Investor Polarization, Trading Volume, and Return Dynamics

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Abstract

We document a growing polarization of investment strategies of institutional and individual investors in the US equity market since the 1990s. Institutional investors have been focusing more and more on active trading of individual securities, while individual investors have increasingly shifted towards investing in mutual funds and exchange traded funds. Specifically, institutional investor ownership of individual equities has doubled since the late 1990s, and it currently exceeds 70% of the total equity ownership. Meanwhile, institutional ownership of exchange traded funds has remained constant at approximately 40%. This trend has been accompanied by a significant increase in the volatility of trading volumes. Exchange traded funds outraced the trading in individual equities by a factor of ten in the early part of the sample, but volumes collapsed in the aftermath of the financial crisis of 2007-2008. Low trading volumes have been puzzlingly persistent, despite the large recovery in equity market returns following the crisis. To shed light on these developments, we build a model of heterogeneous portfolio choice. We model the choice of investment strategies by households and sophisticated investors in an environment in which information acquisition and processing are costly (in the sense of Sims (2003), and Kacperczyk, van Nieuwerburgh, and Veldkamp (2012)). The key choice in the model is participation in active (informed) trading versus passive trading. This gives rise to endogenous market segmentation into sophisticated and unsophisticated investors. We explore the implications of the model for the behavior of equity returns and their volatility, as well as the endogenous market structure of the institutional asset management industry.