



# Political conflict and foreign portfolio investment: Evidence from North Korean attacks☆



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## ABSTRACT

We examine the response of foreign investors to escalating political conflict and its impact on the South Korean stock market surrounding 13 North Korean military attacks between 1999 and 2010. Using domestic institutions and domestic individuals as benchmarks, we evaluate the trading behavior and performance of foreign investors. Following attacks, foreigners increase their holdings of Korean stocks and buy more shares of risky stocks. Performance results show foreigners maintain their pre-attack level of performance while domestic individuals, who make the overwhelming majority of domestic trades, perform worse. In addition, domestic institutions improve their performance. Overall, the results are consistent with the predictions based on the benefits of international diversification. Unlike domestic individuals, foreigners trade more shares than usual and deviate from their general strategy of positive feedback trading.

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## 1. Introduction

Emerging market economies command increasingly greater weight in foreign investment portfolios, making foreign investors more susceptible to the risks associated with politically or economically fragile regimes. Political conflicts are common in many areas of the world, including large parts of Africa, Asia, and the Middle East. Accordingly, a growing literature has examined the economic effect of war, terror, and more generally, political instability, providing insight into the impact of political conflicts on the economy and financial markets.<sup>1</sup> However, previous studies tend to focus on the aggregate effect and do not distinguish the roles played by foreign and domestic investors. A host country's political risk may have different implications for foreign investors than for domestic investors, leading them to respond differently. Thus, the role foreign investors play in the local equity market subsequent to political conflicts can be very different from what is implied by the effects aggregated over all investor types. The literature on international capital flows suggests that foreign and domestic investors can be motivated by different factors (e.g., Forbes and Warnock, 2012; Rothenberg and Warnock, 2011). A decomposition into foreign and domestic investors not

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<sup>1</sup> See Section 2 for a review of relevant literature.

only provides insight into foreign portfolio investment decisions but also has policy implications in that a different policy response may be required depending on whether an observed pattern is driven by foreigners or domestic investors. Our study attempts to fill this gap in the literature by analyzing the behavior of foreign investors separately from that of domestic investors surrounding events that escalate geopolitical risk on the Korean peninsula.

Since the Korean War ceased in 1953 without a peace treaty,<sup>2</sup> North Korea has intermittently initiated military conflicts such as border fights and naval battles. These abrupt attacks raise concerns about the possibility of an all-out war between the two Koreas. Increased instability in the region can discourage corporate investment and domestic consumption, which in turn can hurt equity markets. According to the *Wall Street Journal*, political instability is one of the reasons why Korean stocks trade at the lowest valuation among Asia's major markets – about eleven times expected earnings in 2010.<sup>3</sup> However, North Korean risk is not limited to domestic investors in the Korean markets. The reclusive state also poses a potentially serious threat to neighboring countries such as Japan and Taiwan. Furthermore, today's interconnected economies and well-diversified foreign portfolio investment imply that North Korea poses real political risk to many investors around the world. Indeed, Nomura Securities ranked the inter-Korean tension as the world's 5th most serious geopolitical risk in 2012.<sup>4</sup>

The conflict between South Korea and North Korea presents a unique setting to study the impact of political risk on stock markets. First, the timing of the North Korean attacks is largely exogenous from the perspective of investors. As we discuss in Section 3.3, the attacks are to some extent predictable, but there is still a lot of uncertainty about their exact timing and magnitude. Unlike some cases of increased political risk in which economic factors may have contributed to the political conflict, the attacks seem to be driven mostly by internal political processes in North Korea. Given that the country is insulated from the rest of the world, it is highly unlikely the timing of the attacks is influenced by developments in the South Korean stock market. Second, political events around the world tend to be unique in nature and one-off developments, making it difficult to obtain reliable results based on an extended period of time-series data. North Korean attacks are different in that they are recurring events with 13 attacks during the sample period of 12 years. Third, unlike many political crises in which the precise starting date is hard to pinpoint (e.g., Willard et al. (1996) and Zussman et al. (2008)), these military attacks are observable; thus the exact timing of attacks can be identified.

