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# Institutional shareholdings and the January effects in Taiwan

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ABSTRACT

Many studies have documented the "January Effect" across stock markets. In this paper, we investigate the existence of a January Effect in the Taiwanese market. We document a statistically significant January return, consistent with previous research. However, we also document a new pricing anomaly that appears to exist during the post-liberalization "Great Recession" period of 2005–2010, namely, a "Reverse January Effect", of statistically significant lower returns during January. Furthermore, we examine the role of three types of institutional investors, and their differential impact on market efficiency in Taiwan. Our results indicate that for the overall time period, foreign institutional investors and domestic investors mitigate the January effect, whereas domestic trusts do not. However, when we segment across time periods, we find that pre-liberalization, when foreign institutional ownership was low, only the domestic institutions promoted efficiency by reducing the January effect. In the 2005–2010 post liberalization period, we find that while FIIs reduce the magnitude of the "Reverse January Effect", domestic institutions exacerbated it. Domestic trusts appear to have no impact on the January Effect. Taken together, our results provide interesting insights into liberalization and emerging markets. We find that an explanation for the January Effect is related to the participation by various types of institutions in the market.

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Further, it appears that foreign institutions require a learning curve in terms of efficient pricing, but that greater foreign institutional ownership can ultimately promote greater market efficiency.


## 1. Introduction

Due to the increasing globalization of financial markets over recent years, there has been an explosion of cross-border portfolio investment. According to the International Monetary Fund,[1] foreign holdings of equity securities in 74 counties amount to a total of $30 trillion at the end of 2008, close to six times the total of 2001. Leading the charge of these equity investments have been institutional investors. Mostly from OECD countries[2] with huge funds to invest, these foreign institutional investors (FIIs) are welcomed by recipient countries, especially those in the emerging markets aspiring to be integrated into global financial markets. For policy makers in these countries, weighing the benefits of integration against the risks associated with the inevitable free flow of “hot money” in and out of the country, one issue of interest is the impact that sophisticated and well-resourced FIIs may have on their markets.

In markets that are dominated by individual retail investors who tend to trade on noise, one desirable potential impact of greater foreign institutional investment is the improved market efficiency, defined as market prices reflecting information rather than noise. Presumably, such improvement is possible because of the rigorous fundamental analysis underlying FIIs’ long-term investments. The purpose of this study is to explore this potential impact in Taiwan by examining the relationship between FII investment and the presence of seasonal anomalies, one most investigated market efficiency topics.

Taiwan’s stock market offers many advantages to examine this relationship with the most recent data. First, it has been among the countries with the greatest weight in the MSCI Markets (EM) Index,[3] second only to South Korea until 2006 when China and Brazil climbed to the top in the index.[4] Given the status of EM as the most tracked emerging market index, many managed funds including top exchange traded funds (ETFs) allocate significant portions of their assets into Taiwan’s market, making Taiwan valuable as a candidate for examining FIIs’ impacts on emerging markets. Second, long being one of the most liquid markets with consistently high turnover[5] and dominated by individual investors, the complete removal in July 2003 of all restrictions on foreign equity investment results in a doubling of FII shareholdings from 5.2% in 2001 to 11.6% in 2007. This increase of 6.4% in shareholdings by FIIs is more than the corresponding increase of 5.6%, from 7.9% in 2001 to 13.5% in 2007, in total shareholdings by all institutions, domestic and foreign together, indicating shareholdings by domestic institutions actually declined modestly during this period.

With FIIs being the primary institutional investors it is plausible that they are also the driving force behind some of the changes in the market, including those related to the seasonal anomalies during this period. Finally, the absence of capital gains tax in Taiwan effectively eliminates the tax-loss selling of individual investors as an explanation for the January effect (e.g., Sias et al., 1997; Poterba and Weisbenner, 2001; Grinblatt and Moskowitz, 2004; Starks et al., 2006) and renders institutional

[1] See Geographic Breakdown of Portfolio Investment Assets: Equity Securities, Year-Ends 2001 and 2008, IMF.

[2] Based on the same source as in Footnote 1, at the end of 2008 the top 10 investing countries are all members of the OECD, accounting for over 75% of the total global equity investment.

[3] For example, as of 9/30/2010, SPDR S&P Emerging Asia Pacific ETF allocates 30.4% of its assets to Taiwan’s market, and Taiwan’s weight in the two most popular emerging markets ETFs, iShares MSCI Emerging Markets Index Fund (EEM) and the Vanguard Emerging Markets Stock Index Fund (VWO) is 10.24% and 11.3%, respectively.

[4] According to MSCI, the weight ranges from 12.20% in 2003, the third highest, to 14.48% in 2005, the second highest. It is 11.36%, ranked number 4, in 2009.

[5] Based on the press release by Taiwan Stock Exchange (TWSE) on July 19. 2010, TWSE is ranked 21st in the world in terms of market capitalization (US$659 billion) and 15th in accumulated trading value (US$289 billion) as of April 2010. Its average daily turnover is ranked 7th in the world.