

# Behavioural Biases of Institutional Investors under Pressure from Customers -Japan and Germany vs the US-

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Corporate Finance and Governance: Europe and Japan Comparisons

Joint Conference with CEPR and REIT

September 13-14 2005 Tokyo

# Main Objectives

- To investigate behavioural biases in fund management of Japanese and German institutional investors in transitional financial systems, comparing with the US.
- To consider implication of behavioural biases for corporate governance, focusing on influences of customers' pressure on fund managers working for institutional investors in different financial systems.

# Contributions of this study

- Throw a spotlight on relation between fund management and corporate governance of institutional investors with behavioural finance approach.
- Examine the hypotheses on behavioral biases in fund management in terms of short-sightedness, herding, and risk aversion with statistical tests based on data from questionnaire surveys in a comparative viewpoint.

# Heterogeneity of fund management

## -Our viewpoint-

### Definition of institutional investors:

asset management companies or institutions which work for the sake of their customers as agents.

### Behavior of institutional investors

might be heterogeneous due to differences in distance to the client.  
Closer the distance, more sensitive to demands from clients.

### Biases in fund management

would distort corporate evaluation and damage fiduciary responsibilities of institutional investors in a long-term viewpoint.  
Therefore, fund management could contradict with their role of delegated shareholders in corporate governance.

# Institutional Corporate ownership: Backdrops (1)

## In Japan

- Since the 1990s, corporate ownership structure has been changed with resolution of cross-shareholdings.
- Relationship-based shareholdings by banks and business corporations have been reduced from 46 % in 1990 to 29% in 2002, while institutional investors have become a major player holding 31%.

## In Germany

- Institutionalization of ownership is also observed but not so clear.
- Business corporations still hold 34% of shares in 2002. Banks still occupy significant amount.

Institutionalization of ownership is a phenomenon commonly observed in Japan and Germany since the 1990s. But relationship-based shareholdings might be still more obvious in Germany.

# Institutional Corporate ownership: Backdrops (1)

Table 1 Corporate Ownership Structure

						(%)
Japan	Bank	Non bank Institutions	Business Corporations	Individuals	Foreigners	Others
1970	15.8	15.8	23.9	37.7	4.9	1.9
1980	19.9	18.3	26.2	27.9	5.8	1.9
1990	15.7	27.3	30.1	20.4	4.7	1.8
2000	10.1	29.0	21.8	19.4	18.8	0.9
2002	7.7	31.4	21.5	20.6	17.7	1.1

  

Germany	Financial Institutions	Insurance companies	Business Corporations	Individuals	Foreigners	Public Institutions
1970	7.3	4.2	41.8	27.4	7.9	11.5
1980	9.7	5.9	45.0	19.0	10.5	10.0
1990	10.3	11.2	41.6	16.9	16.4	3.6
2000	27.2	15.7	31.8	13.8	14.5	1.1
2002	27.9	16.2	33.7	8.6	18.1	1.0

Sources: DDB; TSE..

# Fund management industry in Japan: Backdrops (2)

## In the 1990s

- Financial reform aiming more market-based system started in 1996, but institutional investors were silent shareholders.

## Since the beginning of the 2000s

- Investment trust fund reform: more competition, more disclosure
  - Pension fund reform: lifted ban on asset allocation, deregulated trustee business, required to fulfill fiduciary responsibilities.
  - Accounting reform: disclosure of pension funds liabilities
- Corporate pension funds have faced demand from sponsors for better investment performance so as to improve pension budgets.

Fund management becomes competitive and institutional investors face strong pressure from customers as well as the society to adapt to new circumstances.

# Fund management industry in Germany: Backdrops (2)

## In the 1990s

- Investment funds grew under government tax-exemption policy which introduced in the 1970s.
- Statutory pension system with pay-as-you-go scheme dominated and corporate pension scheme was very limited.

## Since the end of the 1990s

- Capital market development policy to adjust to globalization has been promoted, but pressure from market to the industry is weak.
- Large investment companies are mostly held by banks, which serve as marketing channels for investment funds.
- This dual role gives influences on decision of investment companies and creates a conflict of interests between the banks and investors.

Institutional investors are likely under less pressure than in Japan.



# Corporate governance in Japan: Backdrops (3)

## Before the 1990s

### -Conventional view:

Bank-based corporate governance system worked at least in the high economic growth era before the mid 1970s.

(Aoki and Patrick, 1994; Hoshi, Kashap and Scharfstein, 1990, 1991)

### -Competition view:

Banks did not monitor their corporate borrowers but fierce competition in product markets disciplined the corporate management. (Hanazaki and Horiuchi, 2000)

## After the Bubble economy burst in 1989

-Banks in distress retreated from relationship-business.

