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Biases in international portfolio allocation and investor protection standards

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ABSTRACT

Economic reasoning suggests that financial globalization that encourages optimal international portfolio investments should improve investor protection standards (IPS) of a country. In practice, however, investors manifest varying degrees of suboptimal international portfolio allocations. Using a panel dataset covering 44 countries spanning over 15 years we examine whether suboptimal equity portfolio allocation in part is associated with the cross-country variations in IPS. Consistent with economic reasoning we find robust indications that international portfolio allocation may play an important role in the development of IPS. More specifically, the quality of IPS improves with higher degrees of optimal international equity portfolio allocation of domestic and foreign investors.

1. Introduction

Economic conjecture notes that financial globalization affects the factor productivity of a country by promoting better corporate governance and signalling a higher quality of state governance (Henry, 2000).[1] Pursuing financial globalization, i.e. encouraging optimal international portfolio allocations that integrates local with world capital markets may thus have a lasting effect on the improvement of investor protection standards (IPS).[2] With respect to what should be the optimal portfolio allocations, finance theory suggests that investors should hold the world market portfolio to optimise their expected utilities (see Chan, Covrig, & Ng, 2005). However, studies note that both domestic and foreign investors substantially deviate from holding optimal international portfolios (see, for example, Lau, Ng, & Zhang, 2010). Such deviations are referred to as home and foreign biases in international portfolio allocations. Home bias refers to the phenomenon in which domestic investors over-invest in the home market relative to the theoretical conjecture, thus leaving a significantly lower share of the country's investable assets to foreign investors. On the other hand, foreign bias indicates that foreign investors tend to either over or underweight foreign markets relative to implied benchmarks (see Cooper, Sercu, & Vanpée, 2015 for an excellent review). While substantial evidence exists on why home and foreign biases exist, much less is known about the implications of such biases. In this study we investigate whether the puzzle of home and foreign bias carries any consequences for the differing states of IPS observed across the world.

Empirical evidence concludes that the prevalence of home and foreign biases explains the degree of international integration/segmentation of the domestic equity markets vis-à-vis the world capital markets (see Janakiramanan, 1986; Lau et al., 2010). This suggests that higher home bias reflects a lower degree of financial globalization, while higher foreign bias implies a higher degree of financial globalization (see Lau et al., 2010 for a theoretical analysis). Consequently, greater home bias implies a relatively closed and less integrated economy with a lower presence of foreign investors. Alternatively, in a relatively open and financially integrated market economy, higher foreign bias signifies a greater presence of foreign investors. Since varying degrees of home and foreign biases reflect varying depths of foreign portfolio investments, studies document several channels through which foreign investors may influence corporate and state governance practices.

With respect to corporate governance Kang and Kim (2010) note that foreign investors particularly institutional investors play an

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[1] As argued by La Porta et al. (1997) it is axiomatic that standards of investor protection regulations and practices are pivotal for the welfare of corporates and countries.

[2] Bonaglia, Macedo, and Bussolo (2001) also argue that allowing optimal foreign portfolio investments should improve the quality of IPS.

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influential role in domestic governance practices by employing various governance tactics. Such disciplinary methods may take the form of hostile takeover threats, proxy contests, expressing opposition to or attempting to amend anti-takeover provisions,[3] initiating efforts to seek representation on the target boards, threatening the replacement of top executives and demanding asset downsizing. Likewise, Boubakri, Cosset, and Guedhami (2005) note that foreign ownership could lead to improvements in the post-privatization performance of newly privatized firms because foreign investors normally demand high information disclosure standards, inject funds into newly privatized firms and, for the sake of their reputation, maintain stern control of managers' action. Kho, Stulz, and Warnock's (2009) theoretical framework argues that foreign investors, particularly those from countries with better investor protection institutions, become valuable inside monitors as the laws of their home countries restrict their ability to consume private benefits made by other insiders. On the empirical front, using data on China's split-share structure reform, Huang and Zhu (2015) show that involving foreign institutional investors in corporate governance practices can significantly lower the possibility of expropriation by the controlling shareholders in emerging markets.

With reference to the standard of state governance, economists remark that competition for foreign financial resources compels policymakers to reform the state and corporate governance practices[4] (see Errunza, 2001). With respect to state governance, Stulz (2005) argues that financial globalization makes it difficult for the state itself to expropriate investors as it risks losing the much needed foreign investments if it does not heed the demands of foreign investors.[5] Similar sentiments are echoed by Rajan and Zingales (2003) who conjecture that competition for financial resources becomes stronger when foreign investors become involved in the domestic economy. As a result, the growing interest of foreign investors drives reform[6] in the domestic investor protection regulations (see Rajan & Zingales, 2000). For example, responding to foreign investors' pressure, domestic regulatory bodies signal their intention to improve the quality of governance through the adoption of international accounting standards. Errunza (2001) also posits that with their increasing interest, foreign investors demand the formulation and observance of regulations, which compels corporates to disseminate timely and relevant information to the investor fraternity. Using data from emerging markets, Huang and Zhu (2015) show that the flow of foreign institutional investors help promote the market-based principle of corporate governance, thus reducing the “twin agency” problem associated with state ruler's discretion.

