An early warning system for global institutional investors at emerging stock markets based on machine learning forecasting

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Abstract

At local emerging stock markets such as Korea, Hong Kong, Singapore and Taiwan, global institutional investors (GII) comprised of global mutual funds, offshore funds, and hedge funds play a key role and more often than not cause severe turmoil via massive selling. Thus, for the concerned local governments or private and institutional investors, it is quite necessary to monitor the behavior of GII against a sudden pullout. The main aim of this article is to propose an early warning system (EWS) which purposes issuing warning signal against the possible massive selling of GII at the local market. For this, we introduce machine learning algorithm which forecasts the behavior of GII by predicting future conditions. Technically, this EWS is an advanced form of the EWS developed by Oh et al. (2006). An early warning system for detection of financial crisis using financial market volatility. Expert Systems, 23, 83–98 which issues a warning based on classifying present conditions. This study is empirically done for the Korean stock market.

Keywords:
- Early warning systems
- Global institutional investors
- Machine learning
- Case-based reasoning

1. Introduction

Over the last 10 years, emerging stock markets such as Korea, Hong Kong, Singapore and Taiwan have been incorporated into the world financial market (Ghysels & Seon, 2005). Globalization and removal of the regulations at the local markets make global institutional investors (GII) to be major influences at the local markets. As a result, the movements of GII actually direct the local markets particularly when severe external or internal shocks hit the market. For example, GII, by May 2004, has occupied almost half the Korean stocks in terms of total market capitalization and in cases of external or internal shock such as Asian financial crisis in 1997, Russia moratorium in 1998, liquidity crises of Daewoo group in June–December 1999 and Hyundai group in June–December 1999, and 9/11 terrorists attack in 2001, the abnormal pullouts of GII has led the Korean stock market to the near collapse (Choe, Kho, & Stulz, 1999; Kim & Kwon, 2003; Kim & Kwon, 2003; Kim & Wei, 1999). In order to prepare against such a devastating situation, a proper early warning system (EWS) that can detect or predict abnormal pullout of GII, especially global hedge funds, is strongly desired at the local markets.

In order to develop EWS for GII (EWGII), we will follow a standard procedure developed by Oh, Kim, and Kim (2006) which employs machine learning algorithms for establishing EWS for financial markets. Technically, their procedure is based on classifying the current situation according to some standard measures such as market volatility. The core of the procedure is defining the gray zone as its main feature vector which may proceed to either stable condition or collapse and issuing a warning when the market enters the gray zone. In this article, we present an advanced EWS which issues warning by classifying and forecasting future conditions of a market. The core of the procedure is defining the oracle rule which determines the future market conditions in advance and then tracing (forecasting equivalently) the oracle rule with trained machine learning algorithm.

The rest of this study consists of as follows: Section 2 reviews the previous studies about behavior of GII and the existing EWS algorithm. A discussion of technical aspects of the EWS monitoring GII (EWGII) is also given. Section 3 presents the detailed construction procedure of EWGII. Section 4 is devoted to the empirical case study for building EWGII for the Korean stock market. Concluding remarks are given in Section 5.

2. Background review for EWGII

GII is becoming more influential at the Asian local markets. Stock holdings by GII have reached 18.8% in Japan, 20% in Taiwan, and 43.5% in Korea. Especially in the Korean stock market exchange (KSE), GII have increased their stock holdings from 11.9% in 1995 to 43.5% in 2004, which means KSE is extremely overweighed by GII. Therefore, there is always a calculated risk at the local market that GII may destabilize the market easily by dumping their stock holdings massively when severe shocks hit the market.
3. EWSGII algorithm description

Building EWSGII based on forecasting consists of two phases. The first phase is to construct the oracle classifier and the second phase to construct the trained classifier (or EWSGII in a narrow sense). The oracle classifier is needed since trained classifier is designed to predict (or trace) the future market condition predetermined by the oracle classifier. For building the oracle classifier, we assume that GII react to external or internal stimulus over a period of time with a contingency plan and TP as the period at which GII turns from net long position (or buying trend) to net short position (selling trend) to initiate the contingency plan. Assuming these, SP, TP and CP are defined in terms of the quarterly, monthly, and daily net sale of GII. Let the above four variables \( O_{X_1}, O_{X_2}, \ldots, O_{X_4} \) be the oracle predictor variables and \( O_y \) the oracle response assuming values 1, 2, 3 which corresponds to SP, TP, CP respectively. At the given time \( t \) oracle classifier

\[ O_f : O_X \rightarrow O_Y \] (1)

which maps \( O_{X_t} = (O_{X_{1t}}, O_{X_{2t}}, \ldots, O_{X_{6t}}) \in X \) to its classification label \( O_{Y_t} \).