-Vacuum of corporate governance

# Corporate governance in Japan: Backdrops (3)-cont.

## New development in the 2000s

- The role of institutional investors has become closed up. Pension funds and their trustee bodies are expected to act as delegated shareholders. (Omura et.al.,2002; Kitamura et.al., 2004)
- Actually, institutional investors began to voice and Pension Fund Association (PFA) has led activism and has gradually influenced corporate management.
- Internal governance patterned to a US type of outsider system was introduced in 2002.

Corporate governance develops towards more shareholders-oriented system. But it is questioned to function properly or Satisfactorily.

# Corporate governance in Germany: Backdrops (3)

## Traditional German corporate governance system

- relied on a large extent on compatible mutual expectation, on long-term cooperation and on implicit deals between insiders . (Schmidt, 2004)

## Changes in the 1990s

- Large banks were likely to withdraw from traditional universal banking business based on relationship and to extend investment banking in capital market. (Hackethal, Schmidt and Tyrell, 2005)

# Corporate governance in Germany: Backdrops (3) –cont.

## Corporate governance in the 2000s

- New business development motivated banks to reduce their active involvement in corporate governance. (Hackethal, Schmidt and Tyrell, 2005)
- The capital market is still limited and do not play an important role in corporate finance, especially in corporate governance.
- Institutional investors, both investment funds and pension funds, are not motivated to act as shareholders.

Both the financial system and corporate governance system have lost their former consistency, but they cannot shift towards a new system yet.

# Possible distortions in Fund Management under pressure from customers

## Myopic Investment Time Horizon

Frequent performance checking by customers drives towards shorter-sighted fund management .

## Information Processing and Herding

Fund managers could follow trend or use same data source to mitigate pressure from customers and to avoid reputation risk. So they herd.

## Self-marketing and Risk Aversion

Competition pushes them toward self-market-making to add shine to performance by window-dressing, portfolio pumping, portfolio churning etc. Sometimes they become risk-averse.

# Hypotheses Development

## **H1: Short-termism**

Fund managers have more myopic bias in fund management under the stronger pressures from their customers who are concerned with short-term performance.

## **H2: Herding**

Fund managers are more likely to behave homogeneously or to herd under stronger pressure from their customers in order to avoid reputation risk.

## **H3: Risk aversion**

Fund managers are more risk-averse under stronger pressure from customers in order to mitigate negative assessment of their ability in loss.

# Data and Sample

## -Japan, Germany , the US-

### Questions in survey

- personal profile of fund managers
- performance incentives
- personal investment decision and information processing

### Survey periods: Apr.2003-Feb 2004

Japan (Oct-Dec 2003); Germany (Apr-Jun 03); US (Sep 03-Feb 04)

### Responses

Japan: 48 from 78 companies (61.5%), 488 fund managers.

Germany: 51 from 66 companies (77.3%), 263 f. m.

US: 74 from 250 (29.6%), 148 f.m.

# Profile of Respondents

Table 2

## Types of Funds

	Japan	Germany	USA
	N=488	N=263	N=148
	03/10-03/12	03/4-03/6	03/9-04/2
Type of managed funds (%)			
Mutual funds	19.1	32.5	30.9
Pension funds	49.2	50.6	42.6
Both	22.5	16.9	26.5
Others	0.8	0.0	0.0
	100.0	100.0	100.0
Major investment segments (%)			
Equities	58.1	71.7	62.7
Bonds	35.9	26.7	33.2
Money market	2.4	1.6	4.1
	100.0	100.0	100.0

Table 3

## Personal Profile of Respondents

	Japan	Germany	USA
Age (%)			
<31	7.2	21.0	9.4
31-35	24.0	35.5	15.4
36-40	44.1	22.9	19.5
41-45	18.2	14.9	19.5
46-50	3.9	3.8	13.4
	100.0	100.0	100.0
Gender (%)			
Male	96.7	88.6	90.0
Female	3.3	11.4	10.0
	100.0	100.0	100.0
Professional experience in asset management (years)			
<4 years	4.8	32.0	10.9
7-9	19.0	19.1	9.5
13-15	24.0	7.8	10.9
>15	16.7	9.4	49.7
	100.0	100.0	100.0
Current position within your company (%)			
Junior AM	59.5	32.0	15.2
Senior AM	17.9	46.1	46.9
Head of AM	17.5	16.4	20.0
CIO/CEO	2.3	5.5	17.9
	100.0	100.0	100.0



# Profile of Respondents

- Structure of types of funds has high similarity.  
40-50% of respondents-pension fund management  
20-30% of them -investment fund management.
- Major investment segment:  
Share of equities in portfolio is the largest in Germany and the smallest in Japan.
- Personal profiles  
Japanese and German fund managers are younger, less matured or less experienced than the US.

