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Global Investors and Foreign Ownership Linkage

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As the world becomes more integrated, the amount of foreign investment has grown accordingly. We have seen rapid growth of foreign ownership in many countries over the last two decades. As a result we see greater attention being placed on the actions of foreign investors. For example, foreign investment in Korean equity market grew to more than 30% of total market capitalization at present from almost zero in early 1990s. News on Korean stock market almost always cites how foreign investors traded during the day and discusses the possible reasons for their actions.

Despite the level of attention given to the foreign investors by the media and policy makers, traditional asset pricing theories and empirical studies mainly focus on fundamentals. International stock returns were usually understood by its originating country characteristics (country factor) or its industry compositions. In view of traditional theories, actions by any type of investors, including foreigners, could only deviate the fundamental value of a stock for a short period of time.

However, there is more than enough evidence that the actions taken by investors have significant effects on asset prices for a prolonged period of time. For example, asset fire sales or forced sales often push prices below the fundamental values for significant durations. Another interesting example is the relationship between investor's classification of stocks and co-movement of the stock returns—grouping of stocks into categories by investors is known to explain part of the excessive co-movement in stock returns. Also, it was found that increased foreign investor participation in Japanese equity market was associated with last year's rally while it had little to do with domestic demands of the stocks.

Consequences of investors' actions have become more important and increased activities by foreign investors lend itself as an interesting topic for research. Söhnke Bartram, John Griffin, David Ng, and I have extended this line of literature by focusing on the role of foreign ownership. We find that foreign ownership linkage is very important in explaining international stock returns and that our results provide a useful guideline in constructing a well-diversified international portfolio.

To quantify the foreign ownership linkage effect, we first measure the magnitude of linkage between two stocks that are formed by institutional ownership. We say two stocks in two countries are ownership-linked by an institution, if the institution holds the two stocks at the same time. In other words, the institution is a common owner of the two stocks. We also define that the ownership link is stronger if there are more common owners holding the two stocks. This particular structure of the linkage is then summarized for each stock over all ownership linked stocks that are foreign to the stock. This summary is designed to emphasize the stocks that are closely linked in terms of common ownership, therefore it would capture the ownership linkages formed by global investors.

Using the new summary measure, we get several interesting findings. First, we find that foreign ownership is important even after controlling for traditional fundamental factors. Second, the ownership linkages formed by global institutions and mutual funds are the most important types of institutions. Third, including a stock that has a large ownership linkage to a portfolio does not help diversifying the portfolio return.

The fact that foreign ownership linkages are important is interesting because it implies that the returns of two fundamentally unrelated stocks can move together if they share a lot of common ownership. This also sheds light on one of the mechanisms of contagion between seemingly unrelated stocks. Moreover, the findings suggest that investors may better understand potential risks of the stock's return by paying attention to the risks of ownership linked stocks.

We may also test several channels through which the ownership linkages affect stock returns. Distinguishing the types of ownership linkages that are the most significant enables us to sort out the most probable underlying mechanism. Our results show the most important type of institutions through which foreign ownership-linkage is formed are global mutual funds that invest all around the world and moves capital at short notice with little restriction.

We also discover a negative relationship between the foreign ownership-linkage and portfolio diversification benefits. Stocks that are highly ownership-linked with a portfolio are likely to co-move with the portfolio, thus there is not much of a diversification benefit by including the stock. In order to gain the most effective diversification, one needs to select stocks that are not fundamentally linked with the portfolio at the same time does not have significant ownership-linkages with the stocks in the portfolio.

Admittedly, ownership linkages between assets may be complex and not so easy to understand. However, the benefits are substantial. I believe by understanding the ownership-linkage structure we could gain better insight on the asset return co-movement, contagions, as well as behaviors of foreign investors. Such insight would help investors to make wise investment decisions and also serve policy makers to create and implement well designed policies. KIEP