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The Interaction between Foreigners' Trading and Stock Market Returns in Emerging Europe

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## ABSTRACT

This paper presents the first comprehensive study of foreigners' trading in European emerging stock markets, using complete data compiled at the destination. We also compare European results to Asia, to which available evidence is mainly confined. The findings provide new insight on foreigners' trading: in addition to rebalancing, risk appetite and global information are global drivers of net foreign flows. Foreigners negative-feedback-trade with respect to local returns at longer horizons. They do so with an asymmetry: they sell following increases but do not buy following declines. Net foreign flow persistence decreases with local return volatility.

*JEL Classification:* G11; G14; G15

*Keywords:* foreign equity flows; emerging-European stock markets; foreigners' trading behavior; feedback trading; trading flow persistence; information content and price impact of flows.

## 1. Introduction

As international investors are perceived to have a large impact on host emerging markets and, at the same time, to herd and positive-feedback-trade, the interaction between foreign investors' trading and emerging equity market returns has been a main focus in the international finance and microstructure literatures. Empirical research on the joint dynamics of foreign investors' trading and emerging equity market returns has examined: *i*) the global (push) factors that drive equity portfolio flows, *ii*) positive feedback trading, which has been considered a symptom of foreign investors' informational disadvantages, *iii*) the price impact and forecast ability of foreign flows. However, extant empirical evidence is mainly confined to Asian markets (Choe et al., 1999; Griffin et al. 2004; Richards, 2005; Dvořák, 2005; Choe et al., 2005; Bailey et al., 2007; Samarakoon, 2009; among others) due to data availability. Emerging Europe, where the role of foreign investors is much more pronounced, has been surprisingly neglected.

This paper provides the first comprehensive study of foreigners' trading in European emerging markets, using complete foreign flows data compiled at the destination. By comparing the results for European and Asian emerging markets, we provide a critical out-of-sample assessment of the extent to which available empirical evidence dominated by Asian markets can be generalized. We also contrast the analysis at the monthly and daily frequency, where daily data are available. These, in turn, allow a comprehensive out-of-sample assessment of theories of international investor behavior (Brennan and Cao, 1997; Dvořák, 2003; Griffin et al., 2004; Hau and Rey, 2004, 2006; Albuquerque et al., 2007; Barron and

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