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Firm headquarters location, ownership structure, and stock return co-movements

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ABSTRACT

This paper investigates the link between firm headquarters location and its stock return co-movements in a full sample of Chinese listed firms from 1999 to 2007. The empirical results show a significant stock return co-movement pattern for firms located in the same province. And both firm-level factors, such as firm size and ownership structure, and provincial-level factors, including GDP per capita and the number of firms in a province, are found to be influential to this pattern. Moreover, results from a subsample of firms listed in the Shenzhen Stock Exchange show a reduction of local co-movement when firms have better information quality.

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1. Introduction

Local bias, defined as the preference for investors to hold local companies, has been well documented in many studies.[1] It implies that local investors try to obtain higher stock returns by exploiting local information (Gomez, Priestley and Zapatero, 2012). Current literature tries to explain this phenomenon from different aspects, such as local fundamentals and geographic segmentation (Coval and Moskowitz, 1999; Ivkovic and Weisbenner, 2005; Pirinsky and Wang, 2006; Almazan et al., 2010), information

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[1] For instance, Coval and Moskowitz (1999) and Pirinsky and Wang (2006) for the US; Grinblatt and Keloharju (2001) for Finland; and Massa and Simonov (2006) for Sweden.

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asymmetry (Coval and Moskowitz, 1999; Davis and Henderson, 2004; Ivkovic and Weisbenner, 2005; Malloy, 2005), and investor interaction (Benatzi, 2001; Hong et al., 2003, 2004).[2]

There has not been consensus as to the impact of localism on the price of shares and the covariance structure of stock return. For instance, Seasholes and Zhu (2010) find no evidence to support the role of individual value-relevant information in local stocks, while Ivković and Weisbnner (2005) document a strong preference of household to local investments. In addition, Hong et al. (2008) document empirical findings consistent with the presence of local bias, and Bodnaruk (2009) states that investors sell shares of a firm if they move away from the location of the firm. This paper tries to shed additional light on this issue by investigating the local co-movements of stock return of Chinese listed firms, an important market in the word today and surprisingly be ignored in previous studies. A further elucidation of this issue can facilitate a better understanding of the existence of local factors in asset pricing in emerging markets in addition to developed markets, and it is important for portfolio decisions, capital evaluations and performance assessments (Pirinsky and Wang, 2006).

Examining the stock market in China is important for at least three reasons. Firstly, the existence of specialization and inequality across Chinese regions provides a good opportunity to investigate this issue. The highly segmented Chinese stock market exhibits some unique characteristics comparing to the other more integrated and developed markets, such as stock market in the US. For example, many of the public firms in China localize their product operations in the headquartered provinces, where their information mainly comes from and makes influences to. In addition, government-owned firms are more closely connected to the local government, since their management teams are appointed by local governments, while listed private firms have to make all kinds of efforts to build connections with the local government to facilitate their local operations. Moreover, in China, economic activities are managed and planned at the provincial level, under the guidance of the Chinese central government, so that each province has a relatively independent social and economic integration. Under the current local government official promotion criteria, provincial government tries hard to promote GDP in its jurisdiction and local protectionism is easily promoted. As can be seen from the above arguments, the cross-region social integration level is lower in China than in other developed markets. Young (2000) argues that China is "a fragmented internal market with fiefdoms controlled by local officials" (p1128), and Poncet (2001, 2005) also confirms that China's domestic fragmentation across different provinces is great. Bai et al. (2004, 2008) find that local protectionism is a major factor contributing to China's regional specialization, and Tsui (2007) studies the forces to cause the interprovincial inequality in China. Secondly, stock market in China is in a developing stage, which has lower quality of accounting information disclosure and lower transparency of firm's operations because of the lack of powerful legal regulations and consensus of investor protection. Meanwhile, the corporate governance in China is generally poor (Allen et al., 2005). All of the contributing factors make the study informative to both domestic and international investors who intend to invest in the Chinese market. Thirdly, the ownership structure of Chinese firms is unique. Chinese government owns approximately two-thirds of listed companies and it leads to the majority of outstanding shares to be non-tradable, so that the stock market in China is heavily segmented before the end of 2005. The segmentation of the Chinese stock market is further evidenced by the separation of A-shares (tradable for Chinese domestic investors only) and B-shares (tradable for foreign investors only before February 19, 2001). Foreign investors in China face a quite different investment environment compared with those in other countries, because of the strong policy constrains applied by the Chinese government toward foreign capital.

The empirical results, based on a full sample of all Chinese publicly listed firms from 1999 to 2007, show a strong co-movement pattern of stock returns for firms located in the same province, and foreign ownership influences this local co-movement.[3] This demonstrates the severe segmentation of Chinese markets at provincial level, reflected on localization of operations, information products, and the close connections of local firm

[2] A similar phenomenon called home bias in the international context, is well examined by Aggarwal et al. (2005), Chan, Covrig, and Ng (2005) and Beneish and Yohn (2008). Theoretical study of Nieuwerburgh and Veldkamp (2009) argues that home investors benefit from the information asymmetry.

[3] This paper measures local co-movement as the time series sensitivity of a firm's stock returns to a local index incorporating all firms with headquarters in the same province and excluding the foreign ownership firms. When estimating beta, the overall market and the relevant industry indices are controlled to take into account the joint clustering effect of geography and industries (Glaeser et al., 1992; Pirinsky and Wang, 2006).

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