Institutional Investors, Intangible Information and the Book-to-Market Effect

Discussion

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Starts from the results of Daniel and Titman (2006)

- D&T identifies tangible and intangible returns per share:
  - Each year a cross-section regression of past market return on initial book-to-market and past book return
  - Intangible past returns are identified as the residuals of this regression
- Returns are negatively related to past intangible return, but not to past tangible return
- Thus return reversals (and predictability) are caused by reversals in the intangible return
  - this causes the book-to-market effect
  - no evidence of reversals in the tangible return

The message of the present paper

- Institutions trading in the same direction (herding) drives the reversion of intangible returns

- D&T: Return reversion is only found in stocks with high intangible returns
- New contribution: Return reversion is due to institutional herding

Evidence I

- VAR study of the relationship between
  - total returns
  - intangible returns
  - institutional ownership
- Tests for Granger causality
  - Intangible returns cause institutional ownership
  - Institutional ownership does not cause intangible return

Evidence II

- Constructs portfolios with stocks sorted by intangible return and institutional herding
- Computes the return differential between high and low intangible return stocks
  - controlling for the Fama-French factors
- Return differential is statistically significant only when comparing portfolios with a high level of institutional herding
  - Thus the book-to-market effect only exists for stocks with high levels of institutional herding
- This is not due to the size effect:
  - Stocks with a high level of institutional herding are on average larger than stocks with low institutional herding

Do I believe the results?

- Many institutions use a core-satellite approach to investing
  - holds the market, trades in stocks that the manager believe is under- or overvalued
- Relatively few stocks are actively traded by each manager
  - Manager reward structures benefit trading in more volatile stocks
  - May easily be the same for a number of institutions; high institutional herding will result

Some minor comments

- The measure of herding
  - Counts the number of institutions that are net buyers or sellers
  - Does not necessarily reflect the volumes traded
- The measure of trading
  - Difference in holdings over a full year
  - Round trips may be more frequent than in quarterly data
  - In particular in stocks with high institutional herding, which may be more actively traded

A final question:
Aren't institutional investors likely to drive most anomalies in the stock market?

- Non-retail trading accounts for 96% of the total trading activity on the NYSE
  - Footnote page 1
- Institutions essentially represent the market?