

Investors' Herd Behavior: Rational or Irrational

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ABSTRACT

This study examines the relationship between herding of different investor groups and trading noise in the Taiwan stock market to determine which investor group tends to herd rationally. The study uses a unique and comprehensive dataset on intraday transactions and limit order book on the Taiwan Stock Exchange (TWSE). We calculate the high-frequency herding measure and trading noise in a call auction market. We find that the overall herding increases trading noise on the TWSE. Institutional investors are likely to be informed traders and herd rationally on superior information. Institutional investors' herding has a negative impact on trading noise. Their buy (sell) herding predicts positive (negative) future market returns. In contrast, the herding of individual investors tends to contain limited information as it increases trading noise; buy (sell) herding of individuals is negatively correlated with future market returns. These findings are more significant for stocks with greater turnover.

Keywords: Trading noise; Herding; Institutional investors; Individual investors; Intraday transactions.

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