



Culture's impact on institutional investors' trading frequency



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ARTICLE INFO

Article history:

Received 23 January 2013

Received in revised form 12 August 2013

Accepted 4 October 2013

Available online 19 October 2013

JEL classification:

G11

G15

G23

Z10

Keywords:

Trading frequency

Institutional investor

Culture

Home bias

Ambiguity aversion

Trust

ABSTRACT

This paper examines how cross-cultural differences influence institutional investors' trading frequency within their own portfolio. We find evidence that as cultural distance between the investors and their stock holdings increases, institutions trade with lower frequency. Findings are consistent with our hypothesis that trading frequency and cultural distance are negatively related due to increasing difficulty of interpreting investment environments in culturally distant foreign markets. We also show that traders from different cultural backgrounds behave differently when faced with information asymmetry that cultural differences generate. Specifically, we show that ambiguity aversion and lower trust relate to lower trading frequencies at home and abroad.

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1. Introduction

Culture's impact on economic exchange is a new and emerging field in international finance research. Many recent papers have documented that cross-cultural psychology is an important determinant and driver of many observed finance phenomena. As cultural differences between investors' or firms' home markets and foreign target markets increase, access to information, interpretation of information, and understanding of business and market environment becomes increasingly difficult. Cultural differences between countries have been shown to impact trade flows, foreign direct investment, portfolio flows (Aggarwal, Kearney, & Lucey, 2012; Felbermayr & Toubal, 2010; Guiso, Sapienza, & Zingales, 2009), success of cross-border mergers (Ahern, Daminelli, & Fracassi, *in press*; Chakrabarti, Gupta-Mukherjee, & Jayaraman, 2009), and portfolio performance (Choi, Fedenia, Skiba, & Sokolyk, 2013).

In this paper, we contribute to the literature of culture and finance. Specifically, we examine culture's influence on trading frequency of institutional investors. The theory on how often rational investors

should trade stocks differs from much of the evidence documented in the literature. Investors trade more frequently than theory suggests, and of all factors, investor competence (Graham, Harvey, & Huang, 2009), overconfidence, self-attribution bias (Barber & Odean, 2000, 2001), and familiarity (Chan & Covrig, 2012; Coval & Moskowitz, 2001) appear to be the most consistent in explaining frequent and often excessive trading.

The purpose of this paper is to study trading frequencies from a new angle. We study trading behavior of institutional investors in international setting. We test how cultural difference between an investor's home market and the markets of the investor's stock holdings (target markets) affect the trading frequencies inside each investor's own portfolio. We argue that a manager from a culturally distant market has a lower ability to access and process information compared to his or her home market or a target market that is culturally close to his or her home market. Therefore, we hypothesize that the institutional investor's trading frequency inside the manager's own portfolio will vary, so that the turnover will be the highest in the investor's home market and culturally close markets, where information asymmetry is the lowest. As cultural distance increases and the information asymmetry increases, we expect to observe declining trading volumes in the same portfolio. To further study the effect of cultural characteristics on trading frequency, we also test whether the level of cultural characteristics on trading frequency, we also test whether the level of ambiguity aversion, trust, and overconfidence of the investors' home country relate to trading frequency.

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In addition to the cultural distance, we also examine the impact of geographical distance between the investor's home market and target markets on trading frequency. In a recent study by [Chan and Covrig \(2012\)](#), the authors document that an increase in geographical distance between an investor's home market and target markets increases trading volumes because investors are less familiar with distant target markets. Building on [Chan and Covrig's \(2012\)](#) findings, we argue that geographical distance is directionally dependent and that across longitudes, as fewer business hours overlap, information barriers between home markets and target markets increase. Therefore, we hypothesize that as longitudinal distance increases, the trading volumes will decrease, so that the effect of longitudinal distance is similar to the effect of cultural distance on trading volumes.

Consistent with our expectations, the main finding of our analysis suggests that institutional investors trade with higher frequency in their home market and in markets that are culturally close to their home country. The results provide new evidence for observed excessive trading that takes place in financial markets, and that trading behavior changes, not only from individual to individual and from institution to institution, but also inside investors' own holdings. The decline in trading frequency is especially rapid as cultural distance increases between each investor's home market and the target markets. This suggests that, on average, investors believe that they are unable to benefit from more frequent trading in target markets where they may be informationally disadvantaged. This finding is consistent with some prior papers that provide evidence on negative relationship between the barriers to obtain information and trading and market participation activity ([Coval & Moskowitz, 2001](#); [Graham et al., 2009](#)). The difference in trading frequencies is large in magnitude. On average, investors' home market turnover exceeds culturally close target markets' turnover by a factor of 7 and the culturally most distant target markets by as much as 21 times. In addition, we find evidence that cultural ambiguity aversion is related to lower trading frequency and that cultural trust is related to higher trading frequency. Finally, we document that geographical distance matters much more, when investor moves further away from the target market across time zones. Longitudinal distance is negatively related to trading frequencies, and it is statistically and economically significant, whereas latitudinal distance is not a significant determinant of trading frequency in most of our analyses.

