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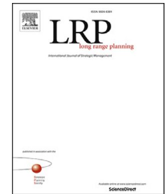

Family firm local involvement and the Local Home Bias phenomenon

Giulia Baschieri, Andrea Carosi, Stefano Mengoli

Research has documented that most of retail and institutional investors exhibit a strong preference for stocks issued by nearby listed firms (i.e. Local Home Bias). This phenomenon shapes corporate market value and the cost of funding. In this paper, we investigate whether the Local Home Bias is enhanced in family firms as a consequence of their symbiotic connection with the local community. Using a dataset of 2,951 Italian firm-year observations (1,481 are family firms) over the period 1999–2011, we find that Local Home Bias is not a widespread phenomenon and mainly occurs in founding family firms where the founder serves as CEO. The Local Home Bias is absent in non-family firms or in family firms where the owner has acquired control through a market transaction. Overall, results suggest that locally committed family firms trigger investor preference for local stocks and, in doing so, exploit the dedicated local clientele which shrinks the cost of funding. Ultimately, we argue the social contributions of family firms to the local community could even have opportunistic traits and a non-trivial economic effect.

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Introduction

Research highlights that most investors have the tendency to tilt their portfolios towards stocks issued by nearby listed firms (the so-called Local Home Bias, henceforth also LHB). One out of ten companies in a US fund manager's portfolio is chosen because it is located in the same city as the manager (Coval and Moskowitz, 1999) and about twenty percent over optimal is invested, by US retail investors, in firms headquartered within 250 miles (Ivković and Weisbenner, 2005). Literature recognizes the LHB defines segmented markets at the regional level and affects corporate market values and a firm's cost of capital (e.g., Hong et al., 2008; Korniotis and Kumar, 2013). In fact, the LHB implies a portion of local investor wealth will be invested in local equity and the equity-markets are segmented based on investor proximity with the issuing firms: consequently, firms isolated from other listed firms benefit from a larger dedicated clientele of local investors, pushing the market prices up on the available local stocks (e.g., Baschieri et al., 2015; Hong et al., 2008). As a consequence, isolated firms trade at a premium compared to clustered firms. Understanding the root of the LHB, which seems to be partly based on the feeling of familiarity investors have toward local firms (e.g., Huberman, 2001), will therefore have important implications for firm management strategies and entrepreneurial decisions. To date, very few studies have dealt with this issue or provided significant empirical evidence.

We explore a gap in the knowledge and investigate whether the feeling of familiarity among local investors is triggered by the distinctive bond family firms have with their local community, ultimately boosting the preference for stocks issued by nearby (family) firms. There is voluminous research pointing to rational decisional models for stock investment decisions (e.g. Coval and Moskowitz, 2001); yet, recent studies also point to behavioural models which suggest that familiarity is a key factor in explaining these decisions (e.g., Grinblatt and Keloharju, 2001). For instance, previous evidence suggests investors exhibit a bias towards firms that produce easily recognizable products (Frieder and Subrahmanyam, 2005), and towards geographically proximate firms whose chief executives speak the same language as the investor or shares the same cultural background (Grinblatt and Keloharju, 2001). To explain such behaviour, Cao et al. (2011) propose a model where individuals psychologically tend to use a focal choice as benchmark (the *status quo*) to compare to other possible alternatives. The *status quo* benchmark is 'familiar, cognitively simple to analyse, salient, and assigned by default' (Cao et al., 2011, 174), which cannot easily be replaced by an alternative due to a psychological fear of change and a fear of the unfamiliar.

We apply this framework to the LHB, and conjecture that local investors have stronger feelings of familiarity toward family firms than toward non-family firms, due to the way family firms establish tighter bonds with local communities and their

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close relationships with stakeholders (see among others Berrone et al., 2010). This increases the willingness of local investors to hold local family firm stocks which become the focal choice or *status quo* in portfolio decisions. To test this hypothesis we compare the LHB in different kinds of firms, based on the type of owner. Firms are divided into four categories: non-family firms, family firms, founding family firms, and founding family firms where the founder serves as CEO. We expect the effect of the LHB to increase as we move in the analysis from non-family to founder CEO founding family firms, as a consequence of their different capacities to build ties with (and within) the local community (Khanna and Rivkin, 2001).

