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# Do foreign investors improve informational efficiency of stock prices? Evidence from Japan<sup>☆</sup>



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### ABSTRACT

This study investigates the impact of foreign investors on the informational efficiency of stock prices in local markets. Using a large sample of Japanese firms over the period 1976 to 2008, we find that prices deviate less from a random walk for stocks with a large change in foreign ownership. This relation is robust to controls for local institutional ownership, stock liquidity, and firm fixed effects. Granger causality tests show that changes in foreign investor trading predict changes in price efficiency in the next period, but not vice versa. Finally, we use a quasi-natural experiment to show that an increase in foreign ownership causes an improvement in price efficiency. Collectively, these results suggest that foreign investors improve price efficiency in local stock markets.

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## 1. Introduction

After waves of financial liberalization, foreign investors become increasingly important players in most equity markets. Prior studies have documented various benefits of opening a market to foreign investors, such as lower cost of capital (Henry, 2000a), higher economic growth (Bekaert et al., 2005, 2011), and better corporate governance practices and higher valuations for firms (Aggarwal et al., 2011).<sup>2</sup> In a recent study, Bae et al. (2012) show that in emerging markets share prices respond in a timelier manner to global

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<sup>2</sup> Some researchers find that trading by foreign investors increases price volatility (Bae et al., 2004) and reduces stock liquidity (Rhee and Wang, 2009), but the evidence is inconclusive since recent studies show that foreign institutional investors might actually decrease price volatility (Li et al., 2011) and improve stock liquidity (Wei, 2010).

information for stocks more accessible to foreign investors. Their results suggest that foreign investors facilitate the transmission of global information across stocks in emerging markets.

This study adds to the literature by investigating the impact of foreign equity investors on the informational efficiency of stock prices in a developed market. Building on prior research, we posit that foreign investors are likely to improve the stock price efficiency in the local market in two perspectives. First, foreign investors could directly facilitate the incorporation of value-relevant information into stock prices via their informed trading. The evidence in [Bae et al. \(2012\)](#) implies that foreign investors help incorporate the global information into stock prices and improve the price efficiency in local markets. Furthermore, foreign investors, mostly institutional investors, are likely to be sophisticated arbitrageurs who eliminate possible mispricing, making the share prices to more closely track the fundamental value. In a closely related study, [Boehmer and Kelley \(2009\)](#) find that more active institutional trading is associated with more efficient stock prices in the U.S. market.<sup>3</sup>

Second, foreign investors could help improve the price efficiency indirectly via enhanced corporate governance. Foreign investors, especially those from countries with strong shareholder protection, could promote the corporate governance practices in the invested firms ([Kho et al., 2009](#); [Aggarwal et al., 2011](#)). Enhanced corporate governance helps restrain insiders and controlling shareholders from expropriating other shareholders and thus encourages sophisticated investors to engage in information discovery and informed arbitrage, which results in more efficient stock prices ([Fan and Wong, 2002](#); [Morck et al., 2000](#)).

We empirically test the informational role of foreign investors using a sample of Japanese stocks from 1976 to 2008. The choice of the Japanese stock market is based on the following considerations. First, as one of the most important stock markets in the world, Japan's stock market shares many characteristics, such as systematic regulation and dominance of institutional investors, with other developed markets. We expect the findings in this study to have general implications for other developed markets and thus complement the evidence from the emerging markets as in [Bae et al. \(2012\)](#). Second, Japan happens to be the only developed market with publicly available data on firm-level foreign ownership for a long period ([Kang and Stulz, 1997](#)). Finally, for Japanese firms we can also obtain data on firm-level ownership by local institutional investors. Since local institutional investors are shown to be related to stock price efficiency in previous studies (for example, [Jambalvo et al., 2002](#); [Boehmer and Kelley, 2009](#)), it is important to control the impact of local institutional investors in order to avoid potential biased inferences and erroneous conclusions.

Following [Boehmer and Kelley \(2009\)](#), we measure stock price efficiency based on the deviation of stock prices from a random walk. Modeling efficient prices as a random walk is appealing because it is consistent with the basic idea of Efficient Market Hypothesis (EMH): if prices follow a random walk, prices are unpredictable. Prior studies have widely used random walk models to test EMH (see, for example, [Lo and MacKinlay, 1988](#)). Following the literature, we construct the following two measures of informational efficiency of stock prices based on serial correlations of stock returns. The first measure is the absolute value of the first order autocorrelation coefficients of stock returns. The intuition for this measure is if prices follow a random walk, returns should not be auto-correlated. The second measure is based on variance ratios of stock returns at various horizons. Random walk models imply that the variances of stock returns are additive over time. Therefore, the ratio of multi-period return variance (deflated by the number of periods) to one-period return variance should be one. Based on this implication, we use the absolute value of the difference between one and variance ratios as our second measure of stock price efficiency. For both measures, the higher the value, the less efficient the stock prices, and thus they are termed as 'price inefficiency measures' below.

Using a comprehensive sample of Japanese firms from 1976 to 2008, we find a robust negative association between price inefficiency measures and the absolute change in foreign ownership. This negative association holds after we control for other potential determinants of price efficiency such as the level and change in domestic institutional ownership, firm size, stock price level, and liquidity. There is evidence that the absolute change in domestic institutional ownership is also negatively related to price inefficiency measures. To facilitate the comparison of regression coefficients, we standardize variables to have a mean of zero and a standard deviation of one. The results suggest that the contribution of foreign investors to price efficiency is comparable to that of local institutional investors. To the extent that annual

<sup>3</sup> Studies based on the U.S. market also show that institutional investors trade aggressively to exploit mispricing ([Campbell et al., 2009](#), [Ke and Ramalingegowda, 2005](#)) and mitigate stock return anomalies such as post-earnings announcement drift ([Bartov et al., 2000](#)). [Brockman and Yan \(2009\)](#) show that block ownership is associated with more informative stock prices in the U.S.

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