# Method

To questions on Personal investment decisions, respondents are requested to choose one from 1-6 (completely approval to completely contradict)

Statistical tests on differences:

- Mean difference T test

- Non-parametric test (Mann-Whitney U)

# H1: Short-termism

## Distribution of responses

Table 4 Distribution of Responses: Short-termism

		Japan	Germany	USA
(1) Forecasting Time Horizon		%	%	%
Days		6.7	0.8	2.0
Weeks		16.8	13.2	0.7
2-6 months		49.2	59.3	20.8
6-12 months		19.1	21.3	38.9
Years		8.2	5.4	37.6
Total		100.0	100.0	100.0
mean				
(2) Trading too much for client's demand		%	%	%
complete approval	1	2.3	0.4	0.0
	2	11.6	4.2	6.1
	3	18.0	12.6	8.2
	4	13.6	18.0	15.0
	5	25.8	31.8	29.9
complete contradiction	6	28.7	33.0	40.8
Total		100.0	100.0	100.0
mean		4.350	4.755	4.912

# H1: Short-termism

## Difference Tests

Table 5 Test of Mean Differences : Short-termism

	Mean Differences	T test	U Test
(1)Forecasting time horizon			
Japan-US	-1.034	***	***
Germany-US	-0.920	***	***
Japan-Germany	-0.114		**
(2)Trading too much for client demand			
Japan-US	-0.562	***	***
Germany-US	-0.157		
Japan-Germany	-0.405	***	***

Notes: \*\* 5% of significance. \*\*\*1% significance.

# Results: Short-termism

## Investment time horizon:

- Japanese and German respondents have much shorter-time horizon than the US.
- Contradict to a conventional view that investment time horizon in market-based system is shorter than in relationship-based system.
- Japanese respondents are especially short-sighted.

## Trading too much for clients' demand

- 30% of Japanese fund managers chose approval (from 1 to 3) and the percentage is the highest. While, there is no significant difference between German and the US.

In sum, Japanese fund managers are particularly sensitive to customers' demands for short-run performance.

# H2: Herding

## Distribution of responses

Table 6 Distribution of Responses: Herding

		Japan	Germany	USA
		%	%	%
(1) I generally follow the trend	complete approval			
	1	2.3	2.3	1.4
	2	27.2	13.5	4.1
	3	32.8	34.4	15.5
	4	17.3	24.3	27.0
	5	15.3	17.0	35.1
complete contradiction	6	5.2	8.5	16.9
	Total	100.0	100.0	100.0
mean		3.320	3.656	4.412
(2) Public news dose not surprise me	complete approval			
	1	4.9	1.9	8.1
	2	10.1	21.0	23.0
	3	21.9	39.9	31.8
	4	22.5	28.2	24.3
	5	23.5	8.0	10.8
complete contradiction	6	17.1	1.5	2.0
	Total	100.0	100.0	100.0
mean		4.010	3.240	3.128

# H2: Herding

## Distribution of responses –cont.

(3) Statement of economic opinion leader		%	%	%
complete approval	1	9.7	2.3	4.1
	2	22.7	14.8	12.2
	3	28.9	26.2	16.9
	4	16.7	20.5	19.6
	5	11.6	25.1	27.0
complete contradiction	6	10.3	11.0	20.3
Total		100.0	100.0	100.0
mean		3.290	3.844	4.142
(4) Decisions of other market participants		%	%	%
complete approval	1	4.1	1.1	0.0
	2	19.3	7.6	11.5
	3	37.3	22.4	29.7
	4	19.9	25.1	27.7
	5	12.8	29.3	23.0
complete contradiction	6	6.6	14.4	8.1
Total		100.0	100.0	100.0
mean		3.380	4.171	3.865

# H2: Herding

## Difference Tests

Table 7 Test of Mean Differences : Herding

	Mean Differences	T test	U Test
(1) I generally follow the trend			
Japan - US	- 1.092	***	***
Germany - US	- 0.756	***	***
Japan - Germany	- 0.336	***	***
(2) Public news dose not surprise me			
Japan - US	0.882	***	***
Germany - US	0.112		
Japan - Germany	0.770	***	***
(3) Statement of economic opinion leader			
Japan - US	- 0.852	***	***
Germany - US	- 0.298	**	**
Japan - Germany	- 0.554	***	***
(4) Decisions of other markets participants			
Japan - US	- 0.485	***	***
Germany - US	0.618	**	***
Japan - Germany	- 0.791	***	***

Notes: \*\* 5% of significance. \*\*\* 1% significance.



