



Dynamic relationships among equity flows, equity returns and dividends: Behavior of U.S. investors in China and India

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ABSTRACT

This research examines the linkages among U.S. equity flows to China and India, their equity returns, and their fundamental variables. We find that positive shocks to U.S. equity flows to China and India elicit an insignificant response to returns. This finding provides evidence that U.S. institutional investors are not a destabilizing influence in these markets. However, positive innovations to dividends in both China and India have a negative impact on returns. We conjecture that the high potential growth rates in these markets make it preferable for companies to retain earnings rather than pay dividends. In India, shocks to dividend yields have a strong negative influence on U.S. equity flows. Our results validate the need to take into account fundamental variables when examining U.S. investor behavior in emerging equity markets.

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1. Introduction

International equity flows have become an important policy issue in rapidly growing emerging markets such as China and India. Although both countries escaped most of the consequences of the 1997 Asian financial crisis, the danger of a 'Thailand-style' abrupt and sudden withdrawal of portfolio investment and resulting destabilization of equity markets are of concern due to potential contagion effects among Asian markets.¹ In spite of these justifiable concerns and the substantial growth in the equity markets of China and

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¹ Refer to Kaminsky and Schmukler (1999) and Maroney, Naka, and Wansi (2004).

India, relatively few studies analyze the dynamic relationships among equity flows, equity returns, and fundamental variables in these emerging markets. Existing empirical evidence indicates a strong relationship between inflows of foreign capital and equity market returns for emerging as well as developed markets.² What is not settled is the interpretation of the relationship and implications of the role of U.S. investors in these markets.

One of the competing hypotheses is that the participation of foreign investors in emerging markets brings about a demand shift and hence a permanent price change. The broadening of investor base increases risk-sharing opportunities and thereby lowers the required rate of return. Empirically, this demand shift translates into a positive relationship between inflows and returns. A theoretical model for this mechanism was originally developed by Merton (1987), and empirical work on the effects of liberalization on emerging markets is presented by Bekaert and Harvey (2000), Bekaert, Harvey, and Lumsdaine (2002), and Henry (2000). Bekaert et al. (2002) use dividend yield to proxy cost of capital and find an inverse relationship between cost of capital and inflows of foreign capital following liberalization of the a country's capital account. A related but opposite hypothesis is that foreign investors create temporary upward price pressure. This effect is due to market illiquidity in absorbing the extra demand. It follows from this hypothesis that the resulting price change should tend to reverse in subsequent trading periods.³

The role of foreign investors in emerging markets is also much debated. They are described as trend chasers (Bohn & Tesar, 1996; Choe, Kho, & Stulz, 1999), informed traders (Grinblatt & Keloharj, 2000; Seasholes, 2004), or investors with an information disadvantage (Brennan & Cao, 1997; Brennan, Cao, Strong, & Xu, 2005). The majority of the existing literature assumes that foreign investors have inferior information sets. Although it is reasonable to assume that the average domestic investor is better informed than the average foreign investor, particularly in emerging markets, it is also plausible that large foreign institutional investors may be able to gain informational advantages over locals. Seasholes (2004) suggests that this assumption is particularly rational when the best foreign investors and local traders tend to have similar backgrounds and skills. If foreign investors were informed, then a positive shock to equity inflows would be associated with a positive innovation in prices, and even if they are uninformed, a shock to flows should increase prices via Merton's base-bordering mechanism.

The current paper examines the dynamic relationships among U.S. equity flows to China and India, their equity returns and their fundamental variables. We employ a structural vector autoregressive model and a time series that contains only post-liberalization data. One of the objectives is to address the issue of information asymmetry between foreign (China and India) and domestic (U.S.) investors. This paper steps back from a-priori assumption that foreign investors are uninformed and decomposes the behavior of U.S. institutional investors. If large institutional investors were able to gain an informational advantage, they might try to conceal this informational advantage, this attempt would lead to rationing behavior in order to minimize the price impact of their purchases, and hence new purchases could be predicted from past purchases (Seasholes, 2004). Thus, the observed autocorrelation of equity inflows could be a result of rationing behavior by U.S. institutional investors with superior information or could reflect a learning process, depending on one's assumption about information endowments.⁴ Since portfolio equity flows are observed to be autocorrelated, we expect greater demand from foreign investors in the future after a positive shock to equity inflows, and this would cause prices to be bid higher following the flow shock. The work of Merton (1987), Bekaert et al. (2002), and others support the use of equity flows as a proxy of the U.S. participation in the Chinese and Indian markets. The idea that U.S. investors may not have inferior information endowments is signified by the nature of the economies of China and India, where both countries export significant amounts of products and services to the United States. According to Alfaro, Kalemli-Ozcan, and Volosovych (2005), information asymmetries between countries decrease as the trade between nations or regions increases.

Using a structural vector autoregressive model, we find that positive shocks to equity inflows to China and India elicit an insignificant response to returns. This finding provides evidence that U.S. institutional investors appear not to be a destabilizing influence in these markets. This is likely due to the sheer size of

² See Henry (2000), Griffin, Nardari, and Stulz (2004), Brennan et al. (2005), and Hau and Rey (2006) for examples of this work.

³ Warther (1995) fails to find evidence of price pressure with inflows of capital to mutual funds. Similarly, Clark and Berko (1997) did not find evidence of foreign investors pressuring prices upward due to illiquidity in the Mexican equity market.

⁴ For example, see Froot et al. (2001), Froot and Ramadorai (2005), and Grinblatt and Keloharj (2000).

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