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Journal of Banking & Finance

journal homepage: www.elsevier.com/locate/jbf

Information immobility, industry concentration, and institutional investors' performance

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ARTICLE INFO

Article history:

Received 29 November 2011

Accepted 27 January 2013

Available online 9 February 2013

JEL classification:

G11

G15

G23

Z10

Keywords:

International diversification

Portfolio performance

Industry concentration

Culture

Home bias

ABSTRACT

This paper examines foreign institutional investors' portfolio allocation and performance in US securities. We test how information immobility, proxied by information barriers between the investors' home markets and the US, influences portfolio strategies. Consistent with theoretical predictions, foreign institutional investors' total investment in the US is negatively related to information immobility. Similarly, information immobility is a significant driver of portfolio under-diversification across industries. Industry concentration has declined over time, consistent with declining search costs. Industry-concentrated portfolios outperform more diversified portfolios for both foreign and US institutional investors. Concentration especially helps institutional investors with the easiest access to information.

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1. Introduction

Investors do not diversify across international markets according to expected benchmark weights as suggested by portfolio theory. Instead, individuals and institutional investors tend to overweight their home markets. The so called home bias has been studied extensively since seminal work by French and Poterba (1991). Similarly, individual and institutional investors prefer to overweight certain types of international markets such as those that are more transparent with better governance mechanisms, are geographically proximate, share a common language with the investor, and are culturally close (Chan et al., 2005; Leuz et al., 2010; Anderson et al., 2011; Aggarwal et al., 2012).

These patterns have been studied mainly in small sample sizes. In country specific studies that investigate security selection, most studies are limited to comparison of domestic versus foreign investors' decision making. For example, Kang and Stulz (1997) show that foreign investors in Japan prefer large, international manufacturing firms. Covrig et al. (2006) find that domestic managers

typically prefer smaller, high market-to-book firms. Foreign ownership is also positively related to analyst coverage of firms, and overall the results provide support for foreigners' preference for stocks with lower degree of information asymmetry.

In this paper, we take the opposite approach. Instead of focusing either purely on one countries' investors or on comparison of domestic versus foreign investors' decision making, where foreign investors are grouped together, we test whether portfolio allocation differs among foreign investors investing in one international market, the US. First, we test whether foreigners' home country characteristics as well as their information distance from the US lead them to allocate different proportions of capital to the US market. Second, we test whether the degree of portfolio diversification varies among the foreigners, where portfolio diversification is measured as the degree of industry concentration. Third, we test whether the portfolio diversification by foreigners increases over time as technological advances reduce information barriers. Fourth, we test whether the foreign investors' performance is enhanced by industry concentrated holdings.

Van Nieuwerburgh and Veldkamp (2009, 2010) provide a theoretical framework for studying portfolio under-diversification. According to the authors, when investors face a decision between acquiring noisy information about a large set of assets or more

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precise information about a narrow set of assets, specialization competes with benefits of diversification. Van Nieuwerburgh and Veldkamp's (2009) theory relates information cost to home bias and under-diversification of foreign investments. Following these theoretical predictions, we first hypothesize that the cost of information acquisition among foreign investors differs. For example, geographically and culturally proximate investors from English speaking countries may find it easier and cheaper to acquire information about the US securities. This results in a relative information advantage among certain groups of foreign investors and in a relative information disadvantage among other foreign investors. We expect information disadvantage to be related to the degree of under-diversification among foreign investors' portfolios.

Second, we expect that during the time period of our sample, technological advances have reduced information cost to foreign investors. Because of the reduction in information cost and easier access to information, we expect the change in information barriers to be related to change in the degree of under-diversification among foreign investors' portfolios.

Third, we hypothesize that foreign investors who concentrate their holdings outperform diversified foreign investors. We predict that this outperformance is especially pronounced for those foreign investors who also benefit from proximity to the US market. In addition, we test whether the foreign investors with industry concentrated holdings and with the largest relative informational disadvantage in the US market outperform industry diversified institutional investors from the same home markets by more compared to the performance differential between industry concentrated and industry diversified investors with the largest relative informational advantage, so that benefits of specialization increase with information immobility.

