Investor sentiment and country exchange traded funds: Does economic freedom matter?

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ARTICLE INFO

Article history:
Received 1 May 2017
Received in revised form 24 July 2017
Accepted 27 July 2017

JEL Classification:
G15
G38
F36

Keywords:
Exchange traded fund (ETF)
Economic freedom
Investor sentiment
Quantile regression

ABSTRACT

Using unbalanced panel data of 27 iShares MSCI country-specific exchange traded funds (ETFs) over the period 1996–2014, this paper applies quantile regression to examine the impacts of global, foreign, and U.S. investor sentiments on the returns of the ETFs traded in the U.S. markets. We further investigate whether a country’s economic freedom affects the relationship between investor sentiments and ETF returns. We find that ETF returns are strongly determined by investor sentiments and the ETF expense ratio. The quantile regression approach reveals that high-return ETFs are positively sensitive to changes in global sentiment (measured by market turnover, VIX, U.S. federal funds rate), foreign sentiment (measured by current account balance, inflation, market turnover, public debt), U.S. sentiment, currency exchange ratio, and expense ratio, while negatively influenced by economic freedom and Asian proxy. The effects of VIX and foreign inflation are a reversal; that is, returns from lower (higher) quantiles have a negative (positive) relation with VIX and foreign inflation. Not all components of economic freedom affect returns equally.

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1. Introduction

Exchange traded funds (ETFs) are one of the most popular and fastest-growing classes of financial assets available in today’s markets. Having grown significantly in popularity, single-country ETFs traded in the U.S. include ETFs of assets in many foreign countries, because they allow investors to diversify their portfolios via a basket of foreign country assets that are traded in U.S. markets and are denominated in U.S. dollars. Investors searching for diversified investments can purchase foreign country ETFs without worrying about trading in local currencies through overnight markets and holding undiversified positions in international stocks.

In an increasing complex economy, no task is more important than allocating capital to the right projects (Boaz, 1997). Empirical studies present evidence that investor sentiment affects equity returns (Baker & Wurgler, 2006; Brown & Cliff, 2005). The majority of the related literature addressing cross-border impacts of sentiment typically focuses on the returns of depositary receipts (DRs) by examining their impact on individual stocks, while neglecting the situation when investors diversify their portfolios internationally. Mainly, they would like to build a diversified index portfolio rather than investing...
only in individual DRs (Rosenberg, Weintraub, & Hyman, 2008). In addition to foreign countries’ and a traded country’s investor sentiments, Baker, Wurgler, and Yuan (2012) reveal that global sentiment is also an imperative predictor of country-level returns. Thus far, there are few studies that have delved into the relationships between cross-border ETFs’ returns as well as investor sentiments emerging from the world, traded countries, or home countries.

As for home country-specific factors that sway the impact of investor sentiment on cross-border equity returns, Schmeling (2009) shows that the impact of a home country’s sentiment on returns is higher for countries with less market integrity and those that are culturally prone to be overreacting. However, Johnson (2009) finds that home country factors cannot explain the tracking errors of ETFs.¹ Thus, the impact of foreign country-specific factors on the link between investor sentiment and cross-border returns is still inconclusive.

In an environment in which economic freedom varies across countries, investors in global equity markets continually labor over identifying attractive investment opportunities (Stockler, 2005). Businesses seek economic freedom so as to increase their involvement in the economy and facilitate international exchange, both inbound and outbound (Akhter, 2004). Empirical studies have widely observed that economic freedom is important to economic performance (De Haan & Sturm, 2000; Gwartney, Lawson, & Holcombe, 1999). Furthermore, economic freedom has been investigated in equity return analyses, such as country equity returns (Stockler, 2005) and the stability of American depositary receipt (ADR) prices (Blau, Brough, & Thomas, 2014). Until now, few studies focus on the association between economic freedom and cross-border country index returns. While economic and financial research studies confirm that a country’s economic freedom and investment sentiment can affect equity returns, they do not explore the impact of a foreign country’s economic freedom on the relationship between investor sentiment and cross-border equity returns.

The reason why we use ETFs to proxy country index returns is that ETFs allow individual investors to have access to invest in international stock markets for asset allocations (Tse, 2015), implying ETF return patterns close to the viewpoints from individual investors. The most relevant studies of ETFs to this present work are the following. Chau, Deesomsak, and Lau (2011) examine whether investor sentiment influences the level of feedback trading in ETFs. Johnson (2009) explains the existence of tracking errors between foreign country ETFs and the underlying home index due to the influence of a foreign country’s financial integration (proxy by economic freedom). Blau et al. (2014) study the link between economic freedom and the price stability of ADRs.

The theoretical impact of economic freedom on investor sentiment and cross-border ETF returns, as implied by the general equilibrium theory, is that economic freedom improves economic efficiency with respect to resource allocation. Stockler (2005) shows that larger increases in economic freedom are associated with higher equity returns, implying that for investors seeking superior investment returns, countries that are likely experiencing increasing economic freedom should be selected as good investment targets. On the contrary, Smimou and Karabegovic (2010) indicate that a high level of economic freedom provides countries with a higher degree of financial integration with outside capital markets. There are no impediments to financial flows under financial integration, and thus capital movements will fully and immediately arbitrage away any difference in marginal returns to capital (Gourinchas & Jeanne, 2006). Therefore, the association among a foreign country’s economic freedom, (foreign, U.S., and global) investor sentiments, and cross-border ETF returns is still an enigma.

Conventional techniques (i.e., OLS) employing conditional means of the variables do not take full account of the heterogeneity of a sample of ETFs. Thus, Luo and Li (2008) examine the heterogeneous effect of investor psychology on conditional institutional trading behavior by applying a quantile regression. This present study evaluates the impacts of investor sentiments on country-specific ETF returns, as well as the impacts of economic freedom on the link between ETF returns and (U.S., foreign, and global) investor sentiments across various locations of ETF return distributions through a quantile regression (QR hereafter), along with a comparison of the results with OLS estimates.²

Using an unbalanced panel of monthly data for 27 single-country ETFs from the second month following an ETF’s inception to 2014/12/31 and employing a QR approach, we find that the significant determinants of ETF returns are quite different for the ETFs across various quantiles. Conditioned on lower ETF returns, the currency exchange rate and global sentiment (proxied by U.S. federal funds rate and market turnover) increase returns, but global risk aversion (volatility index, VIX) and foreign inflation seem to alleviate them. The significant determinants that increase (decrease) ETF returns in higher return quantiles include global market turnover, U.S. federal funds rate, VIX, foreign current account balance, inflation, U.S. sentiment, currency exchange rate, and expense ratio (foreign GDP, economic freedom, and Asia dummy). As the components of economic freedom, the associations of property rights, monetary freedom, freedom from corruption, investment freedom, and business freedom with ETF returns are salient. The findings are generally robust when altering the degree of economic freedom as well as altering country dummies or area dummies.

The paper proceeds as follows. Section 2 provides the literature review. Section 3 presents the data and variables. Section 4 discusses the model and methodology. The results and the discussion of our findings are in Section 5. Section 6 concludes.


² According to Li (2009), the quantile is a statistical term describing a division of observations into certain defined intervals based upon the values of the data. The return quantile of a specific ETF could show the relative magnitude of the returns of this specific ETF in comparison with the entire set of ETF observations.
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