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Large foreign ownership and stock price informativeness around the world

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A B S T R A C T

This study investigates the relation between large foreign ownership (*LFO*) and the informativeness of stock prices in 40 markets. We show that *LFO* is positively related to price informativeness, measured by probability of informed trading (*PIN*) and price non-synchronicity (*NONSYNC*) which reflects firm-specific variations in stock returns. We also find a stronger association between stock returns and future earnings innovations for firms with higher *LFO*. Further analysis reveals that the effect of *LFO* on price informativeness is stronger in developed economies and markets with strong investor protection and a transparent information environment.

1. Introduction

Foreign investors have emerged as an important group of investors in many financial markets. Take our sample of 2002 as an example, foreigners on average owned 28% of shares in 3189 firms in 40 markets. Given the significant presence of foreign investors in local markets, the specific roles played by foreign investors in local markets have attracted considerable attention from both academics and

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policy makers. One stream of research has studied the effects of foreign equity investments on the real side of invested firms and local economy, such as productivity, investment and growth (e.g., Henry, 2000a; Bekaert et al., 2005, 2009). Another stream of research examines properties of stock prices including liquidity (Bekaert et al., 2007; Rhee and Wang, 2009), return volatility (Bae et al., 2004; Li et al., 2011), and the cost of capital (Bekaert and Harvey, 2000; Henry, 2000b).

This study investigates whether foreign investors, particularly large foreign investors (*LFO*), affect the extent to which stock prices incorporate value-relevant information and thus are informative about a firm's fundamental value. In an efficient market, stock prices incorporate all the available information and reflect a firm's intrinsic value. However, prices could fail to reveal all the available information because of various frictions such as information cost (Grossman and Stiglitz, 1980) and limits to arbitrage (Shleifer and Vishny, 1997). Consequently, the degree of price informativeness varies across firms and has important implications for both managers and investors. More informative stock prices can help managers make better decisions in capital investment, resulting in higher efficiency in capital allocation and corporate investment (Wurgler, 2000; Durnev et al., 2004; Chen et al., 2007). Informative prices also reduce the risk for uninformed investors and thus lower the cost of capital for the firm (Fernandes and Ferreira, 2009). Therefore, given foreign investors' substantial share ownership, it is important to understand the impact of foreign investors on a firm's stock price informativeness.

The existing literature suggests two potential channels through which large foreign shareholders could improve the informativeness of stock prices of the invested firm. First, large foreign shareholders could improve the informativeness of stock prices through their informed trading. Compared with small shareholders, large shareholders tend to have a stronger incentive and better capability to collect and process value-relevant information.[4] Thus the information-based trading by large shareholders, for example, selling their stakes upon negative information, facilitates the capitalization of fundamentals into stock price (Edmans and Manso, 2011; Admati and Pfleiderer, 2009; Edmans, 2009).[5]

Second, large foreign shareholders could enhance price informativeness by improving corporate governance and disclosure quality of the invested firms.[6] Jin and Myers (2006) show that poor investor protection and opaque financial disclosure reduces price informativeness. The reason is that managers and controlling shareholders tend to engage in self-dealing activities to extract private benefits at the expense of other shareholders (e.g., Shleifer and Vishny, 1989; Morck, 1996). To camouflage their self-dealing activities, managers may withhold information or manipulate accounting disclosure, which makes stock prices less informative about a firm's fundamentals (Fan and Wong, 2002; Jin and Myers, 2006; Gul et al., 2010). Furthermore, agency problems could deter sophisticated investors from engaging in costly and risky informed arbitrage, which also reduces the amount of relevant information in stock prices (Morck et al., 2000). If large foreign shareholders, due to their significant interest at stake, closely monitor managers and constrain agency problems, we expect to find more informative stock prices.

However, it remains an empirical question whether large foreign investors can be effective monitors of local managers and insiders. On the one hand, relative to domestic shareholders, foreign shareholders may incur a higher cost to collect relevant information to effectively monitor insiders due to the geographic and cultural distance (Kang and Kim, 2008, 2010). On the other hand, large foreign shareholders would be less engaged with insiders compared with their domestic counterparties, which could facilitate their monitoring role. Further, the differences in corporate governance practices

[4] A number of studies document mixed evidence on whether foreign investors have better information than local investors (Grinblatt and Keloharju, 2000; Hau, 2001; Seasholes, 2004; Choe et al., 2005; Dvorak, 2005). We note that foreign investors in these studies are likely to be foreign mutual funds with relatively small ownership in local companies. In contrast, we focus on large foreign investors that own at least 5% of shares of a firm's stock. The substantial shareholding of large foreign investors should allow them to be better informed than outside investors.

[5] In their theoretical model, Edmans and Manso (2011) show that the monitoring role of large shareholders does not necessarily rely on active trading by large shareholders. The mere threat of exit upon negative information could effectively convey information about firm value and improve the informativeness of stock prices.

[6] The vast majority of blockholder literature focuses on how blockholders add value through direct intervention or monitoring. See, Shleifer and Vishny (1986), Admati et al. (1994), Kahn and Winton (1998), Maug (1998), Aghion et al. (2004), among others.