Our investigation uses a novel data set. The Korean stock market makes publicly available daily transactions data aggregated by three investor types: foreigners, domestic institutions, and domestic individuals. The breakdown into different investor types allows us to analyze the difference in difference by evaluating foreigners' behavior before and after the attacks relative to that of domestic investors. Because foreign investors tend to be large institutions, having two sets of benchmarks, domestic institutions and domestic individuals, also helps pin down whether the observed trading patterns of foreigners are attributable to foreign characteristics or institutional characteristics. In addition, the Korean stock market is an attractive testing ground for several reasons. First, the market imposes no restrictions on foreign ownership during our sample period of 1999 through 2010. Second, the market has a high level of foreign participation with foreign ownership representing 32.9% of total market capitalization in the KOSPI market, South Korea's main stock exchange in 2010 year-end. Third, the Korean stock market is large and liquid, with its annual turnover the 9th highest in the world and its total market capitalization the 17th highest in 2011. In sum, we have a unique setting for testing how foreign investors respond to unexpected and repeating political conflicts.

Since our analysis is primarily focused on the response of foreign investors, it requires a sample of stocks with nontrivial foreign ownership. While the average foreign ownership stake in Korean stocks is high, the size of foreign ownership varies substantially across stocks. Kang et al. (2010), for example, document that half of the stocks listed on the Korea Stock Exchange have foreign ownership of less than 1% for the 2000–2004 period. As such, an equal treatment of all Korean stocks cannot provide an accurate assessment of the behavior of international investors. We consider stocks that were included in the Morgan Stanley Capital International (MSCI) Korea index in 2010 because having greater representation in the MSCI Index tends to drive investment by foreigners (Ferreira and Matos, 2008). Excluding the stocks with missing transactions information results in the final sample of 53 Korean stocks. The 53 sample stocks, which constitute more than half of KOSPI's total market capitalization, closely track the market around the attacks. The KOSPI and sample stock average daily returns are  $-0.78\%$  and  $-0.85\%$ , respectively, on attack days. In dollar terms, KOSPI's market capitalization drops by an average of \$4 billion, roughly 0.5% of the country's GDP, on days of North Korean attacks during our sample period. This is substantial considering that it represents a drop in one day. Not surprisingly, regression analysis reveals that the sample stock returns become positively correlated with the size of stocks following attacks, suggesting flight to safety.

We use this unique setting to understand what drives foreign investors' trading strategies and performance during attacks. The home bias literature suggests that local investors are endowed with superior information about companies located in close geographic proximity, and that this information asymmetry leads to a bias in their investment portfolios (e.g., Brennan and Cao, 1997; Gehrig, 1993; Coval and Moskowitz, 1999, 2001). Kang and Stulz (1997) further show that home bias may manifest in a foreign country in the form of higher holdings of large firms by foreign investors than suggested by market portfolios. That is, domestic investors may have more information about the companies headquartered in Korea, allowing them to evaluate the effect of political risks on operations and profits of these firms better. We then would expect foreigners to reduce the size of their Korean portfolios following attacks, and to shift their portfolio weights among Korean stocks toward larger firms where the information asymmetry problem is less severe. Alternatively, foreigners may demand more risky stocks to realize the well-documented

<sup>2</sup> The Korean War started when North Korea invaded South Korea in 1950. Fighting ceased in 1953 with an armistice that restored the border between the two Koreas near the 38th Parallel and created the Korean Demilitarized Zone (DMZ), a buffer zone between the two Koreas. Technically, the two Koreas are still at war.

<sup>3</sup> *The Wall Street Journal Online*, Mohammed Hadi and James Simms, "As ties go south, Korean investors shrug," 24 November 2010.

<sup>4</sup> Nomura Securities International Inc., 2011, Global FX Outlook 2012.

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