Empirical results provide support for our predictions. First, we document that foreign institutional investors from countries with informational advantage in the US invest more in the US as a percentage of their total portfolios. Also, investors with informational advantage invest in a more diversified set of securities compared to institutional investors with informational disadvantage, where diversification is measured with respect to industry benchmark portfolios. Second, we document that industry concentration declines during our sample period and the decline is especially pronounced among foreign institutional investors' portfolios. Third, we document that industry concentrated institutional investors outperform diversified institutional investors. This result is consistent with Kacperczyk et al.'s (2005) who document a similar result among actively managed US mutual funds. In addition, we show that the foreign institutional investors with informational advantage and industry concentrated portfolios have the highest performance in the US, even outperforming US institutional investors by a statistically significant amount.

This paper makes several contributions to the existing literature on international portfolio allocation and under-diversification. First, this paper provides new insight to foreign institutional investors' ownership in US firms. The sample includes a large number of institutional investors from 35 countries with holdings in US securities from 2000 to 2009. Second, we enrich the international diversification literature by showing that investors' information advantage impacts security selection in addition to the total portfolio flows. Third, we show that investors' home country characteristics are related to security selection and performance. Instead of comparing domestic and foreign investors, we show that there are significant differences among foreign investors as well. Fourth, our performance study shows that as information becomes more difficult to obtain for foreign investors, the benefits of specialization become especially important. Industry concentrated foreign institutional investors from countries that have informational advantage in the US have an edge in US securities.

The rest of the paper is organized in the following way: Section 2 develops testable hypotheses while reviewing relevant literature, Section 3 discusses data and methodology, Section 4 shows the results, and Section 5 concludes.

2. Testable hypotheses and related literature

There are two competing theories on how rational investors select securities. One possibility is that portfolio investment abroad is allocated to less correlated securities and markets so that the overall risk of the investment portfolio is reduced. In the traditional portfolio setting, there should be a large amount of diversification in foreigners' US holdings and as a result, the portfolios containing US securities should be mean-variance optimized.

Merton (1987) deviates from the traditional CAPM setting and argues that because of search costs investors focus on the familiar because they believe to know the stock return distribution. Therefore, if search costs are lower for investors from countries that are more familiar with the US, then those investors will have more diversified ownership in the US securities compared to less familiar countries' investors.

Similarly to Merton's theory on optimal, yet under-diversified portfolios, Van Nieuwerburgh and Veldkamp (2010) provide a theoretical model where investors face a decision between acquiring noisy information about a large set of assets, or more precise information about a narrow set of assets, and specialization competes with benefits of diversification. Van Nieuwerburgh and Veldkamp's (2009) theory relates information cost to home bias and under-diversification of foreign investments.

Empirical literature so far has shown that familiarity and perceived information advantage lead to unbalanced portfolios so that investors prefer nearby firms within countries (Coval and Moskowitz, 1999). Empirical literature provides support for Merton's and Van Nieuwerburgh and Veldkamp's (2010) argument in international setting as well, because foreign investors focus their holdings to selected few large, safe, and visible firms (Kang and Stulz, 1997; Dahlquist and Robertsson, 2001; Ferreira and Matos, 2008). At the country level, investors overweight familiar markets compared to unfamiliar markets, perhaps due to higher search costs. Chan et al. (2005) find that amount of capital allocated by mutual funds to markets around the world depends on investors' familiarity with the foreign markets. Familiarity traits in that study include common language, bilateral trade flows, and geographical proximity between the investor and the target countries.

This study focuses on portfolio allocation by institutional investors in US securities. Our sample contains both domestic and foreign investors. First, consistent with prior findings in Merton's (1987) and Van Nieuwerburgh and Veldkamp's (2009, 2010) framework, we expect to observe foreign institutional investors from countries with lower information costs in the US to invest a higher amount of their total portfolio in US securities. We formally test the following hypothesis:

H1. Institutional investors from countries with informational advantage in the US invest a higher percentage of their portfolio in US securities.

Security selection studies that compare domestic investors and foreign investors' preferences conclude that foreign investors prefer large, safe, and internationally visible firms. This finding is consistent with Merton's (1987) and Van Nieuwerburgh and Veldkamp's (2009, 2010) arguments because it might be true that search costs of foreign investors are higher away from their home markets and therefore investors prefer to focus on the firms about which they can most easily find information. Consistent with the argument about search costs, we expect to observe differences in

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