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Foreign equity flows and the "Size Bias": Evidence from an emerging stock market

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ABSTRACT

This paper examines foreign investors' equity-level transactions in an emerging stock market, the Istanbul Stock Exchange, for the period 1997–2008 to derive insights into the debate on information asymmetries between domestic and foreign investors and the home bias puzzle. The analysis suggests two important findings. First, foreign investors do not consider the market portfolio of domestic securities as predicted by standard theories of international portfolio diversification. Second, the firm's size and the expected return are central to explain foreign investors' equity trades. The results are consistent with models based upon the hypothesis of differential information between foreign and domestic investors.

1. Introduction

The *home bias* in portfolio investments remains an actual, yet unresolved question in international economics and finance. The term basically refers to the fact that investors hold disproportionately larger shares of their wealth in domestic securities in contrast to the predictions of a large body of theoretical and empirical research (see, among others, van Wincoop and Warnock, 2010; Sorensen et al., 2007; Baele et al., 2007). Empirically, such a behavior is considered to be irrational since there is substantial evidence suggesting that the international diversification of portfolios is potentially more beneficial than domestic diversification (Baele and Inghelbrecht, 2009; Chiou, 2009; De Santis and Sarno, 2008; Driessen and Laeven, 2007; Gilmore and McManus, 2002). Although the magnitude of the home bias worldwide has slightly declined during the past decades (Fidora et al., 2007), data on existing foreign holdings suggest that investors are still underdiversified despite the lifting of

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many barriers to cross-border portfolio investments. Academics have so far come up with several explanations to rationalize the home bias,[1] however, none seems to have provided a fully satisfactory account of the phenomenon.

This paper contributes to this literature by analyzing foreign investors' portfolio trading patterns[2] in an emerging stock market and, thus, providing insights into the asymmetric information hypothesis between local and foreign investors. Indeed, the argument of asymmetric information between local and foreign investors provides a simple and direct way to understand the reason as to why investors tilt their portfolio toward local stocks. As long as investors are less well-informed about the payoffs on foreign securities, overweighting domestic securities becomes a rational behavior.

Specifically, I explore a unique dataset[3] that comprises equity-level transactions (purchases and sales) issued by foreign investors on 84 firms traded in the Istanbul Stock Exchange (the "ISE" henceforth) for the period 1997–2008. Although the complete list includes on average more than 300 firms' shares over this period, the subset used in this study captures a significant portion of foreign investors' transactions in the ISE such that the year-end market capitalizations of this subset of stocks represent on average 86% of the total market capitalization over the sample period. The analysis basically consists on examining the determinants of non-residents' stock-level trades using an array of explanatory variables drawn from prior studies. As such, this paper complements a number of related studies like Aggarwal et al. (2005), Dahlquist and Robertsson (2001), and Kang and Stulz (1997), since these papers also examine the portfolio preferences of foreign investors in different contexts. Meanwhile, the analysis also extends other papers that focus on the country-level determinants of cross-border portfolio investments (see, among others, Lane and Milesi-Ferretti, 2008; Portes and Rey, 2005) by analyzing firm-level determinants of foreign investors' firm-level portfolio trades within an emerging stock market.

Preliminary inspections reject the well-known hypothesis that foreign investors consider the standard international CAPM framework when investing into the Turkish stock market. Neglecting the market portfolio of securities, they focus on a smaller subset of large capitalization stocks. The sectoral breakdown of the transactions issued by non-residents suggests that foreigners prefer particularly financial stocks. The share of their transactions within this group generally exceeds the share of financials in the value-weighted market capitalization of the ISE. On average, 61% of the transactions issued by foreign investors are concentrated within the financial stocks for the period 1997–2008 while the average share of financial stocks in the ISE composition is about 52% over the same period.

To examine the determinants of foreign investors' firm-level trading patterns, I employ regression analyses and relate foreign investors' transactions (e.g. purchases, net purchases and traded value) in local stocks to an array of financial metrics that capture different characteristics of the firm of interest. The predictor variables include different proxies for the firm's size (market capitalization), market characteristics (expected return and beta), leverage (total debt/total capital ratio), valuation (price/book ratio), profitability (return on assets), dividend yield (dividend payout ratio), and liquidity (turnover). Estimations point out to the firm's market capitalization and the expected return on the corresponding stock as the main significant variables in explaining the preferences of foreign investors when they trade in local stocks. For other variables the results remain mostly inconclusive, both statistically and economically. The significance of the market capitalization and the expected return is robust to alternative subsamples, disaggregation across sectors and other additional controls.

[1] Typical explanations include explicit barriers to international capital movements (Rowland, 1999; Stulz, 1981), investors' hedging motives against the price uncertainty due to deviations from the purchasing power parity (Cooper and Kaplanis, 1994) or the existence of non-traded goods and production factors (Baxter and Jermann, 1997), information asymmetries between foreign and domestic investors (Barron and Ni, 2008; Brennan et al., 2005; Hatchondo, 2008; Ni, 2009) and, more recently, behavioral finance related explanations such as the familiarity bias (Grinblatt and Keloharju, 2001), cultural frictions (Beugelsdijk and Frijns, 2010; Lucey and Zhang, 2010), overconfidence (Strong and Xu, 2003; Suh, 2005), narrow framing (Magi, 2009) etc. For reviews of the literature on home bias, see, among others, Hau and Rey (2008), Campbell and Kraussl (2007), Karolyi and Stulz (2002), and Lewis (1999).

[2] Although, the use of equity holdings data is potentially more accurate to draw lessons for the home bias puzzle, the main result obtained in this study using portfolio flows data, i.e. the positive effect of the firm's size and the stock's expected return on foreign investors' trades in local stocks, is fully consistent with the asymmetric information story of the puzzle.

[3] Following Dvorak's (2005) argument regarding his study on investors' performance in the Indonesian market, to my knowledge, this dataset has not been so far explored for such an empirical analysis of foreign investors' portfolio trading patterns in the Turkish stock market.