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Dynamic Interaction between Institutional Investment and Stock Returns in India: A Case of FIIs and MFs

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Abstract

This paper investigates the interaction between institutional investment and market return in Indian stock market. We have used daily net investment data of Foreign Institutional Investors (FIIs) and Mutual Funds (MFs) from January 2000 to December 2009. Empirical result has shown that FIIs investment is positively related to lagged market return whereas MFs investment is negatively related to lagged market return. Bi- directional causality is found between FIIs investment and market return whereas in case of MFs only market return causes the investment. Impulse response analysis confirms that impact of shock to market return is more lasting on institutional investment than otherway round. Sub- period analysis confirms that relationship between FIIs flows and market return did not change significantly during the study period in comparison with MFs.

1. Introduction

THE FLOW OF institutional investment and its relationship with security returns has been of perennial interest to investors and policy makers alike. Generally the flow of institutional investment has been highly correlated with the market returns. Various explanations have been advanced in the extant literature. There are three prominent hypotheses viz. first, price pressure hypothesis, trading by institutional investors affect stock prices contemporaneously [Harris and Gurel (1986); Shleifer (1986)]; second, feedback trading hypothesis, institutional investors have a tendency to be momentum traders [Davidson and Dutia (1989); Delong *et al.* (1990)]; third, information revelation hypothesis, institutions have superior information which helps them to time their trades better [Lee *et al.*, (1991)].

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