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Can individual investors drive stock market growth?

Nomura Research Institute, Ltd.

With the spread of online trading, individual investors now account for a growing share of equity trades. While foreign investors remain the driving force behind the Japanese stock market, individual investors tend to be contrarians, moderating price fluctuations by buying or selling in the opposite direction of market movements.

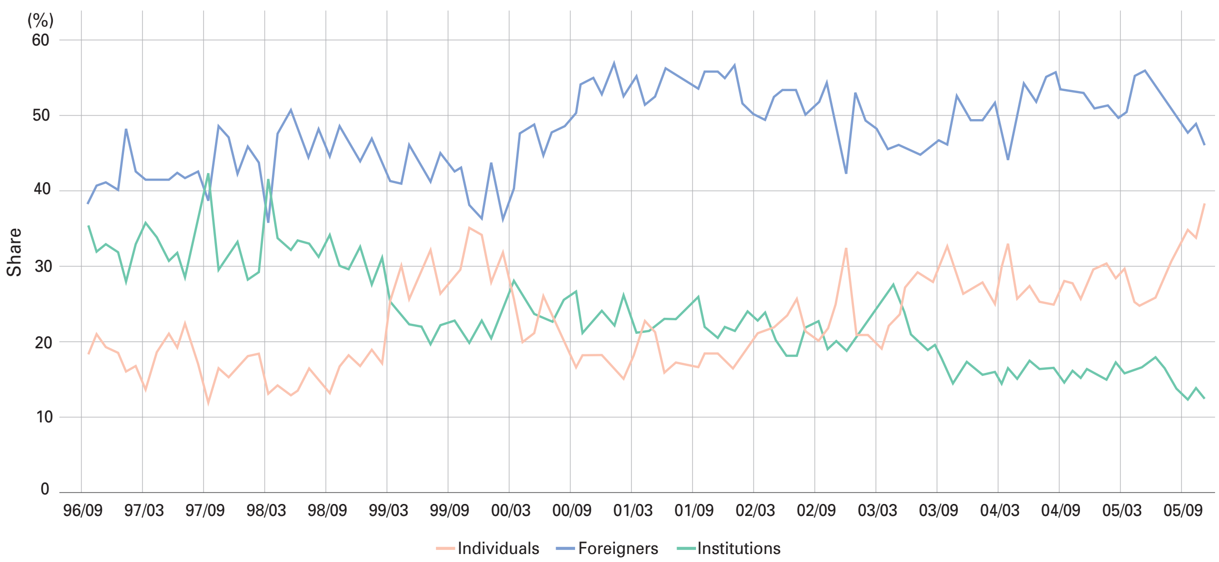
Stock market leadership viewed by trading share

Key investor classes in the Japanese stock market include individuals, institutional investors,[1)] and foreigners.[2)] Until now, attention has focused on foreign investors as having the greatest influence on the market. But the spread of online trading has sharply increased the importance of individual investors.

Exhibit 1 follows the trading share of these three groups among agency orders placed on the first section of the Tokyo Stock Exchange (TSE-1). The chart looks at the value of al trades,[3)] including margin transactions. Foreign investors have consistently accounted for a large share of trading, which meshes with the general perception among market participants. With the exception of the so-called IT bubble from 1999 to early 2000, individual investors have generally been responsible for less than 20% of trading. But this figure began to rise in early 2003 and now stands at almost 40%. Institutional investors were on an equal footing with foreign investors through 1998 with a share of about 35%, but their influence has declined steadily since then. Their share dropped below that of individual investors in June 2003 and has languished around the 15% mark.

In short, foreign investors continue to drive the market in terms of trading share, but individual investors play an increasingly important role.

Exhibit 1. Share of trading by investor class



Source: Compiled by NRI from TSE data

Market leadership as a function of correlation with stock prices

We next examined the relationship between stock price fluctuations and the behavior of different investor groups. To do so, we calculated the correlation coefficients between net weekly purchases by each investor class and the change in TOPIX during the same period. Exhibit 2 shows the results of our attempt to measure the impact of the rising trading share of individual investors. We examined the periods before and after June 2003, when the trading share of individual investors began consistently to exceed that of institutional investors.[4)]

Exhibit 2. Correlation between investor fund flows and TOPIX price moves

	Full period	First period	Second period
Foreigners	0.50	0.45	0.67
Individuals	-0.60	-0.60	-0.75
Institutions	-0.23	-0.23	-0.13

Note: First period from September 1996 to May 2003.
Second period from June 2003 to December 2005.

Source: Compiled by NRI from TSE data

It is interesting to note that the buying and selling activity of foreign investors was positively correlated with market price moves. We offer two interpretations of this result.

One is that foreign investors are simply following moves in the market, buying when the market rises and selling when it falls. Foreign investors who manage funds with a TOPIX benchmark and who buy following upward moves in the index would produce this sort of correlation, as would portfolio insurance strategies, which call for scaling back portfolio beta as the market declines.

A second interpretation is that foreign investor activity is the cause and not the effect of market movements. This kind of relationship exists when the sheer amount of funds being invested causes buying to push market prices higher.

In contrast, individual investor activity exhibits a strong negative correlation with the TOPIX. As it is unlikely that purchases by individual investors have actually caused share prices to fall, it is reasonable to conclude that individual investors tend to buy stocks when prices fall. This interpretation seems intuitively correct, as the investment style of the typical day trader is characterized by frequent, short-term trading and profit-taking. We think the spread of online trading, which has led more investors to employ similar trading styles, is why this trend is more pronounced in the second period than in the first.

Do individual investors help to stabilize prices?

Finally, we present a simple hypothesis to explain the phenomena described above. The first interpretation holds that foreign investor activity amplifies swings in market prices; the second, that foreign investors may be able to move prices to a certain degree. In both cases, foreign investors are the drivers of price movements.

Individual investors, on the other hand, tend to cushion price swings by moving against the market. Calculation of actual TOPIX volatility showed that annualized volatility was about 20% in the first period noted above but fell to around 16% in the second period, during which we think individual investors were responsible for a higher share of trading.

As online trading has grown more popular, some have voiced concerns that the rising number of individual investors is leading to excessive price swings in individual issues. The Bank of Japan's recent decision to step up monitoring of margin transactions reflects these concerns. From a macroeconomic perspective, however, the growth in individual investors may have enhanced market liquidity and actually dampened price swings via their contrarian investment style. We hope that any attempts to tighten regulation are based on a solid understanding of the problem and are not applied overzealously.

Note

1) In this report, institutional investors include investment trusts, life and nonlife insurance companies, long-term credit banks, city banks, regional banks, trust banks, and other financial institutions as defined by the TSE. Although fund flows into investment trusts hinge on the willingness of individual investors to invest, investment trusts are treated as institutions because they differ fundamentally from individuals, who directly buy and sell individual stocks.

2) According to the TSE, individuals, foreigners, and institutions generally account for more than 90% of all agency orders.

3) TSE data are available for both trade value and share volume. We used the former data set because it correlates better with stock market trends. Incidentally, individual investors' share of trading tends to be higher when share volume is used as the basis for comparison.

4) The results presented here are based on an analysis of aggregate net purchase and net sales data. However, similar results were obtained for purchases and sales when the two were analyzed separately.

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