Full length article

Portfolio choice in Mexico
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A B S T R A C T

We study a comprehensive dataset of more than 25,000 portfolios from 28 different banks or investment banks in Mexico during the period from September 2008 – August 2009. Some of these portfolios are administered by an external advisor and/or contain motivated assets – assets bought by a bank’s client for whom the bank is also the underwriter. We find that portfolios containing motivated assets underperform. These assets usually are allocated to wealthy retail investors, who are less likely to have an external advisor since their account services generally include an internal advisor. Mexican investors’ portfolios are under-diversified and have a significant home bias. External advisors do not seem to improve the performance of a portfolio during the period studied. However, they do help to reduce the home bias and increase a portfolio’s diversification.

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1. Introduction

Financial decisions can have a large impact on households’ lifetime utility. However, a large body of research on investors in developed countries finds that many retail investors make mistakes that significantly reduce their lifetime wealth (Odean, 1998; Grinblatt and Keloharju, 2000; Campbell, 2006; Malmendier and Shanthikumar, 2007; Goetzmann and Kumar, 2008; Barber et al., 2009; Badarinarz et al., 2016).

For example, it is reported that investors hold under-diversified portfolios, hold under-performing assets for too long, pay little attention to relevant information, and over invest in local relative to foreign assets (Cooper and Kaplanis, 1994; Odean, 1998; Grinblatt and Keloharju, 2000; Goetzmann and Kumar, 2008; Barber and Odean, 2013). It also seems that investors are often over-confident with respect to their own skills (Barber and Odean, 2001).

Further, it seems that receiving expert advice does not necessarily improve portfolios’ performance. Although there is some evidence suggesting that external advisors improve portfolios’ diversification, external advice often does not improve portfolio performance (Foerster et al., 2014, 2017). Indeed, in some cases, it seems that financial advice can have a negative effect on the returns and Sharpe Ratios, especially when the advisors’ interests differ from those of the clients (Cain et al., 2005; Bergstresser et al., 2009; Hoechle et al., 2015; Angalo et al., 2017).

Less is known, however, about the choices of retail investors in developing countries. In these countries, investors’ financial literacy is lower than that of their counterparts in developed countries (Xu and Ziu, 2012). Also, it is likely that the regulation on external advisors in developing countries is less strict than in developed countries.

It can therefore be expected that investors in developing countries will have greater home bias and greater tendency to hold under-diversified portfolios than investors in developed countries. It is also likely that in developing countries, external advice will be less efficient in improving portfolios’ performance than in developed countries (Duarte and Hastings, 2012).

In this paper we study a comprehensive dataset of more than 25,000 portfolios from 28 different banks and investment banks in Mexico. We have data on the portfolio size of each investor, investor’s wealth class (assigned by the type of banking service they have access to), whether the investor is a retail (person) investor or a company, and the investor’s risk profiles.

Our data covers the period September 2008–August 2009. We are therefore able to study, at the micro level, the portfolio choices of different types of investors in a developing country at a time of a market bust followed by a recovery: From September 2008 to February 2009, the Mexican Stock Exchange index (IPC) dropped by around 30%. From March 2009 to the end of August 2009, the index rose by almost 60%.
We use this dataset to describe the behavior of retail investors in Mexico. We study the diversification, returns and home bias of different types of Mexican investors. We also study the effect of using external advisors on portfolios’ performance, and the characteristics of investors that are likely to employ an external advisor, buy foreign assets and have better diversified portfolios.

We find that Mexican investors hold under-diversified portfolios. We also find that there is a strong home bias, with a large share of investors holding mostly Mexican Debt Investment Societies and Mexican Government Bonds (local fixed income securities). Consistent with results reported in studies of investors in developed countries, we find that companies and high income retail investors tend to hold more diversified portfolios and earn higher returns than the average retail investor (Grinblatt and Keloharju, 2000; Barber et al., 2009).

However, because of the special time period that we study, we find that holding an under-diversified portfolio had only a small effect on the investors’ portfolios’ performances. In the market crash that occurred in the first part of our dataset, holding Mexican bonds yielded higher returns than foreign stocks. Thus, in the time period that we study, holding an undiversified portfolio of fixed-income local securities paid off.

In addition, about 600 of the investors in our dataset used an external advisor. We find that wealthy retail (person) investors, as classified by the service type they have access to, are less likely than other investors to employ an external advisor. This is because those special accounts (Private Banking and High Net Worth Client accounts) include the services of a financial advisor assigned by the bank. This not withholding, we find that retail investors with large portfolios are more likely to employ an external advisor. Consistent with findings on retail investors in developed countries, we find that having an external advisor does not improve portfolios performance (Foerster et al., 2014, 2017; Hoechle et al., 2015), but does not harm the performance either. We also find that Mexican external advisors reduce the home bias and improve the diversification of the portfolios they manage.

