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International Review of Financial Analysis 17 (2008) 83 – 107
IRFA
INTERNATIONAL REVIEW OF Financial Analysis

U.S. investors and global equity markets ☆

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Received 27 February 2007; accepted 27 February 2007
Available online 16 March 2007

Abstract

This study examines international equity flows of U.S. residents to emerging markets in Latin America and Asia and to developed markets in Europe, Canada, and Japan. The major issues addressed are (1) appropriate means of measuring relationships between returns and flows, (2) role of volatility in these relationships, and (3) effects of the Asian crisis. Basic findings include: (1) the information contribution argument is stronger than the feedback trading argument (flows affect returns more than past returns affect flows), (2) volatility of flows and of returns are not of major importance, (3) the Asian crisis effects are important and strongest for Asia followed by developed markets and by Latin America, and (4) regional measures and U.S. returns play significant roles in international equity flows to many countries.

JEL classification: E44; F02; G15
Keywords: Equity flows; Feedback trading; Information contribution; Global markets

As the integration of world capital markets continues, the role of international equity flows becomes increasingly important. A major challenge is the ability of policymakers to assess the effects of international equity flows into and out of their markets. International equity flows were considered to be primary culprits in the 1997 Asian crisis, and developed countries have become increasingly concerned about the impact of flows on interest rates and equity returns in their domestic markets. When many of the world's economies are faltering, such as today, changes in international equity flows become especially important because, during recessionary periods, the dangers of adverse capital flows grow even stronger. There is evidence surfacing that, at least for

☆ Financial support was provided by the National Science Council of Taiwan: NCS 91-2416-H-005-019.
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1057-5219/$ - see front matter
doi:10.1016/j.irfa.2007.02.002

Asian emerging markets, foreign equity flows not only have a much stronger influence than has been suggested by previous studies (Richards, 2002), but also, when studied in the context of the transition dynamics of emerging markets from pre-liberalization to post-liberalization, when capital leaves, it leaves faster than it came in (Bekaert, Harvey, & Lumsdaine, 2002). Increasing integration of world capital markets also affects investors as it decreases possible diversification benefits. Kearney and Lucey (2004) conclude that international equity markets are becoming more integrated due to fewer trade restrictions and closer trading linkages. However, diversification possibilities continue to exist as evidenced, for example, by Laopodis (2005) who finds only weak evidence of cointegration (common trending) between the U.S. market and European Union equity markets. Thus relationships between returns and international equity flows are important to both policymakers and investors.

This paper addresses these issues by evaluating the effects of international equity flows for a wide range of countries, including countries in Latin America, Asia, Europe, and North America. Specifically the paper (1) investigates an appropriate method for examining relationships between international equity flows and equity returns, (2) studies the role of volatility in these relationships, (3) analyzes the effects of the Asian crisis on the relationships, and (4) considers geographic regional effects in addition to individual country effects.

Identification of an appropriate method for examining relationships between international equity flows and returns requires clarification of past terminology. Several definitions have appeared in the literature. For simplicity and clarity in this paper, concepts of momentum trading, return chasing, and feedback trading will be identified as “feedback trading.” This relationship indicates that current international equity flows are affected by last period returns. The second approach identifies fundamental relationships between flows and returns and investigates the effects of current flows on current returns where long term effects result from changes in fundamentals and short-term effects are viewed as noise effects (price pressure). This second approach will be designated “information contribution” in this paper.

Past studies of feedback trading suggest that foreign equity flows and equity returns are positively associated, with investors tending to underreact to new information over short time horizons (Jegadeesh & Titman, 1993, 2001; Shleifer, 2000). The implication is that foreign equity markets incorporate information gradually, providing positive profits from feedback trading (De Long, Shleifer, Summers, & Waldmann, 1990, 1991; Froot, O’Connell, & Seasholes, 2001; Sias, 2004). Griffin, Nardari, and Stulz (2002) and Richards (2002) confirm that stock return performance is an important determinant of equity flows while Brennan and Cao (1997), Brennan, Cao, Strong, and Xu (2005) and Dvorak (2005) point out that institutional investors’ feedback trading activities reveal an information advantage of domestic over foreign institutional investors.

The information contribution concept encompasses two ideas: (1) that equity flows incorporate fundamental prospects making the impact of flows on returns permanent (Dann, Mayers, & Raab, 1977; Kraus & Stoll, 1972; Scholes, 1972) and (2) that equity flows incorporate noise rather than fundamentals, making the impact of equity flows on returns temporary (often called price pressure) (Froot & Ramadorai, 2001; Harris & Gurel, 1986; Shleifer, 1986). Both these explanations predict a positive correlation between equity flows and market returns.

The second aspect of the study is to analyze effects of volatility on the relationships between flows and returns, an area where little work has been done. Kim and Singal (1997) and Richards (1996) conclude that returns are associated with past returns and with volatility. Focusing on volatility in emerging markets, Stulz (1999) analyzes the impact of international equity flows on local equity markets and finds weak evidence that equity flows (1) adversely affect the performance of equity markets, (2) increase the volatility of equity returns, or (3) destabilize the