We posit that the entrepreneur, through her/his actions, can boost and exploit local investor preference for her/his firm's stocks and, in doing so, affects the cost of funding. In fact, we assume the interaction between entrepreneurs and communities is dynamic and as such, the entrepreneur can use her/his networks even to create the business environment (see among others, Miller and Le Breton-Miller, 2005). The networking process should be particularly well enhanced in family firms with respect to non-family firms, due to their stronger ties to the local communities (e.g., Astrachan, 1988; Kahn and Henderson, 1992), especially when the founder serves as CEO (e.g., Fahlenbrach, 2009). To the best of our knowledge, no investigation of this kind has been conducted.

Bridging the research on LHB and family firms, the intent of our paper is at least twofold. On one hand, we test whether the stronger feeling of familiarity toward the local family firms drives the investor preference for local stocks and on the other, we test from a new perspective whether (even large listed) family firms and communities interact, in a way that ultimately shrinks their cost of funding. We expect the LHB and related implications on firm value and entrepreneurial decision making to strengthen in isolated family firms. In addition, we suggest the mixed evidence supporting family firms as best performers in financial markets (e.g., Anderson and Reeb, 2003) is not merely due to the way in which family businesses are defined (Miller et al., 2007) but even to the different emotional and/or economic attachments family firms have to the hosting community, compared to non-family firms. Adding a novel and relevant dimension to family firm research, we believe our study deepens the current understanding on the conflicting findings of family firm performance, and fills a gap in the literature introducing the effect of the local economic development on family firm management strategies and entrepreneurial decisions. The literature already recognizes that – compared to non-family firms – family firms are more prone to active engagement with their stakeholders and preserve their socio-emotional wealth (Cennamo et al., 2012), though we are the first to investigate whether a firm's socio-emotional goal has an economically rational, yet concealed, origin. We suggest the link developed with local communities by a family firm could be instrumental to its economic interests, improving the financial performance via a LHB effect. For the family firm more embedded with its local stakeholders, the consequence would therefore be the reconciliation of the socio-emotional wealth with the economic wealth, two aspects so far kept unrelated by the literature on the topic (e.g., Berrone et al., 2010).

We first present a detailed analysis of the 7,487 shareholders owning at least one share in a typical Italian founding family firm. Conclusive evidence on the existence and the drivers of LHB within the family firm setting, and support for the empirical investigation of the LHB in the family firm context follows. Then, a thirteen year (1999–2011) dataset on 2,951 Italian listed firms (1,481 of which are family firms) is used to estimate the LHB across different types of family firms and non-family firms. The investor preference for local stocks results in isolated firms trading at a premium compared to clustered firms located in regions with the presence of several listed firms. Consistently, we find that the isolated founder-managed family firm has a market value that is on average about 33 percent higher than the similar but clustered founder-managed family firm. Remarkably, we do not find any difference in values when isolated vs. clustered non-family firms are taken: this (lack of) evidence is novel compared to prior findings which do not account for the specific local dynamics related to family (and non-family) firms. Overall, our findings show that the preference for local stocks is enhanced by the family firm status, and suggest only locally committed family firms dynamically interact with the hosting community to exploit the local dedicated clientele and shrink their cost of capital.

The remainder of the paper is as follows. Section 2 presents the theoretical development and testable hypothesis. Data collection and research methodology is detailed in Section 3. Section 4 presents the findings, while conclusions and implications for practitioners and researchers are discussed in Section 5.

Family firms and LHB: research focus and theoretical development

LHB: types of local investors and drivers of their preference for local stocks

The financial literature recognizes different roots of LHB. On the one hand, LHB stems from information advantages on the local firms: proximity gives investors greater value-relevant information about the local companies, leading to a preference for local firms over the non-local firms (e.g., Coval and Moskowitz, 2001; Ivković and Weisbenner, 2005). On the other hand, behavioural factors also come into play as familiarity is a key element in explaining the preference for local equity: it is associated with a sense of comfort toward what is well known and discomfort with the alien, and adds a non-pecuniary dimension to investment choices (Grinblatt and Keloharju, 2001).

The main drivers underlying the LHB differ according to the type of investor. The preference for local firms affects institutional investors such as mutual funds (e.g., Coval and Moskowitz, 2001), hedge funds managers (e.g., Teo, 2009), investment advisors (e.g., Baik et al., 2010), block acquirers (e.g., Kang and Kim, 2008), and professional traders (e.g., Hau, 2001): in all the cases, the information advantage of the local institutional investors over the local firms is the driver of LHB and the local equity-holdings lead to substantial and positive abnormal returns. However, a growing number of studies highlight that

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