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National culture, information environment, and sensitivity of investment to stock prices: Evidence from emerging markets

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ABSTRACT

This paper uses the data from 37 emerging markets and shows that national cultures play important role in determining sensitivity of investment to stock prices during the period between 2008 and 2014. We show that investments of firms headquartered in cultures with high power distance, high individualism, and high pragmatism (high uncertainty avoidance, high masculinity, and high indulgence) are significantly less (more) sensitive to their stock prices than that of firms headquartered in their counterpart cultures.

1. Introduction

Does culture effect sensitivity of investment to stock prices? This paper seeks to answer this question by arguing that culture exerts its effect on sensitivity of investment to stock prices by affecting informtiveness of stock prices. Anecdotal evidence suggests that culture affects informtiveness of stock prices via couple of channels. For instance, cultural characteristics can affect the information transmission capacity of stock prices by making them less informative. Zarzeski (1996) argues that cultures with high power distance are not conducive to information disclosure. Stock prices are, therefore, relatively less informative in these cultures. We argue that, in these cultures, stock prices may not be able to convey much information to managers. As a result, sensitivity of investment to stock prices is weaker in these cultures. Furthermore, cultures can introduce certain behavioral biases in stock market agents. These biases may result in stock prices that are far from fundamental values. Markus and Kitayama (1991) and Heine et al. (1999) note that individualistic cultures are characterized by overconfidence and self-attribution bias. They argue that these biases result in stock prices that are less efficient and have excess volatility. We argue that stock prices in these cultures may also not be able to convey much information to managers. Consequently, sensitivity of investment to stock prices may is low in these cultures.

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Our arguments are consistent with prior literature that argues that sensitivity of investment to stock prices is an increasing function of informativeness of stock prices. Chen et al. (2007) show that sensitivity of corporate investment to stock price increases as the amount of information in stock prices increase. In another related study, Foucault and Frésard (2012) also come to same conclusion by showing that investment sensitivity to stock prices is an increasing function of informativeness of stock prices. They argue that sensitivity of investment to stock prices increase because value-maximizing managers are forced to use all available information to forecast cash flows of their capital allocation decisions. Their forecasts depend not only on their own private information but also on information revealed via stock prices. They argue that informative stock prices reflect private information of informed investors and reveal information that is new to value maximizing managers. Consequently, managers are forced to incorporate this information in their analysis, thereby increasing sensitivity of investment to informative stock prices.

Consistent with above arguments, we show that sensitivity of investment to stock prices depends on the cultural environment of the country. Using data from 37 emerging markets, we show that cultural factors – power distance, uncertainty avoidance, individualism, masculinity, pragmatism, and indulgence – affect sensitivity of investment to stock prices during the period between 2008 and 2014. More specifically, our results show that cultures with high scores on power distance have weaker sensitivity of investment to stock prices. Our result is consistent with cultures with high power distance are likely to have businesses that discourage information sharing (Zarzeski, 1996). Consequently, financial disclosure may be inadequate, thereby resulting in less informative stock prices. Lower informativeness of stock prices may induce managers from cultures with high power distance to place less importance on information revealed via stock prices, thereby decreasing the sensitivity of investment to stock prices. Our results are also in line with Mihet (2013) who argue that cultures with high power distance have weaker rule-of-law. Therefore, institutional and governance environment is also weak in these cultures. As a result, it is possible that managerial decision making is less prudent, thereby resulting in neglecting information revealed via stock prices and causing low sensitivity of investment to stock prices.

We also show that cultures with high uncertainty avoidance have stronger sensitivity of investment to stock prices. Prior literature argues that managers in cultures with high uncertainty avoidance have relatively lower preferences for information asymmetries (Beugelsdijk and Frijns, 2010; Huang, 2008). In these cultures, people try to minimize the possibility of uncertainty by safety and security measures. We argue that one way to minimize uncertainty is by incorporating as much information as possible in investment decisions. Given that stock prices contain information that is unknown to managers, managers from cultures with high uncertainty avoidance may use stock prices more for investment decisions than managers from cultures with less uncertainty avoidance. As a result, we observe higher sensitivity of investment to stock prices in cultures with high uncertainty avoidance.

Moreover, this paper also shows that cultures with high individualism have weaker sensitivity of investment to stock prices. We argue that managers in individualistic cultures overestimate their abilities (Markus and Kitayama, 1991; Heine et al., 1999). Managers from these cultures are more likely to be characterized by overconfidence and self-attribution bias (Markus and Kitayama, 1991; Kagitcibasi, 1997). Beckmann et al. (2008) argue that overconfidence associated with individualistic cultures lead investors to analyze information on their own and be less concerned about opinions of the others. As a result, managers from individualistic cultures are less likely to use information revealed via stock prices in their investment decisions, thereby decreasing the sensitivity of investment to stock prices. Daniel et al. (1998) also show that overconfidence leads investors to overweight the precision of their private signals, and self-attribution bias causes them to underweight public signals.

We also report higher sensitivity of investment to stock prices in cultures with high masculinity and high indulgence. Consistent with Chang et al. (2012), we argue that managers from masculine cultures are eager to show their superior ability and performance to shareholders and investors. To show better performance and to get recognition, these managers tend to incorporate various dimensions of information in their investment decisions, thereby strengthening the sensitivity of investment to stock prices. Similarly, we argue that managers from cultures with high indulgence place more importance on freedom of speech and personal control (Hofstede et al., 2010). They are more likely to voice opinions and give feedback. Therefore, they are they are expected to be more transparent (Once and Almagtome, 2015). We argue that higher transparency associated with indulgent cultures translate into more informative stock prices, thereby strengthening the sensitivity of investment to stock prices. Lastly, we show lower sensitivity of investment to stock prices in cultures with high pragmatism. We argue that pragmatic culture has bank-based systems (Chang et al., 2012). Given that stock markets are less developed in bank-based systems, the stock prices are supposed to reflect less valuable information in these cultures. As a result, there should be lower sensitivity of investment to stock prices in pragmatic cultures.

The remainder of paper is structured as follows: Section 2 summarizes the data and Section 3 documents the effect of culture on sensitivity of investment to stock prices. The paper ends with Section 4 where we present our conclusions.

2. Data

This paper documents the effect of national cultures on the sensitivity of investment to stock prices in emerging markets during the period between 2008 and 2014. For the purpose of this study, our sample consists of non-financial firms listed in Argentina, Bangladesh, Brazil, Bulgaria, Chile, China, Colombia, Czech Republic, Egypt, Ghana, Greece, Hungary, India, Indonesia, Israel, Jordan, Kuwait, Malaysia, Mexico, Morocco, Nigeria, Pakistan, Peru, Philippines, Poland, Romania, Russia,