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Foreign versus domestic institutional investors in emerging markets: Who contributes more to firm-specific information flow?

Jeong-Bon Kim, Cheong H. Yi *

Department of Accountancy, City University of Hong Kong, Hong Kong

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ABSTRACT

Using a large sample of firms listed on the Korea Stock Exchange over 1998–2007, this study investigates whether and how trading by foreign and domestic institutional investors improves the extent to which firm-specific information is incorporated into stock prices, captured by stock price synchronicity. We find, first, that stock price synchronicity decreases significantly with the intensity of trading by foreign investors and domestic institutional investors. Second, trading by foreign investors facilitates the incorporation of firm-specific information into stock prices to a greater extent than trading by aggregate domestic institutions. Third, among domestic institutions with differing investment horizons, short-term investing institutions, such as securities and investment trust companies, play a more important role in incorporating firm-specific information into stock prices via their trading activities, compared with long-term investing institutions, such as banks and insurance companies. Finally, we provide evidence suggesting that trading by foreign and domestic short-term institutions reduces the extent of accrual mispricing. Our results are robust to a variety of sensitivity checks.

1. Introduction

The past 25 years have witnessed a growing trend in which many emerging countries have liberalized their stock markets, allowing foreign investors to invest directly in the equity securities of local firms. Foreign access

* Corresponding author. Tel.: +852 3442 8043; fax: +852 3442 0347.
E-mail address: cheongyi@cityu.edu.hk (C.H. Yi).

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to domestic equity markets has raised a number of interesting questions related to foreign investors' portfolio choice and performance. An important stream of research in the "home bias" literature investigates firm-specific factors that influence shareholdings by foreign investors. Although barriers to international investment in emerging markets have significantly reduced since market liberalizations, foreign investors may still face indirect barriers (Karolyi and Stulz, 2003). The home bias literature typically posits the information disadvantage of foreign investors, which influences their asset holdings and performance. For example, Kang and Stulz (1997) and Dahlquist and Robertsson (2001), using Japanese and Swedish data, respectively, find that foreign investors hold disproportionately more shares of large firms and firms with greater recognition or visibility in international markets. Bradshaw et al. (2004) find that U.S. investors prefer foreign firms that exhibit higher levels of conformity with U.S. Generally Accepted Accounting Principles. Covrig et al. (2006) find that foreign managers of mutual funds tend to overweight stocks that are globally well known, while domestic managers prefer stocks with large dividend payouts, low financial distress and high growth potential. Similarly, Leuz et al. (2009) provide evidence that U.S. investors are reluctant to invest in foreign firms with aggressive earnings management, especially those from countries with poor disclosure regimes. Overall, these studies suggest that foreigners prefer to invest in stocks with less information uncertainty to overcome their information disadvantages.

Another stream of research focuses on the investment performance of foreign investors vis-à-vis domestic investors and provides mixed evidence. For example, Shukla and Inwegen (1995), Brennan and Cao (1997) and Hau (2001) find evidence that local investors outperform foreign investors. In contrast, Seasholes (2004), Grinblatt and Keloharju (2000), Karolyi (2002) and Froot and Ramadorai (2008) provide evidence suggesting that foreign investors are more informed and outperform their domestic counterparts. In reconciling the mixed evidence on investor performance, Albuquerque et al. (2009) show the presence of global private information that gives an information advantage to international investors who are not as informed as local investors about local private information.

Since the aforementioned studies focus mainly on foreign investors' asset holdings and investment performance, little is known about the role of foreign and domestic institutional investors in influencing the information environment, particularly in emerging markets with less developed institutional infrastructures. To fill this gap, our study aims to provide systematic evidence on the following under-researched questions:

(1) Does trading by foreign and domestic institutional investors improve the flow of firm-specific information to the market?
(2) Do foreign investors play a more significant role in enhancing firm-specific information flow via their trading than domestic institutional investors?
(3) Does the informational role of domestic institutions differ according to their investment horizons?

To address these questions, we first investigate whether the trading of a firm's shares by foreign and local institutional investors improves firm-specific information flow to the market, particularly the extent to which firm-specific information is incorporated into stock prices relative to common (market-wide and/or industry-wide) information. In so doing, we measure the relative amount of firm-specific versus common information incorporated into stock prices, using stock price synchronicity, or co-movement. Lower stock price synchronicity means that stock prices covary with firm-specific factors to a greater extent than with common factors, leading to less synchronous or more informative stock prices (Durnev et al., 2003; Jin and Myers, 2006). To the extent that institutional investors, whether foreign or local, actively collect, process and trade on firm-specific information, we expect that their trading activities facilitate the incorporation of firm-specific information into stock prices, thereby reducing synchronicity.

Second, we examine whether and how foreign investors differ from domestic institutional investors in their roles of influencing the flow of firm-specific information to the market. Given that foreign investors in emerging markets are typically more sophisticated and have an information advantage of global information, it is interesting to examine whether or not our results on the informational effect of trading by foreign investors are driven by the fact that foreign investors are institutional investors. We evaluate this unexplored question by comparing the informational role of foreign trading with that of domestic institutional trading, using the latter as a benchmark.