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What determines mutual fund trading in foreign stocks?

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A B S T R A C T

We examine the portfolio rebalancing, measured by the equity churn rate, of mutual funds from 29 countries based on annual stockholdings over the 1999–2006 period. We find that funds more often trade the stocks of companies located in countries with higher degree of information asymmetry and are less familiar to fund managers, after we control for the effects of stock market development and investor protection. Consistent with the behavioral bias, fund managers more often rebalance stocks in foreign markets that perform well. This bias is exacerbated when fund managers are less familiar with and less informed about those markets.

1. Introduction

There is a vast body of literature documenting disproportional allocation to domestic versus foreign equities by investors – a phenomenon known as home bias – as investors tend to put a relatively large fraction of their wealth into domestic markets, despite the benefit of international diversification. A number of papers show that home bias is related to information asymmetry between domestic and foreign investors (Kang and Stulz, 1997; Brennan and Cao, 1997; Coval and Moskowitz, 1999; Ahearne et al., 2004) and the familiarity of investors with foreign markets (Grinblatt and Keloharju, 2001; Chan et al., 2005).[1]

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[1] Some other explanations include the barriers to international investment (Errunza and Losq, 1985), departures from purchasing power parity (Cooper and Kaplanis, 1994), and hedging of human capital or other non-traded assets (Obstfeld and Rogoff, 1998), although there is little empirical support.

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In contrast, there is relatively little research into how often investors rebalance their domestic and foreign holdings and whether home bias affects the trading turnover of foreign holdings. Based on cross-border capital flows in five Organisation for Economic Co-operation and Development (OECD) countries, Tesar and Werner (1995) find that the turnover rate in foreign equities is 10 times greater than that in domestic equities. However, using data on gross transactions in foreign equities available from the United States and Canada, Warnock (2002) finds that investors turn over their foreign portfolios only slightly faster than their domestic portfolios. Nevertheless, both studies are confined to a few developed countries, and do not provide a cross-country comparison of trading in foreign equities.

In this paper, we employ a rich and interesting dataset that contains the equity holdings of mutual funds from 29 countries, with a breakdown of their annual portfolio composition across 48 countries from 1999 to 2006. Using stockholding data recorded on an annual basis, we compute the portfolio churn rates based on changes in equity holdings in consecutive years. For each mutual fund, we calculate a churn rate for each country in which the fund is invested. We find that the average churn rate of domestic equities is lower than that of foreign equities, which is consistent with previous findings that investors turn over foreign stocks more frequently than domestic ones.

The major contribution of this paper is its explanation of the potential determinants of mutual fund churn rates across different foreign countries. While considering a number of country characteristics, we are particularly interested in examining whether information asymmetry and familiarity, the two effects that have been shown to affect the holdings of foreign equities in the global portfolio, will also affect the frequency of rebalancing foreign securities. As discussed before, information asymmetry and familiarity are two commonly cited obstacles that investors face when investing in foreign markets. In the case of information asymmetry, foreign investors are discouraged from investing abroad because they have less information than do locals about domestic securities,[2] whereas a lack of familiarity with a foreign market also discourages investors from investing in that market. Although familiarity is related to information asymmetry, evidence indicates that it is psychologically based, as investors are influenced by language and culture (Grinblatt and Keloharju, 2001), geographical proximity (Coval and Moskowitz, 2001; Zhu, 2002; Ivkovich and Weisbenner, 2005), and immigrant origin (Bhattacharya and Groznik, 2008).

We use a number of country-level variables to examine the effects of information asymmetry and familiarity on the rebalancing of foreign securities. Regarding the information asymmetry effect, we hypothesize that churn rate is negatively related to the quality of information disclosure of the foreign country. We posit that the lower the quality of information disclosure in a foreign country and the greater the information asymmetry that fund managers face, the more frequently fund managers will rebalance equity holdings in that country. Regarding the familiarity effect, we examine the closeness between a mutual fund's home country and the target country in which it invests by considering several factors: the existence of a common language, geographical proximity, and the amount of bilateral trade between the two countries. We posit that the closer two countries are to each another, meaning that fund managers are more familiar with the target country, the less frequently the fund managers will rebalance those foreign holdings. In addition to the variables associated with information asymmetry and familiarity, we include other country-level variables to control for other effects, including stock market development, investor protection, market returns and volatility. This allows a comprehensive analysis of the factors that affect the propensity of mutual fund managers to rebalance their foreign holdings.

The major findings of the paper are that the churn rates are higher for the stocks of companies located in countries that have more asymmetric information and are less familiar to fund managers, which represent new set of results in the international finance. The effect of familiarity is especially interesting because it extends previous U.S. studies that document that the length of time that investors hold stocks depends on how much they know about them. For example, Coval and Moskowitz

[2] A few papers show that foreign investors earn lower trading profits than do domestic investors, thus providing direct evidence that domestic investors have an information advantage over foreign investors. See Hau (2001) for Germany, Choe et al. (2005) for Korea, and Dvorak (2005) for Indonesia.