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The impact of the Arab Spring and the Ebola outbreak on African equity mutual fund investor decisions

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ABSTRACT

Financial development and stock markets have been widely considered to be key factors in economic growth. Among institutional investors, mutual funds play a key role in providing financial resources to stock markets, particularly in developing countries. Different from other investments, mutual fund flows could be affected by retail investors' behavior and their overreaction to specific events. We considered 78 equity mutual funds that are geographically specialized in African countries and observed monthly flows and performance for the period of 2006–2015. We find that two major events, Ebola and the Arab Spring, significantly affected the fund flows, controlling for fund performance, expenses and market returns. Retail investors overreacted to these major events, withdrawing their savings from the African mutual funds. This result is particularly strong when connected to the media coverage of these events: the higher the number of articles about Arab Spring and Ebola, the higher the withdrawals. These irrational investors' behavior damaged the funds' managers market timing ability, and reduced the equity capital injection into African stock markets. Our results have several implications for both holders of frontier market mutual funds and the overall asset management industry.

Introduction

The effects of financial development on economic growth have been widely investigated in the literature since the last century, but only a few studies have focused on emerging and frontier countries (Kar et al., 2011 ; Samargandi et al., 2015). The authors have identified stock market development as a key variable in attracting private capital investment and promoting economic growth (Levine and Zervos, 1993, 1998; Rousseau and Wachtel, 2000; Beck and Levine, 2003, among others). Hence, the importance of institutional investors and mutual funds is to feed financial markets with private capital flows to support firm development, particularly in emerging and developing countries. In fact, in recent years, retail and institutional investors have witnessed notable growth in a specific sector of the asset management industry, involving emerging market equity mutual funds. With only a handful of emerging market funds at the beginning of the 1990s (Kaminsky et al., 2001), there are currently hundreds of funds investing in specific emerging market countries or areas. Such a development is related to the impressive rise of total private non-resident capital flows from $25 billion in 1990 to an all-time high of $1.35 trillion in 2013, before falling to under $1.1 trillion in 2014 (Institute of International Finance, 2015).

We are now seeing the same interest in African financial markets. Although later than in other emerging markets, during the last decade, private capital flows to African countries have grown substantially (Bokpin, 2017). Before the 2000s, the development of the

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Africa region was in an early stage, primarily because of political instability. This condition prevented capital flows from flooding into the continent, just in the period when there was great interest in other emerging market areas (Asia Pacific and Latin America, etc.). However, from the 2000s onward, African countries received growing interest from foreign institutional investors before the onset of the subprime financial crisis caused these flows to retreat (IMF, 2014; Sugimoto et al., 2014). Then, in 2010, the recovery of financial markets coupled with unprecedented monetary policies led to another significant spike in private capital flows to sub-Saharan African countries, in particular. According to the IMF (2014), during the period 2010–2012, those inflows doubled from the period 2000–07, and they had a five-fold increase if we focus on Sub-Saharan frontier markets. Then, portfolio flows to African markets experienced a significant retracement due to several factors, including geopolitical tensions and Ebola. Those exogenous shocks could have pushed investors to withdraw liquidity from African mutual funds, causing a collapse in portfolios' flows to emerging and frontier countries.

Based on a sample of 4368 monthly observations of 78 African Equity mutual funds for the period of 2006–2015, the objective of this paper is to assess the impact of Ebola and the Arab Spring on African mutual fund flows and performance.

Our paper is related to the extensive literature on financial markets anomalies and especially investors' over-reactions (De Bondt and Thaler, 1985). Using past returns, they predict price reversals in the case of a huge overshoot, providing evidence of the directional effect of Brown and Harlow, 1988 ("*large stock price movements will be followed by price reversals in the opposite direction*"). This is one of the first studies that fights the weak form of market efficiency theory (Malkiel and Fama, 1970), as all investors can obtain abnormal returns taking advantage of long-term mispricing, in particular the negative serial correlation. Since then, several papers have investigated over-reaction to a specific event in developed markets, focusing especially on abnormal stock returns (Seyhun, 1990; Larson and Madura, 2003; Edmans et al., 2007).

