Abstract

In recent years the institutional investors have assumed a significant role in managing savings and have thus become a prominent player in market whose trading decision could impact prices. In India the institutional investors together hold more than 50% of the free float equity and are a major trading participant in secondary market. With such high equity holdings, the trading decisions of these institutional investors assume a lot of importance and raise important question for academia concerning their impact on stock price. Our study examines the trading strategies of mutual funds, particularly herding (also called correlated trading) and feedback trading or momentum trading and its impact on stock prices in Indian market.

Our work looks at two prominent institutional trading behaviors which is commonly noted in literature called as "Herding" and "Feedback Trading". Herding is defined as group of investor trading on the same side over a period of time. The herd like behavior often takes a form of information cascade causing market exuberance and panics (Shiller 2000). If institutional investors with their strong presence resort to herding, it will lead to price pressure, exacerbate volatility and may destabilize markets (Scharfstein and Stein (1990); Nofsinger and Sias (1999)). Feedback trading on the other hand looks at trading patters based on past performance. Feedback trading models thus predicts a relationship between past performance of asset and demand for asset. If demand of asset is correlated to its past-performance it can destabilizes market as it leads to jumping on the bandwagon and buying over-priced stock or selling under-priced stock thereby contributing to a further divergence of prices away from fundamentals. If institutional

investor follows such trend chasing strategies it would result in mispricing of stocks which in eventually leads to market bubbles and crashes.

Both behaviors have a tendency to create market imbalances if they are followed in a aggressive manner, in the recent past we have seen how herding and feedback trading behavior manifested amongst internet stock in USA finally leading to a severe economic loss.

This study aims to examine following issues:-

1. To examine the herding behavior of mutual funds in India.
2. To examine the feedback trading behavior of mutual funds.
3. To examine the impact of mutual fund trading on stock prices.

To examine the above issues we have used two data sets. The first is monthly portfolio data of all open ended equity mutual funds operating in India during January2004-March2009 containing mutual funds investment in various companies details like industry, value of holding, fund manager name etc. The second data set is the aggregate market wide daily data pertaining to market returns and net institutional funds flows in the market. We employ the Lakonishok, Shleifer and Vishny (1992) (LSV) measure which is based on holding changes was used to examine the herding and feedback trading behavior of Indian mutual funds. In addition to that we also use the Vector Auto Regression (VAR) model to assess presence of feedback trading. The last analysis looks at the impact of mutual trading on stock prices using both LSV (1992) and Wermers (1999) methodologies.

Major findings based on our empirical analysis are listed below:

1. Mutual funds engage in herding behavior. The herding among Indian mutual funds are significantly higher than herding level observed in the U.S. and other developed markets however it is lower than herding observed in countries like China, Spain and Portugal.
2. Herding is not based on stock characteristics like price–earnings, past performance. Market size however has some impact on herding. Small size stocks have higher herding then large size stocks.
3. Herding examined at fund manager level also indicated results similar to fund based herding measure.
4. Mutual funds engage in negative feedback trading and buy past losing stocks while they sell past winning stocks.
5. The negative feedback trading behavior is more significant in large capitalization stocks where they constantly rotate their portfolio towards past looser stocks.
6. VAR analysis also suggests that mutual funds are contrarian traders and buys on market dips while sells when market rises.
7. Negative feedback trading behavior exhibited by mutual funds doesn't change in the presence of FII investors, in fact our analysis shows that Mutual funds seem to counter the FII transactions by buying when they sell and vice-versa.
8. Mutual fund trading impacts market returns, especially in small capitalization stocks. Evidence suggests that contemporaneous returns show signs similar to mutual fund trade.
9. The impact of mutual fund trading on the aggregate market is stabilizing in nature. The price-pressure created by mutual fund trading does not get reversed in the later period

indicating that mutual fund tend to stabilize the price by incorporating the news and information into prices.

The study contributes to literature on herding and feedback trading by examining a new context of Indian mutual funds. This study provides the first estimate of mutual fund herding and feedback trading in India using comprehensive portfolio level database of virtually all open ended mutual funds operating in India. The study also highlights the contribution of mutual funds in improving market efficiency. Mutual fund herds however their herding stabilizes the market as they impound new information in stock prices. The mutual fund are negative feedback traders who take contrary positions to the current market trends which inherently gives more stability to markets.