swinkels, 2012). Such environments are normally typified by inexperienced market participants, low overall trading activity and incomplete institutional frameworks with weaknesses in the presence and enforceability of disclosure rules. Adding to the above the fact that the infancy stage of their financial development precludes the possibility of their institutional investment section being developed suggests that fund managers in frontier markets lack the investment experience of their counterparts in developed markets while at the same time having to operate in environments of high risk and questionable informational quality. The presence of such conditions increases the likelihood that institutional herding in frontier markets will not only be significant but also intentional and it is this issue that we seek to address in our study.

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To examine whether fund managers herd in frontier markets and whether they do so intentionally or not, we use two unique data sets of institutional holdings involving quarterly portfolio statements of funds from Bulgaria and Montenegro for the January 2005–December 2012 period. Our results denote that institutional herding in both markets is significant, while after partitioning our data on the basis of various market states (market returns; market volatility; market volume) we find that it is intentional, driven by informational and career considerations. We also find that Bulgarian (Montenegrin) fund managers herd significantly after (before) the outbreak of the 2008 global crisis and we attribute this to a volume-effect, since Montenegro (Bulgaria) saw the heaviest trading activity before (after) the crisis' outbreak.

Our research produces important contributions to the extant literature on herd behavior. First, our study contributes to our understanding of institutional herding by providing evidence on the propensity of fund managers to herd in frontier markets for the first time in the literature. Key to this contribution is the fact that, unlike their developed and emerging counterparts, frontier markets are very small in terms of the size of both their fund-industry and their capitalization/volume; this allows us the opportunity to test for institutional herding under very concentrated market conditions, entailing features (e.g. a small number of fund managers facilitates peer-observation) capable of inducing imitation among institutional investors. Secondly, our findings confirm that, although fund managers in frontier markets can herd equally intentionally as their peers in more developed markets (Gavriilidis, Kallinterakis, & Leite Ferreira, 2013; Holmes, Kallinterakis, & Leite Ferreira, 2013), their herding is significantly influenced by their markets' volume. Considering the relative illiquidity of frontier markets, this indicates that the decision of their fund managers to herd is heavily reliant on the prevailing trading activity, since high volume renders their herding feasible by reducing trading frictions, thus allowing "good" fund managers to trade on their information and "bad" fund managers to copy them.

In view of the growing interest on behalf of the global investment community in frontier markets¹, the findings presented in our study are of particular interest to investors, as they can be used as input to inform their strategies in these markets, more so in view of recent evidence (Berger, Pukthuanthong, & Yang, 2011; Goetzmann, Li, & Rouwenhorst, 2005; Speidell & Krohne, 2007) regarding the diversification benefits conferred by investing in frontier markets. From the perspective of frontier markets' regulators our results should be of concern, since the presence of intentional institutional herding can lead funds to choose sub-optimal portfolio allocations; what is more, given the leverage funds command in these markets and the latter's overall low trading activity, their herding can also be potentially destabilizing, thus accentuating the need for regulatory measures aiming at reducing the herding tendencies of funds in these markets.

The rest of the paper is organized as follows: Section 2 presents the key motivations (intentional and unintentional) underlying the decision of fund managers to herd. Section 3 introduces the data sets and the empirical framework employed; Section 4 outlines and discusses the empirical results and Section 5 concludes.

2. Institutional herding and its motivations

Herding as a practice constitutes a "passive" (in the sense that funds engaging in herding end up copying their peers) management strategy, leading to portfolio-allocations that may be neither optimal, nor in line with investors' risk-preferences, compared for example to an active management strategy. The prevalence of herd behavior among fund

managers is considered undesirable from a regulatory viewpoint too, since institutional investors' dominance in equity trading internationally implies that any herding on their behalf can destabilize prices and render markets riskier (Goodhart, Hartmann, Llewellyn, Rojas-Suarez, & Weisbrod, 1999). A key issue arising is why market participants as sophisticated as fund managers would choose to resort to peer-mimicking in their trades instead of relying on their private signals. A series of studies (Bikhchandani & Sharma, 2001; Gavriilidis et al., 2013; Holmes et al., 2013) argued that the choice to herd can be either motivated by intent or be the product of an environmental state commonly affecting all investors that prompts similar reactions on their behalf ("spurious" herding).

To begin with, herding is intentional when the choice to herd is motivated by the anticipation of a positive externality (a benefit) and usually presupposes a relative view of one's position vis-à-vis others. A fund manager, for example, may consider his information to be of low quality or his information-processing abilities to be inadequate compared to his peers'; in other words he may perceive himself to be in an asymmetric situation relative to other fund managers. It would, therefore be rational for him to copy his peers' trades, in order to free-ride on their informational superiority and extract *informational payoffs* (Devenow & Welch, 1996). If fund managers end up discarding their private signals in favor of their peers' actions, this will slow down the signal-flow to the market (information blockage), render the public pool of information poorer and lead to the evolution of informational cascades (Banerjee, 1992; Bikhchandani, Hirshleifer, & Welch, 1992). A second possibility is that the benefits anticipated by fund managers when choosing to mimic their peers intentionally are linked to *professional payoffs*. The issue here relates to the relative performance assessment investment professionals are subject to periodically (e.g. every quarter). A "bad" manager (one e.g. of low ability) has every incentive to copy his "good" peers in order to conceal his true quality and improve his professional image (i.e. appear "good" too). If this happens, the assessment process within asset management companies faces a jamming, since it grows impossible to determine whether a manager performs well as a result of his high ability or his peer-mimicking (Scharfstein & Stein, 1990). Ability aside, reputation can also be a factor here, with less reputed finance professionals being more susceptible towards following the actions of the well-reputed ones (Clement & Tse, 2005; Trueman, 1994).

However, it is possible that institutional herding is unintentional, due to the presence of factors in the funds' industry common to all managers leading them to exhibit convergence in their trades. It is possible, for example, that fund managers behave similarly due to the innate *relative homogeneity* (De Bondt & Teh, 1997; Wermers, 1999) in their ranks. The idea here is that investment professionals bear certain common traits in terms of their educational background, their investment experience, the signals received (they have to analyze the same/similar indicators) and their interpretation, as well as the regulatory framework² they are subject to. It is also possible that herding is unintentional due to the common – among fund managers – practice of *style investing* (e.g. Bennett et al., 2003). If several funds pursue contrarian strategies, for example, one would expect correlation in their trades (they would herd into recent losers and out of recent winners) as a result of the same style followed, without this being due to intent.

¹ Berger et al. (2011) and De Groot et al. (2012) present detailed information on the launch of a series of mutual funds and exchange-traded funds benchmarked against frontier markets, providing easier access to frontier markets' investments.

² An example of the impact of financial regulation over the propensity of fund managers to trade similar stocks is illustrated by a series of studies on pension funds in Chile (Olivares, 2008) and Poland (Vorontkova & Bohl, 2005); in both markets, pension fund managers are subject to a) limitations in the opportunity set of stocks they can invest into and b) the obligation to satisfy a pre-defined minimum-performance requirement based on relative performance evaluation. As both studies show, pension fund managers herd significantly in both markets, with the portfolios of pension funds in each market being very similar, as they are tilted heavily towards the constituents of each market's top-capitalization index.

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