Finally, we use the term motivated assets to describe assets that a bank’s client hold and for which the bank serves as part of the underwriting syndicate. We find that the higher the share of motivated assets in an investor’s portfolio, the lower the portfolio’s performance. Our evidence suggests that banks that are part of an underwriting syndicate of an issued asset sell this asset to their clients even when the asset reduces the clients’ portfolio’s performance.

The rest of the paper is organized as follows. In Section 2 we review the literature on household finance in developing countries. In Section 3 we describe the dataset we use and present some basic stylized facts. In Section 4 we report the results of our main quantitative tests. We conclude in Section 5.

2. Literature review

Household finance studies how households use financial instruments and markets to achieve their objectives (Campbell, 2006; Guiso and Sodini, 2013). Some key findings are that households in developed countries are prone to investment mistakes: They tend to sell winning assets too quickly and hold losing assets too long (Shefrin and Statman, 1985; Odean, 1998; Grinblatt and Keloharju, 2001), hold under-diversified portfolios (Goetzmann and Kumar, 2008; Guiso and Sodini, 2013; Barber and Odean, 2013), over invest in local assets relative to foreign assets (Cooper and Kaplanis, 1994; Guiso and Sodini, 2013; Barber and Odean, 2013; Cooper et al., 2013), make mistakes due to overconfidence (Barber and Odean, 2001; Graham et al., 2009), ignore relevant information about the incentives of analysts and advisors (Cain et al., 2005; Malmendier and Shanthikumar, 2007) and pay to advisors although advised portfolios do not yield better expected returns than unadvised portfolios (Gennaioli et al., 2015; Foerster et al., 2017).

Furthermore, the evidence suggests that education and financial sophistication reduce the likelihood that investors make investment mistakes (Grinblatt and Keloharju, 2000; Dhar and Zhu, 2006). There is also evidence that the institutions that determine financial regulations have a large effect on households’ returns and welfare (Campbell, 2016). Particularly, it seems that in the absence of efficient regulation, firms take advantage of investors’ naivety: Firms intentionally sell complex financial products that mislead consumers into paying high fees (Gabaix and Laibson, 2006; Gennaioli et al., 2015; Zingales, 2015).

The typical consumer in a developing country is likely to be less educated and less financially sophisticated than the typical investor in a developed country (Xu and Ziu, 2012). It is therefore likely that consumers in developing countries are more susceptible to make mistakes than consumers in developed countries. Although evidence on consumers in developing countries is relatively rare, it seems that this is indeed the case.

First, Sercu and Vanpée (2005) and Mishra (2013), using macro data, find that the home bias of investors in developing countries is significantly greater than the home bias of investors in developed countries. For example, according to Sercu and Vanpée (2005), in 2005, the average percentage of domestic assets in the portfolios of investors in 20 developing countries was 94.5%, compared to 68.3% in the portfolios of investors in 21 developed countries.1

Second, a number of papers find that differences in education and financial sophistication have a significant effect on the performances of investors in developing countries. For example, Liivamägi (2016) finds that in Latvia, investors with academic degrees trade more often than investors without higher education and that experienced traders earn higher returns than less experienced traders. Duarte and Hastings (2012) find that many Mexican investors are not sensitive to fees. Campbell et al. (2015), find that, ceteris paribus, education reduces the likelihood that Indian homebuyers default on their mortgages. Vissing-Jorgensen (2012) shows that income and education have a negative effect on the probability that a Mexican consumer default on her consumer credit.

Third, research shows that firms in developing countries are aware of consumers’ lack of financial sophistication. A number of papers find that firms in developing countries often sell complex products that increase the probability that consumers buy the products that maximize the firms’ revenues rather than the products that minimize the consumers’ costs. Duarte and Hastings (2012), for example, find that Mexican consumers pay high management fees for their social security programs, although the number of competing firms is large. Furthermore, they find that when the Mexican government introduced a new index to make the fees salient to consumers, the firms responded by utilizing the new index to their advantage. The firms introduced new products that had low values of the index, but nevertheless charged high fees. Eventually, because the consumers followed the index and ignored the other costs, many consumers paid higher fees than before the index was introduced. Similarly, Anagol et al. (2017) find that life insurance agents in India tend to recommend to the consumers unsuitable products that provide high commissions to the agents.

Taken together, this evidence suggests that investors in developing countries are indeed less financially sophisticated than

1 The list of developed countries includes: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Italy, Japan, South Korea, the Netherlands, Norway, Portugal, Sweden, Switzerland, the United Kingdom, and the United States. The list of developing countries includes: Argentina, Brazil, Chile, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Malaysia, Mexico, Philippines, Poland, Russia, Singapore, South Africa, Thailand, and Turkey.
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