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Foreign investors and stock price efficiency: Thresholds, underlying channels and investor heterogeneity

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ABSTRACT

This paper examines the relationship between foreign shareholding and stock price efficiency for Malaysian public listed firms over the 2002–2009 sample period. We use stock price delay as an inverse measure of price efficiency, and consider the speed of adjustment to local and global common factor information. The results show that foreign investors accelerate the incorporation of both types of common information into the prices of Malaysian stocks, mainly due to their superior skills in processing systematic market-wide factors. However, we find evidence of optimality in foreign shareholding, suggesting that the efficiency benefit disappears after foreign ownership exceeds a certain threshold level. Further analyses shed lights on the channels and moderating variables driving this non-monotonic relationship. Our disaggregate analysis on foreign investor heterogeneity shows that foreign investors who trade through nominee accounts are elite processors of public market-wide and firm-specific news in the Malaysian stock market.

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1. Introduction

Financial liberalisation is one of the most active research areas in international economics. However, there is still no conclusive empirical evidence of its growth-enhancing benefits, whereas the macroeconomic and financial stability risks associated with surging capital inflows are still hotly debated. This paper departs from financial liberalisation's traditional focus on growth and financial crises to a relatively less-explored area, the informational efficiency of stock market. The latter issue deserves greater attention in policymaking because promoting market efficiency is one of the key objectives of securities market regulators. Empirically, the efficiency effect of financial reforms has generated a sizeable literature in recent years, covering areas such as short-sales restrictions (Saffi & Sigurdsson, 2011; Boehmer & Wu, 2013), insider trading laws (Beny, 2007; Fernandes & Ferreira, 2009), investor protection (Morck, Yeung, & Yu, 2000; Lim & Brooks, 2010) and financial liberalisation (Bae, Ozoguz, Tan, & Wirjanto, 2012; He, Li, Shen, & Zhang, 2013). Furthermore, several theoretical and empirical papers have shown that efficient stock prices contribute to the efficient allocation of investment resources because the information contained in stock prices is used to guide corporate decisions, thus confirming a significant link between the stock market and real sector activity (see the survey paper by Bond, Edmans, & Goldstein, 2012 and references cited therein).

Malaysia presents an interesting case study given that in recent years, its government has accelerated the pace of financial reforms, including the relaxation of foreign investment restrictions. Malaysia is one of the earliest of the developing economies to actively pursue financial liberalisation. During the first two decades after the nation's 1957 independence, ownership of Malaysian firms was dominated by foreigners. However, based on the official records of Malaysia's principal government agency, the Economic Planning Unit (EPU), there has been a considerable decline in foreign equity ownership—from a high of 63.3% in 1970 to below 30% in the 1990s (see Table 1). This decline is due to the implementation of various national development policies that place equity ownership at the forefront of the public policy agenda. After Malaysia's 1969 racial riots, the government instituted the New Economic Policy (NEP) to address inter-ethnic socio-economic imbalances with the overriding goal of restoring national unity. To redistribute wealth more equitably among all ethnic communities, one of the government's distributional strategies is to increase Bumiputera (literally "sons of the soil", consisting of Malays and other indigenous ethnic groups) equity ownership with the target of attaining at least 30% of total corporate equity. When the NEP ended in 1990, the underlying principle of growth with equity was furthered by its successors: the National Development Policy (1991–2000) and the National Vision Policy (2001–2010).

Realising that internationalisation is crucial for capital market development, the Malaysian government implemented various bold liberalisation measures in the 2000s, such as allowing 100% foreign ownership in the manufacturing sector and futures brokers (see Bursa Malaysia, 2010). The most sweeping changes were made in 2009 and include the following: (1) the removal of the 30% Bumiputera equity condition for 27 service sub-sectors and from the Bursa Malaysia Listing Rules; (2) full

Table 1
Ownership of share capital (at par value) of Malaysian Limited Companies (% of total).

Ownership group	1970	1975	1982[b]	1985	1990	1995	2000	2004	2008
Bumiputera[a]	2.4	7.8	15.6	18.5	19.3	20.6	18.9	18.9	21.9
Chinese	27.2	27.9	33.4	48.2	45.5	40.9	38.9	39.0	34.9
Indians	1.1	1.2	0.9	0.9	1.0	1.5	1.5	1.2	1.6
Other ethnic groups	–	–	1.6	0.4	0.3	1.0	0.9	0.4	0.1
Nominee companies	6.0	8.2	13.8[c]	8.0	8.5	8.3	8.5	8.0	3.5
Foreigners	63.3	54.9	34.7	24.0	25.4	27.7	31.3	32.5	37.9

Sources: Economic Planning Unit (http://www.epu.gov.my/), various issues of 5-year Malaysian Development Plans.
Notes:

[a] Includes shares held by individuals, institutions and trust agencies.

[b] The statistics for 1980 did not provide detailed breakdown of ownership by ethnic groups.

[c] This figure includes locally-controlled companies whose ownership could not be disaggregated further and assigned to specific ethnic groups.