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Domestic investor protection and foreign portfolio investment

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ABSTRACT

This paper investigates the impact of domestic investor protection on equity cross-border investment. We bring to light the lower sensitivity of foreign investment to destination countries' corporate governance for those investors enjoying a higher degree of investor protection at home. This evidence is consistent with diminishing marginal returns of corporate governance in portfolio choice. Investors benefiting from high levels of rights protection at home recognize that a large fraction of their portfolio, the domestic one, significantly contributes to the optimal level of corporate governance in portfolios. Consequently, these investors are less demanding about this dimension when constructing their foreign portfolios. As an unintended consequence, all other things being equal, assets issued by foreign countries with good investor protection are severely penalized in portfolios held by investing countries featuring higher standards of corporate governance.

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1. Introduction

This paper investigates the impact of domestic investor protection rights on foreign portfolio investment. Irrespective of the benefits from the international diversification of equity portfolios documented long ago (Markowitz, 1952, Sharpe, 1964, Grubel, 1968, Levy and Sarnat, 1970, Solnik, 1974), investors still display a strong preference for domestic assets, the so-called home bias (French and Poterba, 1991, Tesar and Werner, 1995, among others). As reviewed by Lewis (1999) and Karolyi and Stulz (2003), proposed explanations to this puzzling behavior refer to barriers to international investment (Stulz, 1981, Tesar and Werner, 1995), behavioral bias consisting in the over-optimism of domestic investors toward domestic assets (French and Poterba, 1991, Strong and Xu, 2003, Li, 2004), hedging background risk such as inflation risk (Cooper and Kaplanis, 1994) or human capital risk (Baxter and Jermann, 1997, Pesenti and van Wincoop, 2002), and information asymmetry between domestic and foreign investors (Grinblatt and Keloharju, 2001; Chan et al., 2005; Portes and Rey, 2005).

The information-based motive has especially benefited from strong support in the empirical literature and is therefore advocated as a major cause of international underdiversification. Kang and Stulz (1997) and Dahlquist and Robertsson (2001) emphasize that large, financially solid, well-known firms are preferred by foreigners, thereby underlining the asymmetry between resident and foreign investors. Chan et al. (2005) investigate the determinants of foreign and domestic investment, finding that familiarity and variables capturing investment barriers have a significant but asymmetric effect on domestic and foreign bias. This evidence is consistent with the conjecture that foreign investors are more vulnerable to information asymmetry than domestic investors are.

In this context, corporate governance can be crucially relevant to partially offset this lack of information by signaling the quality of institutions in terms of guaranteed investor rights (La Porta et al., 1998, LLSV henceforth). Corporate governance can be particularly influential on investors more affected by information costs, namely, foreign investors.

The literature so far has analyzed the effect of corporate governance in attracting foreign investment (Kho et al., 2009, Leuz et al., 2009, Giannetti and Koskinen, 2010; Giofré, 2013), almost entirely disregarding the role played by legislation protecting the investor at home. The only exception, to the best of our knowledge, is the study of Giannetti and Koskinen (2010). In their setting, domestic investor protection is relevant to the extent that it influences the portfolio share invested in domestic assets: The foreign holdings of portfolio investors in weak investor protection countries are found to be larger than in countries where minority shareholders are more strongly protected.

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We complement the analysis of Giannetti and Koskinen (2010) by highlighting the role of domestic investor protection in shaping foreign portfolio composition. If domestic corporate governance has only a direct impact on foreign investment, then this should uniquely determine the choice between domestic and overall foreign shares (Giannetti and Koskinen, 2010) and should have no impact on foreign portfolio allocations across destination countries. If, instead, domestic investor protection also affects foreign investment indirectly—for instance, by altering its responsiveness to destination country-specific corporate governance—then foreign portfolio composition should be affected.

In this paper, the hypothesis of an even impact of corporate governance on foreign investment is challenged: The empirical evidence shows that laws protecting the interests of minority shareholders asymmetrically affect foreign investors, depending on the degree of investor protection at home. Specifically, we document an unintended effect of strong domestic investor protection rules: They dampen the attractiveness of well-protected foreign investment more than that of poorly governed countries' assets. Countries with higher corporate governance standards are therefore more underweighted in portfolios held by investors in more strongly regulated countries than in portfolios held by investors in countries with weak investor protection.

We argue that this evidence is consistent with decreasing marginal returns on corporate governance. Listokin (2007) suggests the presence of diminishing marginal returns on governance at the firm level, thus establishing an optimal level of governance. We follow a similar reasoning, at an aggregate level, for portfolio allocation, where corporate governance competes with other factors to determine the optimal investment pattern. Insofar as the domestic position is very large and exogenous, as in our analysis, the importance of corporate governance for foreign investments must be decreasing with the level of domestic corporate governance, even if the same optimal level of governance is assumed in portfolios across various investors.

