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Foreign investors and corporate risk taking behavior in an emerging market

Xuan Vinh Vo

School of Banking, University of Economics Ho Chi Minh City, Vietnam
CFVG Ho Chi Minh City, Vietnam

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ABSTRACT

This paper investigates the impact of foreign ownership on the corporate risk taking activity at the firm level in Vietnam. Employing different techniques of panel data estimation, we find that foreign investors help to reduce the corporate risk taking activities. The result supports the notion that foreign investors in Vietnam stock market focus on long run perspectives rather than short term gain. This finding has implications in recognizing the importance of foreign investors in emerging markets.
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1. Introduction

The pioneering work of Shleifer & Vishny (1986), addresses the role of large shareholders in corporate control. This paper paves the way for a huge volume of work investigating the role of shareholders in corporate policies relating to investment, financing and other corporate decisions. Of particular topic is the relationship between foreign ownership and corporate risk taking behavior, which has been the subject of various studies. However, the literature provides mixed results.

Cronqvist & Fahlenbrach (2009), ascertain that large shareholders can influence firm policies directly through electing directors, voting on changes to the corporate structure or charter, or proxy contests and shareholders proposals. Moreover, large shareholders can indirectly influence corporate policies through informal negotiations and governance discussions with the incumbent management. The indirect channel is supported by the paper of Becht et al. (2010), which states that most of the influence of large shareholders on firms appear to be informal. Further, large shareholders normally make investment decisions in response to corporate policy changes. They might sell their stakes if the firm's policies are not in line with their investment mandate and invest in firms that adopt corporate policies that they prefer.

Our paper is motivated by the increasing participation of foreign investors investing in the Vietnamese stock market as a result of local government policy changes to attract further involvement of foreign investors in the market. A number of recent papers consider this issue in different perspectives (Batten & Vo 2015; Vo 2015, 2016). Moreover, like other types of investors, foreign investors are seeking higher returns for their investment. As higher returns are associated with higher level of risk, it is important to understand whether foreign investors force firm managers to take more risk for higher returns. Another motivation is the light volume of literature focusing on the context of emerging markets. More importantly, the

E-mail address: vxvinh@yahoo.com

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influence of foreign investors on corporate decisions in emerging markets is an interesting and meaningful topic on its own merit.

Our paper contributes to the literature in a number of perspectives. First, we add to the corporate finance literature by examining the relationship between foreign ownership and corporate risk taking. Second, we focus on the role of foreign ownership by highlighting an important mechanism which is the risk taking behavior. The importance of risk taking is well recognized in many papers (Nguyen 2012). Further, we contribute to the literature by addressing this issue in the context of an emerging market.

Understanding whether increased foreign ownership leads to higher corporate risk taking activities is a salient issue for different stakeholders. It is not only relevant to both the shareholders and the managers of the firms, but it is also relevant to policymakers and regulators in emerging markets. Vietnamese firms are under constant restructuring process and the influence of foreign shareholders in corporate decisions is of importance. More importantly, foreign ownership in listed firms is the central focus of the recent policy debates and stock market restructuring strategy in Vietnam.

The rest of the paper proceeds as follows. Section two reviews the literature. Section three introduces data and methodology. Section four presents the results and discussion of results. Section five concludes the paper.

2. Literature Review

In a recent paper, Boubakri et al. (2013), argue that foreign ownership can affects corporate risk taking in either direct channel or indirect channel. The former stems from a change in the organization's prevailing incentive structure accompanied by a change in the degree of risk aversion that characterizes the owners/managers and therefore affecting the corporate risk taking. The latter might stem from change in the investment/financing decision which leads to change in corporate risk taking. Similarly, Ben-Nasr et al. (2015), state that foreign ownership is positively related to earning quality. Chen et al. (forthcoming) also suggest that foreign ownership is positively and significantly explained investment efficiency.

It is reported in many papers that foreign investors tend to force firms to conduct restructuring for better efficiency once becoming large shareholders. This is even more profound in transitional economies where foreign investors are considered to have advanced techniques and skills in management and restructuring. Djankov & Murrell (2002) and Estrin et al. (2009), acknowledge that foreign investors lead firms to more restructuring after privatization. Moreover, restructuring by foreign investors is expected to increase volatility of income and hence, level of risk.

Many papers document a channel that foreign investors might affect corporate risk taking in local firms is through the improvement of corporate governance. For example, Gillan & Starks (2003) and Ferreira & Matos (2008), state that foreign investors tend to be more active than local investors in advocating better firm level corporate governance which might influence investment policy. Stulz (1999) and John et al. (2008), argue that increased foreign ownership in firms leads to improvement in firm corporate governance and hence managerial risk taking activities.

Moreover, many authors agree that foreign investors help to improve the firm value, which is a result of more risky investment strategies (Denis & McConnell 2003; John et al. 2008; Boubakri et al. 2013). In a similar vein, Cummins & Sommer (1996), argue that a higher degree of separation of ownership and management might be associated with lower firm risk. This paper finds that publicly traded firms have lower risk than closely held firms. This is because the rationale behind is that non-owner managers might be risk averse and thus hesitant to pursue risky investment while owners are desirable to higher risk to increase shareholder value (Cole et al. 2011).

A number of recent papers also state that in order to avoid information asymmetry, foreign investors tend to avoid poorly governed firms. A possible explanation for this phenomenon is because of managerial risk taking activities. However, Doidge et al. (2009) and Leuz et al. (2010), suggest that foreign investors should be associated with more managerial risk taking.

John et al. (2008), argue that in better corporate governance environment, stakeholders are less able to reduce corporate risk taking to pursue their self-interest. This is because corporate risk taking increases with the quality of country level governance institutions. Similarly, Boubakri et al. (2013), confirm the proposition that the relation between foreign ownership and corporate risk taking is stronger in countries with better levels of governance institutions.

In addition, it is well known that large shareholders tend to have incentive to increase the risk taking of the firm at the expense of debt holders (Jensen & Meckling 1976; Cheng et al. 2011). Large shareholders many encourage firm managers to increase risk taking in order to reap additional advantage at low cost.

On the other side, it is normally assumed that foreign investors in Vietnam stock markets behave like institutional investors (Batten & Vo 2015; Vo 2015). Hence, it might be the case that foreign investors in Vietnam are subject to prudent-man law hypothesis that increased foreign ownership is associated with lower level of risk taking. A number of papers support this hypothesis. For example, Cheng et al. (2011), find the evidence of prudent man law in the life-health insurance industry. In addition, if foreign investors own a significant proportion of holdings in a firms, they might have incentive to limit the risk taking of the firms in order to prevent a great loss to their portfolio at a given point of time (Sullivan & Spong 2007; Cheng et al. 2011).

Following Cheng et al. (2011), we acknowledge that the relationship between the foreign ownership and corporate risk taking is indeterminate. However, given the predominance of the view that foreign investors tend to increase risk taking, we will examine this proposition in the Vietnamese context.

In a related literature, many papers investigate the behavior of foreign investors in Vietnam in many different aspects. For example, Batten & Vo (2015), investigate the investment preference of foreign investors in Vietnam stock market and

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