Our paper makes several contributions to the literature. First, our findings reveal that observed excessive trading in financial markets is also a market specific phenomenon, so that investors' trading frequency changes within investors' own portfolio. Second, we document that "home bias" exists not only with respect to asset allocation, as it has been long recognized, but also with respect to trading frequency. Investors' trading frequency appears to be the highest in markets that are culturally closest to their home market, where information asymmetry is the lowest. Third, our results add to the new and emerging stream of literature on cross-cultural psychology and investor behavior. Specifically, we focus on cultural distance between markets as a determinant of economic exchange, as opposed to many recent papers that have linked cultural characteristics of individual countries to explain firm and investor behavior (for example [Beugelsdijk & Frijns, 2010](#); [Chui, Titman, & Wei, 2010](#)). Our fourth and final contribution is that we study culture and trading frequency in a large sample of institutional investors from 37 international markets. Our extensive holdings' dataset allows us to observe portfolio allocation of institutions at the security level across the global market place in 46 target markets. The holdings data used in the study are the most detailed international portfolio dataset of which we are aware.

The remainder of the paper is organized as follows. [Section 2](#) reviews the literature and develops our hypotheses, [Section 3](#) details the data and methodology used in this study, [Section 4](#) presents and discusses the results and [Section 5](#) concludes.

2. Literature review and hypotheses development

2.1. Excessive trading

[Grossman and Stiglitz \(1980\)](#) use a rational expectation framework and argue that investors only trade if the marginal benefit from trading exceeds its marginal cost. In practice, however, the finance literature provides evidence that overconfident investors trade more often than the rational expectation framework suggests. [Benos \(1998\)](#) shows that overconfident investors who compete with rational investors using limit orders may enjoy higher profits due to a "first mover advantage". Contrary to [Benos \(1998\)](#), [Caballé and Sákovics \(2003\)](#) develop a theoretical model to illustrate that overconfident investors will suffer from trading too much.

In their influential study, [Barber and Odean \(2000\)](#) show that individual investors who trade stocks most frequently earn returns significantly lower in statistical and economic terms than the market average. Moreover, the authors document that these lower returns are accompanied by investing in stocks that are riskier, on average. The hypothesis that overconfidence can explain, at least in part, excessive trading is supported in their study. [Barber and Odean \(2001\)](#) strengthen their overconfidence argument by showing that male traders trade more often and earn lower returns than female traders. The authors establish a link from psychology and gender overconfidence to trading volumes, so that females exhibit lower levels of confidence in areas like finance and therefore turn their portfolios over less frequently.

[Graham et al. \(2009\)](#) study the relationship between investor competence and international asset allocation and trading frequency. Their research builds on the seminal work on the "competence effect" by [Heath and Trevsky \(1991\)](#). [Heath and Trevsky's \(1991\)](#) natural experiment suggests that when people feel more knowledgeable about a subject matter, they are more willing to bet on their own judgment instead of betting on a lottery that carries the same probability of winning. [Graham et al. \(2009\)](#) point out that in financial markets, investors are constantly making decisions based on subjective probabilities. The authors document that individual investors with specific characteristics feel more competent about their ability to understand financial information than others, which in turn, translates into higher trading volumes.

Evidence on competency and trading frequency is also documented by [Grinblatt, Keloharju, and Linnainmaa \(2012\)](#) who show that individuals' level of competency is related to trading behavior and that more competent investors, proxied by their IQ, outperform less competent investors. The better than average effect with relation to trading is also examined by the literature. [Dorn and Huberman \(2005\)](#) observe clients of a German retail broker and show that investors who perceive themselves as more knowledgeable trade more. [Glaser and Weber \(2007\)](#) use survey data from an online broker's investors, and find that investors who think that they have better investment skills and believe to perform above average (but in actuality have average or below average performance) trade more than other investors.

The literature on trading behavior in non-home markets is young and only few papers, complementary to ours, have explored the topic recently. [Lai, Ng, Zhang, and Zhang \(2013\)](#) study trading behavior by global mutual funds, but focus on the momentum patterns rather than trading frequency. The authors find that funds generally follow the same trading strategies at home and abroad, but their buy and sell intensities vary with the location of trades. That is, the momentum investing in local stocks is mostly affected by market momentum anomaly and window-dressing, and that in foreign stocks the information environment of the host country plays a leading role. [Chan and Covrig \(2012\)](#) find that global mutual fund investors rebalance their portfolios more often in less familiar environments, where familiarity is measured by geographical distance, trade flows, and commonality in language.

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