The above discussion convincingly underlines the importance of foreign investments for the development of corporate and state governance. Since a higher level of home (foreign) bias refers to a lower (greater) presence of foreign investors, in this study we hypothesize that a greater degree of home (foreign) bias should be related to a lower (higher) quality of IPS. As noted earlier, a vast body of literature is devoted to explaining the causes of home and foreign biases.[7] However, studies investigating the implications of home and foreign biases are highly limited. More importantly, to the best of our knowledge, there is no study that examines the implications of home and foreign biases on the quality of IPS. Using a sample of 44 countries over the period from 2001 to 2015 and running a series of robustness checks, including the use of a shock-based approach, our study reports the following two important findings.

First, the results suggest that suboptimal international portfolio allocations of domestic and foreign investors may play a critical role in improving the quality of IPS. Specifically, markets where investors observe a higher degree of home bias (i.e. lower presence of foreign investors) are associated with poor quality of corporate and state IPS. Similarly, relative to more closed markets (lower foreign bias), countries that allow/attract greater foreign portfolio investments (greater foreign bias) are related a higher level of IPS. These findings hold after carefully accounting for several other possible determinants of IPS and for the potential reverse causality arising from the possibility that improvement in investor protection may cause a higher presence of foreign investors. In summary, the results support the view that financial globalization that encourages optimal international portfolio investments may carry significant implications for the development of corporate and state IPS.

Second, consistent with the findings reported by Chan et al. (2005), our results show that the developed markets generally exhibit a lower level of home bias compared to emerging markets. We also find that most developed countries experience stronger positive foreign bias, i.e. these countries are preferred by international investors compared to the emerging markets. However, we further contribute to this strand of literature by providing new evidence of biases in the cross-country asset allocations made by sophisticated global fund managers who are ideally expected to achieve optimal global diversification. This evidence uncovers that the manifestation of investment biases is not only observed in the aggregate and macro data, which may include singly country or regional funds, but also in the investment behaviour of the most sophisticated global fund managers.

Our study adds to two different strands of literature. First, and as noted above, to the best of our knowledge, this is the first study to examine the effect of suboptimal international portfolio allocation on the quality of IPS. Our study is remotely related to Lau et al. (2010) who also demonstrate the implications of home and foreign biases. However, their focus is on the level of cost of capital, whereas our study examines the influence of home and foreign biases on the quality of IPS. Few studies that investigate the determinants of investor protection are focused on the role of economic openness, not on financial openness. For example, Islam and Montenegro (2002) demonstrate that trade openness is positively associated with institutional quality but they do not investigate the effect of financial openness. Similarly, Busse and Gröning (2009) also demonstrate the importance of trade liberalization on good governance practices but, again, do not account for financial openness.

Second, the results of our study also add to the growing debate which states that the impact of international diversification and consequent risk sharing benefits should not be limited to cost of capital and growth responses (Kose, Cardarelli, & Elekdag, 2010). Rather, the beneficial results should be examined through the influence of financial globalization on factor productivity, such as improvement of micro and macro institutional quality, including corporate and state governance.

The remaining structure of the paper is as follows. Section 2 describes the data. Section 3 presents and discusses the empirical results, and Section 4 concludes the paper.

[3] For example, in 2005 *The Children's Investment Fund* (*TCI*), a UK-based hedge fund which had a major share of the German Deutsche Börse forced the management to stop a takeover of the London Exchange which led to the resignation of both the chief executives (Economist, 2008).

[4] For example, in 2007 Japan implemented the *Financial Instruments and Exchange Law*, which amended or abolished many laws that regulated foreign securities firms and was intentionally based on the UK's Financial Services Authority's framework (report by Herbert Smith, 2008 on Contemporary issues facing financial services institutions in Asia, http://documents.lexology.com/cd07ed3a-b7d3-4b63-ab50-bcffa0e01dc1.pdf).

[5] TCI initiated legal action against the Indian government under the provisions of bilateral investment treaties between India and UK over the under-pricing of coal by Coal India Limited, in which TCI holds a 1% stake (see: http://www.business-standard.com/article/economy-policy/tci-starts-legal-action-against-indian-govt-under-uk-cyprus-treaties-112032900095_1.html).

[6] Demand from foreign investors may also lead to withdrawal/deferment of reforms. For example, in March 2012 India announced the imposition of controversial general anti-avoidance rules (GAAR) on transactions made by foreign investors, without much clarity, to be effective from 1 April 2012. Foreign portfolio investors demanded immediate reversal of the reform. After intense pressure from foreign institutional investors, India deferred the introduction of GAAR until April 2013 and after further negotiations it was postponed until 2016 (Source: Financial Times, 7 May 2012 and 3 September 2012).

[7] See Cooper et al. (2015) for an extensive survey on the causes of home and foreign biases.