If the degree of minority investors' protection is indeed characterized by diminishing marginal returns, investors benefiting from high levels of rights protection at home recognize that a large fraction of their portfolio, the domestic one, significantly contributes to the optimal level of corporate governance in portfolios. Consequently, these investors are less demanding about this dimension when diversifying their portfolios. The lower sensitivity to corporate governance when building foreign portfolios, reflected in a flatter response of foreign investment to foreign protection rights, penalizes destination countries featuring stronger minority investor rights protection, which indeed appear to be more underweighted in portfolios.

We bring to light that this effect is also quantitatively important. When considering the portfolio allocation in destination countries differing by investor protection, we find that investing countries suffering weak investor protection display a 25% larger foreign portfolio bias in highly protecting countries than in less protective ones, while investors featuring high standard of corporate governance at home show a 53% lower foreign portfolio bias in highly protecting destination countries than in less protecting ones. Moreover, when considering the portfolio allocation in given destination countries made by investing countries differing by investor protection, we highlight that investors benefiting from higher standards of investor protection at home invest in strongly protecting countries up to 60% less than investors acquainted with weaker levels of domestic minority shareholder protection. These findings represent this paper's main innovative contribution to the literature and shed new light on the role of corporate governance on foreign portfolio allocation.

The remainder of this paper is organized as follows. Section 2 discusses the linkage between domestic investor protection and home bias. Section 3 describes the conceptual framework, the equation to be estimated, and its main testable implications. Section 4 presents the data and some descriptive statistics. Section 5 illustrates and discusses the results. Section 6 concludes the paper.

2. Home bias and domestic investor protection

This work analyzes the impact of investor protection laws on stock portfolios held by foreign investors. The various indexes of shareholder rights adopted in this paper are related to the antidirector rights (*ADR*) index, which was originally developed by LLSV in their seminal paper to measure how strongly a legal system favors minority shareholders against managers or dominant shareholders in the corporate decision making process.

Standard asset pricing models assuming a representative agent predict that differences in observable asset characteristics, such as investor rights and the financial development of the issuing firm or country, should be capitalized in share prices such that investing in any stock is a fair investment, regardless of the issuer's level of investor protection (Dahlquist et al., 2003). However, when heterogeneity across investors is accounted for, the equilibrium price discount discloses only the aggregate behavior, thus inducing under- or over-investment by those investors for which the price discount is, respectively, too low or too high (Kho et al., 2009, Leuz et al., 2009, Giannetti and Koskinen, 2010).

In particular, as noted by Leuz et al. (2009), this price discount is likely insufficient for foreign investors, who plausibly face information problems beyond those of domestic investors. Indeed, the home bias puzzle can be read as evidence of the asymmetric perceptions of asset characteristics by home and foreign investors, thus rejecting the representative agent hypothesis.[1] If all investors, domestic and foreign, equally perceive the level of investor protection in country *j*, this would be perfectly priced and all investors would hold the same portfolio, irrespective of nationality. Evidence of the significant positive role played by investor protection in shaping foreign portfolios underlines its stronger impact on foreign investors.

Previous work originating from LLSV emphasizes how investor protection affects financial market development, that is, the supply of equity, leaving the demand side mostly unexplored. This latter perspective is relevant, insofar as one accounts for heterogeneity across investors. Recent work has highlighted the asymmetric impact of corporate governance on different categories of investors (Leuz et al., 2009, Giannetti and Koskinen, 2010; Giofré, 2013). Giofré (2013) highlights how laws protecting different interests asymmetrically affect foreign stakeholders. More specifically, foreign shareholders appear to appreciate strong creditor rights, which potentially mitigate project riskiness, while bondholders are negatively affected by strong shareholder rights, which might induce firms to engage in excessively risky behavior. Giannetti and Koskinen (2010) show that investor protection impacts financial market development by influencing the demand for equity, because different classes of investors—specifically controlling shareholders and outside shareholders—can differ in the benefits accruing to them and therefore in their willingness to pay for stocks. Leuz et al. (2009) investigate the impact of firm-level corporate governance on foreign holdings and find that US investors invest less in foreign firms with poor outsider protection and opaque earnings. In particular, they find that foreign holdings in firms with poor governance are driven by information asymmetry. The authors' identification strategy relies on comparison across countries with different degrees of investor protection: Firm corporate governance within a country plays a role only when national-level institutions are poor.

[1] Gehrig (1993) and Kang and Stulz (1997), among others, focus on the role played by information asymmetry in determining evidence of home bias. See Lewis (1999) for a comprehensive review of the home bias literature.

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