# Results: Herding

## Following trend

- Japanese and German respondents are more inclined to follow trend than the US. Japanese respondents follow trend most.

## Information processing

- Japanese fund managers are most influenced by public news, statement of opinion leaders, and decision of other market participants. So, they are inclined to herd.
- Between the US and Germany, the results are complicated. The US respondents are less moved by public news but more influenced by other market participants.  
It might be explained by less resiliency of German capital market.

In sum, Japanese fund managers are most likely to herd across the three countries .

# H3: Risk aversion

## Distribution of responses

Table 8 Distribution of Responses: Risk Aversion

		Japan	Germany	USA
(1) Personal risk averse as a professional		%	%	%
very averse	1	2.3	1.5	2.0
	2	13.2	9.2	17.7
	3	36.3	36.9	24.5
	4	28.2	42.7	36.7
	5	16.2	8.5	17.0
little averse	6	3.2	1.2	2.0
Total		100.0	100.0	100.0
mean		3.530	3.508	3.551
(2) How actively can you manage portfolio		%	%	%
High tracking error	1	24.6	11.7	12.9
	2	39.1	35.5	38.8
	3	23.1	31.5	23.8
	4	7.8	13.3	15.6
	5	2.7	6.5	7.5
Indexing	6	2.7	1.6	1.4
Total		100.0	100.0	100.0
mean		2.330	2.722	2.701
(3) How actively do you manage portfolio		%	%	%
High tracking error	1	6.3	2.4	11.6
	2	23.0	19.4	33.3
	3	43.9	45.2	31.3
	4	17.7	23.8	14.3
	5	6.3	7.7	8.2
Indexing	6	2.7	1.6	1.4
Total		100.0	100.0	100.0
mean		3.030	3.192	2.782

# H3: Risk aversion

## Difference Tests

Table 9 Test of Mean Differences : Risk aversion

	Mean Differences	T Test T	Significance P	U Test Z	Significance P
(1)Personal risk averse as a professional					
Japan-US	-0.043	-0.437	0.662	-0.618	0.537
Germany-US	-0.021	-0.221	0.825	-0.465	0.642
Japan-Germany	0.022	0.265	0.791	-0.052	0.958
(2)How actively can you manage portfolio?					
Japan-US	-0.371	-3.336	0.001 ***	-3.539	0.000 ***
Germany-US	0.021	0.176	0.861	-0.360	0.719
Japan-Germany	-0.392	-4.305	0.000 ***	-4.850	0.000 ***
(3)How actively do you manage portfolio?					
Japan-US	0.248	2.384	0.017 **	-2.653	0.008 ***
Germany-US	0.410	3.812	0.000 ***	-4.043	0.000 ***
Japan-Germany	-0.162	-2.056	0.040 **	-2.337	0.019 **

Notes: \*\* 5% of significance. \*\*\*1% significance.

# Results: Risk aversion

## Self-assessment of personal risk aversion

- There is no significant difference among the three.

## Gap between possible and actual risk-taking

- Risk-averse bias in fund management is observed in general in the gap between possible risk-taking and actual risk-taking.
- The gap is the largest for Japanese and the least for the US.
- Germans are most indexing among the three both in possible and actual management. It should be explained by investment style.

In sum, Japanese fund managers have the largest risk averse bias. It suggest they are motivated to mitigate pressure from their customers or to avoid reputation risk in increasing demand from customers in the recent circumstances.

# Conclusions

- (1) Japanese and German fund management are more biased than the US.
- (2) Japanese fund managers are especially pressure-sensitive and reputation-sensitive in transitional financial system to more market-oriented with the rapid aging population.
- (3) German fund managers are less pressure-sensitive than Japanese. But it does not necessarily mean that German fund managers are more skilled and experienced. But it might suggest German fund management is not so competitive under the circumstances surrounding investment trust funds and corporate pension funds.

# Implications for Corporate Governance

- The observed behavioral biases in Japanese fund management are inconsistent with role of institutional investors in corporate governance as shareholders.
- Japanese corporate governance reform is confronted with behavioural finance problems in fund management to be solved; relating to incentives system, enhancing consciousness and confidence as professionals, and skill development of fund managers, etc..
- German corporate governance has different issues to be discussed. We should note relation between banks and investment companies and pension fund scheme.