A Trust Model of Institutional Investors' Behaviour

Dr Xiaowen Gao

Coventry University London Campus

Keywords: Institutional Investors, Investment Decisions, Trust

JEL Classifications: G11, Z13

The ultimate concern of financial economists is that financial resources be allocated to the most promising investment opportunities. Given the limitations of the market caused by information asymmetry, institutional investors have played a central role among other investors in improving the efficient allocation of capital. However, the investment process undertaken by institutional investors are rarely studied in academic research. Despite increasing evidence showing strong personal ties between fund managers and public corporates (Cohen, Frazzini and Malloy 2008; Coval and Moskowitz 2001) and in addition other researches indicate direct interactions between the above pair (Gantchev 2013; Edmans & Manso 2011), the relationship developed between fund managers and listed companies to increase transparency appears a difficult area for research.

Since the establishment of modern finance, the main theme has been the belief that market is efficient. It is believed that if the price of any stocks departs from its fair price, it would create an arbitrage opportunity, which would be immediately spotted and acted upon by rational investors and thus disappear quickly. Behavioural finance has succeeded in recent years because it successfully link market anomalies which are unable to be explained under EMH to investors' behaviour such as overconfidence, optimism thinking, ambiguity aversion and indicates that behaviours of irrational investors cause the persistence of anomalies in the markets (Barberis &Thaler 2002). However, the above two main themes did not consider the social character of investment process. Market efficiency is a dynamic process and institutional investors such as mutual funds, hedge funds and pension funds are promoting greater efficiency in their daily practice. Comparing to individual investors, it is institutional investors' active interactions with listed companies which leads to effective information exchange and dissemination.

Although individual and institutional investors share common criteria in deciding which corporates to invest in stock markets, such as dividends, expected returns and financial

stabilities (Lease et al. 1974), the process of decision making between these two groups is fundamentally different. Individual investors are often viewed as 'noisy' investors due to their lack of timely information, investment knowledge and skills, whereas institutional investors are seen as 'informed' investors as a result of their expertise and information advantages over small investors. Accumulating evidence shows that institutional investors such as mutual fund, hedge fund and pension funds are more active in reducing information asymmetry between themselves and their investment targeting firms than individual investors (Lauren, Frazzini and Malloy 2008; Franks, Mayer and Rossi 2007). To cite only one example, Aberdeen asset management, one of UK's largest fund managers describe their investment process on their website as that 'our mainstream equity managers always visit companies before investing, making thousands of visits annually to existing and prospective holdings'. Moreover, institutional investors might actively interact with publically traded companies in order to achieve long-term returns in addition to their short-term goals such as to beat the market benchmark and stand out from their peers. In the UK fund market, 42% companies within fund managers' portfolio are held for five years or more (IMA report, 2011). Surprisingly, despite the large interest shown in institutional investors' investment preferences in selecting satisfied companies, little has been done systemically in research on the frequent interactions between the above two parties.

We propose a trust model (Figure 1) to capture such interactions between institutional investors and their targeting firms and to explain institutional investors' decision-making process. Ryan and Buchholtz (2001) first used social trust theory to explain how individual investors make their investment decision in stock investment to overcome information asymmetry and to reduce risk. In their model, individual investors make investment decisions based on the generalized trust in market efficiency and managers' conscientiousness coupled with each investor's initial investment situation to form their situational trust in a particular targeting firm. However, institutional investors have been left out from their model. To adjust the model to accommodate the investment behaviour of institutional investors is necessary for the following reasons: first, the differences in decision making process between institutional and individual investors need to be documented from a trust theory perspective. For instance, institutional investors usually have large position in many companies and have a strong incentive to monitor the performance of corporates and have the power to exert pressure on management when improvement can be made. Second, institutional investors in stock markets deal with intangible assets which requires information received over public corporations. Given the naturally inherited information asymmetry problem between the

owner and the user of information, rational investors would not be willing to participate if there is an absence of trust between investors and corporations. Finally, institutional investors are now the major force in the markets which is different from the market picture a decade ago, therefore this study will offer a wider impact on policy implication. Drawing on works in inter-organizational relationship, we argue that an investment decision on long a stock or short a stock is determined by presumed rule-based trust at initial stage and by confirmed relationship-based situational trust at the final stage. The final stage dominates the decision making. Our model also describes the cycle of trust to reflect the dynamics of trust building in stock selection. We also explore other commonly recognised antecedents of inter-organizational trust such as social ties, time horizon, power and resource dependence in the setting of stock investment (Zaheer & Harris 2006; MacDuffie 2011). Our model may help institutional investors to identify strategies for better trading performance and it may also help corporate executives to attract the kind of shareholders that are the most appropriate to their firms. Our model may also be useful to explain some long lasting puzzles such as home bias in international investors' portfolios. The structure of the study is organized as follows: in Section I, we outline the differences in trading behaviour between individual and institutional investors. Section II develops the proposing trust model. Section III discusses each component in the model. In Section V, we provide implications and suggestions for further research. Section VI concludes.

A Trust Model of Institutional Investors Behavior (attached separately)

References

Barberis, N. and Thaler, R., 2002. A Survey of Behavioural Finance, *NBER Working Paper No.9222.*

Coval, J. and Moskowitz, T., 2001. The Geography of Investment: Informed Trading and Asset Prices, *Journal of Political Economy* 109, (4), 811–841.

Edmans, A., Manso, G., 2011. Governance through Trading and Intervention: A Theory of Multiple Blockholders. *Review of Financial Studies* 24, 2395–2428.

Gantchev, N., 2013. The Cost of Shareholder Activism: Evidence From A Sequential Decision Model, *Journal of Financial Economics* 107, (3), 610-631.

Lauren, C. Frazzini, A. and Malloy, C. 2008. The Small World of Investing: Board Connections and Mutual Fund Returns. *Journal of Political Economy* 116, (5), 951–979.

Franks, J., Mayer, C. and Rossi, C., 2007. Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes UK, *ECGI Working Paper.*
Focus Fund

Lease, R. C; Lewellen, W. G. and Schlarbaum, G. G. 1974. The Individual Investor: Attributes and Attitudes. *The Journal of Finance* 29: 413-433.

MacDuffie, J. 2011. Inter-organizational Trust and the Dynamics of Distrust, *Journal of International Business Studies*, 42, 35–47.

Ryan, V.L. and Buchholtz, K.A. 2001. Trust, Risk and Shareholder Decision Making: an Investor Perspective on Corporate Governance, *Business Ethics Quarterly*, 11, (1), 177-193.

Zaheer, A. and Harris, J. 2006. Interorganizational trust. In O. Shenkar and J. Reuer (eds), *Handbook of Strategic Alliances*, 169-197. Thousand Oaks, CA: Sage.