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Herding by foreign investors and emerging market equity returns: Evidence from Korea

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ABSTRACT

This paper studies the effect of herding by foreign investors on stock returns in the Korean market. We conduct both pre and post-liberalization analyses and utilize a three-stage least squares analysis in order to control for the simultaneous relationship. We find evidence of a significant impact of foreign investor herding on stock returns in addition to intra-year positive feedback trading by foreign investors. However, changes in domestic institutional ownership do not have any significant effect on stock returns. In addition, foreign investors tend to buy/sell shares that domestic institutions sell/buy in the herding year.

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1. Introduction

Much has been written about the explanatory potential of herding and the associated feedback trading with various phenomena including stock price movements, momentum and even volatility.[1] However, to the best of our knowledge, there has been little research on the impact of foreign investors in newly liberalized markets. Over the last few decades, one of the most important trends in international markets is the liberalization of financial markets in emerging economies. Financial market liberalization has provided global investors with new investment opportunities to invest in what were restricted domestic securities. We believe this resultant growth of foreign ownership in emerging markets is of great significance to researchers interested in understanding the impact of trading behaviors of global investors on local markets as well as to investors — foreign and domestic, individual and institutional. One of the most successful emerging markets is the Korean market which has several unique characteristics that make it of great interest to those curious about investment behavior.

Normally domestic institutional investors are recognized as the most important investment group — particularly in more established markets.[2] However, they may not be the most influential class in some emerging markets. In Korea foreign investors, most of whom are U.S. and European institutional investors, hold more than 40% of the total market capitalization while domestic

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[1] Section 2 discusses and compares the various definitions of herding and feedback trading detailed in the previous literature as well as our applicable usage.

[2] Gompers and Metrick (2001) report that large institutional investors with at least $100 million under management almost doubled their share of the U.S. equity market from 1980 and 1996. In contrast, Khanna and Palepu (1999) document foreign ownership has a positive and significant effect on firm value in India, while domestic institutional investors have a negligible effect on firm value.

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institutional investors hold approximately 17% (as of 2003) with the remainder held by individuals or non-financial companies. This structure is common in emerging markets, particularly in East-Asian markets with the recent innovation of foreign investment.

We add to the literature by concentrating on four issues. First, we investigate the cross-sectional relationship between changes in foreign or domestic institutional ownership and stock returns. This seeks to assess the relative importance of herding by foreign or domestic institutional investors in the Korean market. We generally follow Nofsinger and Sias' (1999) ownership change portfolio approach. We then extend the work by performing a three-stage least squares regression (3SLS) analysis controlling for simultaneity between changes in foreign or domestic institutional ownership and abnormal stock returns. Further, we consider the change of economic regime by dividing the sample period into two sub-periods, pre- and post-1998, when the Korean government abolished the limits on foreign equities ownership. Second, we examine whether changes in foreign or domestic institutional ownership are related to positive feedback trading. Third, we examine whether changes in foreign or domestic institutional ownership are consistent with information cascades.[3] Finally, we investigate the possible existence of information asymmetries between foreign and domestic institutions. Even though a number of papers focus on herding by institutions or retail investors, to our knowledge, this is the first study that investigates herding by foreign investors and its impact on emerging market stock returns.

We find a strong and positive relation between changes in foreign ownership and stock returns. After 1998, when the foreign ownership limit was abolished in the Korean market, the relationship becomes even stronger. Since the ownership data is observed once at the end of the year, the significant correlation between changes in foreign ownership and abnormal returns may come from either the positive impact of changes in foreign ownership on stock returns or intra-year positive feedback trading by foreign investors. We further investigate both hypotheses using three-stage least squares (3SLS) analysis and find that the results are supportive of both hypotheses. We also find little evidence that changes in domestic institutional ownership have a significant effect on stock returns. Neither foreign nor domestic institutional herding is consistent with information cascades — ownership changes during the herding year are not positively correlated with those during the pre-herding year. In addition, we find evidence of information asymmetries between foreign and domestic institutions. This suggests that foreign institutions tend to buy/sell shares that domestic institutions sell/buy in the herding year.

The study is organized as follows. In Section 2, we introduce the theory and empirical evidence on institutional herding. Section 3 describes the data and methodology used in this study and addresses general findings on foreign and domestic institutional herding in Korea. Section 4 examines the effect of herding by foreign investors on stock prices. In Section 5, we discuss additional issues related to pre-herding behavior by foreign investors. In Section 6, we examine informational cascades and information asymmetries and Section 7 concludes.

2. Herding and feedback

We address the issue of the price impact of foreign investors in emerging markets by focusing on their herding behaviors. The literature both theoretically as well as empirically confirms that herding and feedback trading have the potential to explain the behaviors of institutional investors (Lakonishok, Shleifer, & Vishny, 1992; Nofsinger & Sias, 1999; Wermers, 1999; and Dennis & Strickland, 2002). Since institutional investors are regarded as sophisticated investors in the capital markets, researchers have studied extensively whether institutional investors have the ability to identify mispriced stocks and outperform the market. Some authors consider institutional investors to engage in "herding" or "feedback trading" — the trading of securities without appropriate fundamental information. Banerjee (1992) argues that herding is a rational behavior because in following others' decisions, it may "reflect information that they have and we do not." Bannerjee goes on to point out that as this process is extended, it offers less and less information to those with an increasingly distant view of the leader. He identifies this as the "head externality" as fewer and fewer use their own information in making a decision, but base it upon others preceding (the head) which serves to actually impede the flow of information as investors act sequentially.

Avery and Zemsky (1998) identify this sequential investing where the group of investors follows the lead of the market while ignoring or failing to gather private information as an "informational cascade." We avail ourselves of their distinction, examining herding as the concurrent investing, feedback trading as the reaction to the returns of the risky assets and informational cascades as the sequential response of agents following the lead of other investors completely independent of private information. We hold these distinctions as important due to the evidence in the literature that local institutional herding has a significant impact on stock returns in, particularly in non-U.S equity markets (Kim & Nofsinger, 2005; Chen & Hong, 2006). We seek to clarify the specific nature of these general effects on stock market returns.

Why would investors herd? Finance theories offer several explanations of why institutional investors might trade together. Wermers (1999) summarizes four popular theories as to why institutional investors herd. First, institutional managers are subject to reputational risk. This is the risk of acting differently from other managers, with different results, so that managers may ignore private information and trade with the crowd (Sharfstein & Stein, 1990) in order to insure more consistent results. Second, institutional managers may receive similar private information because they analyze the same price factors (Froot, Scharfstein, & Stein, 1992; Hirshleifer, Subrahmanyam, & Titman, 1994). Third, Wermers suggests institutional mangers infer private information from trades of other managers, resulting in informational cascades (Bihkchandani, Hirshleifer, & Welch, 1992; Avery & Zemsky, 1998). Finally,

[3] An information cascade arises when decisions are made by each investor sequentially, but investors begin to ignore their private signals in favor of the observed actions of previous investors (Banerjee (1992), Welch (1992)).

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