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The information content of stock markets around the world: A cultural explanation



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ABSTRACT

We draw on the psychology literature on cross-country cultural differences to explain the information content of stock markets around the world. We show that cultural dimensions in the studies of Hofstede (1980, 2001) such as individualism and uncertainty avoidance closely relate to several behavioral biases widely discussed in accounting and finance research. These cultural dimensions also signal different risk preferences. We argue that behavioral biases and risk preferences influence how international investors act on firm-specific information and empirically test whether individualism and uncertainty avoidance indexes can explain the cross-country information content of stock markets. We compute R^2 from the market model to measure the general information content of stock markets in the long term, abnormal return variance, and abnormal trading volume around earnings announcements to measure the short-term information content of earnings announcements. Using more than 150,000 earnings announcements from 42 countries for the period 1990–2006, we find that the information content of stock markets is higher in more individualistic countries and in low uncertainty-avoiding countries. The relations between cultural dimensions and measures of information content are robust to the inclusion of several control variables or the use of updated cultural indexes that account for possible changes in cultures over time.

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1. Introduction

It has been a generally acknowledged observation that the information content of international stock markets relates to several structural factors specific to each country. For example, [Morck et al. \(2000\)](#) find that the explanatory power of the market model is lower and hence stock price informativeness is higher in countries with more developed financial systems and better investor property rights. They argue that stronger property rights encourage informed arbitrage activities that would cause stock prices to reflect more firm-specific information. Similarly, [DeFond et al. \(2007\)](#) document that the informativeness of annual earnings announcements is higher in countries with better quality earnings, better enforced insider trading laws, stronger investor protection institutions, and lower reporting frequency.

The literature in the area of cross-country stock market information content has generally assumed perfect rationality among international investors. We however argue that investors from different cultural backgrounds exhibit innate differences in behavior and hence display varying degree of reaction to firm-specific information. Consider a passage from a recent study by [Hirshleifer and Teoh \(2009, p. 1067\)](#): *“Much existing positive research on accounting rules and regulation focuses on the benefits of existing rules to rational users, or else to regulation as a result of the battle between rational competing interest groups. . . . However, psychological forces affect individual and group behavior in many contexts. So we argue that to capture important features of accounting, we must go beyond the assumption of perfect rationality.”* Several accounting studies have also identified behavioral biases and cognitive constraints in information processing which affect decision making (see for example, [Maines and McDaniel, 2000](#); [Libby et al., 2002](#)).

In this study, we examine whether cross-country cultural differences in individualism and uncertainty avoidance in the studies of [Hofstede \(1980, 2001\)](#) can explain the information content of international stock markets.¹ We first show that individualism and uncertainty avoidance closely relate to several behavioral biases that are widely discussed and examined in accounting and finance studies. These biases include over-confidence, self-attribution, and conservatism. We also show that these cultural dimensions capture varying risk preferences. We demonstrate that behavioral biases and risk preferences can influence how international investors act on firm-specific information and propose that individualism and uncertainty avoidance indexes can therefore explain the information content across international stock markets.

We employ several measures that capture both the long-term and short-term information content of stock markets. To measure the long-term quality of the information content, we estimate R^2 from the market model as in [Morck et al. \(2000\)](#) for each country. This measure is designed to distinguish the diffusion of firm-specific information versus market-wide information into stock prices over a long-window estimation. A low R^2 estimate suggests a low explanatory power of the market model or a low synchronicity between a typical stock and the market for that country. This indicates a better information environment as stock prices on average incorporate more firm-specific information. To examine the short-term information content of firm-specific information disclosures, we choose to study earnings announcements. Specifically, we compute abnormal return variance and abnormal trading volume in the days around earnings announcements as in [Landsman and Maydew \(2002\)](#) to proxy for the informativeness of annual earnings announcements in each country. Our sample includes 151,394 annual earnings announcements across 42 countries and the sample spans the period 1990–2006.

First, [Hofstede \(1980\)](#) refers to individualism as the extent that individuals in a culture focus on self-images, self-attributes, or self-abilities and the extent that individuals differentiate themselves from others. The psychology literature suggests that investors from individualistic countries are more likely

¹ The study of [Hofstede \(1980\)](#) defines five dimensions in cultures, namely individualism, uncertainty avoidance, masculinity, power distance, and long-term orientation. Among these dimensions, individualism and uncertainty avoidance are most closely related to behavioral biases often discussed in accounting and finance studies. The indexes of individualism and uncertainty avoidance are also available for the widest range of countries and constructed from the largest number of respondents in the survey ([Kagitcibasi, 1997](#)). In this study, we aim to examine the associations between individualism, uncertainty avoidance and the level of information content of earnings announcements in the international markets.

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