Note that \( O_{X_1}, O_{X_2}, \ldots, O_{X_4} \) are known to reflect selling trend with a contingency plan fairly well. In fact these quantities are being monitored by Financial Supervisory Service in Korea which has its own rule of thumb in using the quantities for detecting the abnormal massive selling of GII. One may refer to the expert’s opinion in establishing valid oracle rule. Refer to Section 4 and Table 1.

3.2. Phase 2: lag \( l \) classifier (EWSGII) construction

Once the oracle classifier is assigned successfully, one may start to build the lag \( l \) classifier (or trained classifier for forecasting) as follows. Suppose that its selected predictor variables are \( X_1, X_2, \ldots, X_6 \) and lag \( l \) response is \( Y \). For positive integer \( l \), the training data set is given by

\[ (X_{11}, \ldots, X_{p1}, Y_{1,1}), (X_{12}, \ldots, X_{p2}, Y_{2,1}), \ldots, (X_{1n}, \ldots, X_{pn}, Y_{n,1}) \] (2)

Table 1
Oracle classification rules for CP, TP, and SP

<table>
<thead>
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<th>Classification rule</th>
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<td>( O_f(1) )</td>
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| If Quarterly net sale more than 2.4  
( or) monthly net sale more than 1.6  
( or) weekly net sale more than 0.8  
( or) daily net sale more than 0.4,  
Then \( O_{Y_t} = 3 \) (CP)  
Else If Quarterly net sale more than 1.2  
( or) monthly net sale more than 0.8  
( or) weekly net sale more than 0.4  
( or) daily net sale more than 0.15,  
Then \( O_{Y_t} = 2 \) (TP)  
Else \( O_{Y_t} = 1 \) (SP) |
| \( O_f(2) \) |
| If Quarterly net sale more than 3.0  
( or) monthly net sale more than 2.0  
( or) weekly net sale more than 1.0  
( or) daily net sale more than 0.5,  
Then \( O_{Y_t} = 3 \) (CP)  
Else If Quarterly net sale more than 1.5  
( or) monthly net sale more than 1.0  
( or) weekly net sale more than 0.5  
( or) daily net sale more than 0.2,  
Then \( O_{Y_t} = 2 \) (TP)  
Else \( O_{Y_t} = 1 \) (SP) |
| \( O_f(3) \) |
| If Quarterly net sale more than 4.0  
( or) monthly net sale more than 3.0  
( or) weekly net sale more than 1.5  
( or) daily net sale more than 0.7,  
Then \( O_{Y_t} = 3 \) (CP)  
Else If Quarterly net sale more than 2.0  
( or) monthly net sale more than 1.5  
( or) weekly net sale more than 0.8  
( or) daily net sale more than 0.4,  
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Unit: 1 billion won.

GII are well known for their herding behavior and positive feedback trading (Nofsinger & Sias, 1999). Several studies have explained this by way of examples during the 1997 financial crisis in Asia. Kim and Wei (1999) claim that the 1997 crisis should be attributed to emotional panic reaction and herding behavior of GII rather than economic vulnerability of those countries. Radelet and Sachs (1998), Kim and Wei (1999), Choe et al. (1999) noticed that the sudden pullout of GII accelerated the crisis by causing a financial chaos and policy failure during the 1997 financial crisis in the Korean financial market. As a recent study, Ghysels and Seon (2004c) and Oh et al. (2006) introduce the gray zone which is characterized by abrupt reversals of market sentiments or sudden change of market volatility. What makes the gray zone uniquely important for their EWS is that it is regarded as a transition period (SP), transition period (CP or the gray zone by Kim et al. (2004c)) and crisis period (CP) exclusively. For building \( O_f \) we assume CP as the period during which GII sell enormous stocks with a contingency plan and TP as the period at which GII turns from net long position (or buying trend) to net short position (selling trend) to initiate the contingency plan. Assuming these, SP, TP and CP are defined in terms of the quarterly, monthly, weekly, and daily net sale of GII. Let the above four variables \( O_{X_1}, O_{X_2}, \ldots, O_{X_4} \) be the oracle predictor variables and \( O_y \) the oracle response assuming values 1, 2, 3 which corresponds to SP, TP, CP respectively. At the given time \( t \) oracle classifier

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| If Quarterly net sale more than 4.0  
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( or) daily net sale more than 0.7,  
Then \( O_{Y_t} = 3 \) (CP)  
Else If Quarterly net sale more than 2.0  
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( or) weekly net sale more than 0.8  
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Then \( O_{Y_t} = 2 \) (TP)  
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Unit: 1 billion won.
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