However, to the best of our knowledge, only one paper examines over-reaction to specific events in emerging market economies (Boubaker et al., 2015). Using data from the Egyptian stock exchange (EGX) over the period of 2003–2009, the authors investigate short-term over-reaction to four major events, i.e., terrorist attacks, tensions in the Middle East region, the formation of new governments, and the announcement of the privatization of state-owned enterprises (SOEs). They provide evidence of short-term over-reaction and the leakage of information in the EGX, showing that the negative and significant abnormal returns post-event in both terrorist attacks and tensions in the Middle East region are followed by strong price reversal.

Through a sample of 78 African mutual funds, we contribute to the literature investigating the over-reaction to specific major events, namely Ebola and the Arab Spring. Differently from Boubaker et al. (2015), we decided to analyze the impact on African stock markets rather than a single stock index, as Ebola and the Arab Spring affect more than one country. Then, we focus both on the performance and the flows of the equity mutual funds to the African stock markets. Mutual funds are the favorite investment vehicle of retail investors. The literature has widely reported that retail investors in developed markets do not behave rationally (Barberis et al., 2001; Barberis and Thaler, 2003; Subrahmanyam, 2007 among others). Also in this case, only a few papers focus on emerging markets, especially on specific countries such as Turkey (Tekce and Yilmaz, 2015; Tekce et al., 2016). In particular, Tekce et al. (2016), analyzing Istanbul Stock Exchange transactions, found that behavioral biases are common among Turkish retail investors. to the best of our knowledge, no study has examined the impact of specific major events on a large sample of mutual funds covering different emerging and frontier countries in Africa.

Our main hypothesis is that retail investors in African funds have been influenced by the huge media coverage of these events, which were (and still are) related to a portion of the entire continent. It is well known in the literature that media coverage of major events could influence investors' behavior (Engelberg and Parsons, 2011). Moreover, according to Tversky and Kahneman (1971), people make erroneous judgments about the probability of an event under uncertainty. This is a particular type of bias that the authors call representativeness heuristic, happening when people, in general, use a rule of thumb strategy to solve a specific problem or during the process of decision making. That is why we suppose that retail investors, affected by representativeness heuristic, generalize major events such as Arab Spring and Ebola that affect just a part of Africa to the whole continent. We find that both Ebola and the Arab Spring have had a negative and statistically significant impact on monthly net flows, as expected. This result is particularly strong when connected to the media coverage of these events: the higher the number of articles about Arab Spring and Ebola, the higher the withdrawals. These exogenous shocks have caused investors over-reaction, affecting asset managers' market timing. They also have reduced financial resources that, through the capital flows, could have easily fed financial markets and supported firm development, eventually promoting economic growth.

These results confirm retail investors' biases mainly for the Ebola shock, considering that in 2014, Ebola actually affected a geographical area of less than 10 million people (World Health Organization, 2015), representing 5% of the entire continent's GDP (World Bank, 2014). The overall African continent's reputation as an investment opportunity area was damaged by the Ebola outbreak more than the political instability due to the Arab Spring insurgency in North Africa. Our results clearly show that such a confined exogenous shock has reduced liquidity to all African mutual funds industries, although they are able to obtain good performance. As described above, the diminishing of mutual funds' capital flows could severely affect economic growth.

From the policy implication standpoint, we can argue that the media coverage of such events plays a critical role in influencing investors' behavior. Excessively alarmist news could have induced retail investors to withdraw their savings from African mutual funds, thus reducing financial resources to the entire continent.

Literature review and hypothesis development

The first author analyzing the effects of financial development on economic growth and providing a theoretical framework for our work was Shumpeter (1934), followed by McKinnon (1973), while more recent empirical studies have shown a strong correlation