

Chapter 1 : Home bias and high turnover reconsidered - CORE

Home bias and high turnover reconsidered Francis E. Warnock — Board of Governors of the Federal Reserve System, Division of International Finance, Washington.

Introduction Since June , global finance has faced a crisis of great magnitude. The subprime financial crisis, initially regarded as a crisis of the US housing market, soon spread to the international financial system confirming the globalization of equity markets. If the globalization of stock markets and ICT information and communication technologies enable investors to invest in all markets, globalization does not prevent them from developing local strategies. Indeed if capital flows theoretically can be invested everywhere global strategies , the distribution of capital flows in global markets reveals their concentration in some markets financial centers [1] [2]. Generally, to understand several aspects of investor localization strategies, standard portfolio models are used but they present some limits. Indeed, according to these models, assets are purchased on the basis of investor analysis regarding the return and risk of these assets and the covariance of these returns with other financial assets in the investment portfolio [10]. The capital asset pricing model CAPM is the most widely used tool in asset pricing theory and implies that investors select optimal portfolios that either minimize the variance of portfolio return, given expected return, or maximize the expected return, given variance. In the framework of CAPM model, rational investors who focus on risk-return factors should maximize international portfolio diversification without regard for the origin of the securities held. Prospect theory and behavioral portfolio models make different predictions. Contrary to standard financial models that postulate rationality on the part of investors, prospect theory considers that investors are not effective decision makers under risk and uncertainty [11]. Although the CAPM model enables investors to choose optimal portfolios, behavioral portfolio models state that investors are sensitive to the context in which they find themselves and may be characterized by heuristical traits such as overconfidence, extrapolation, or making frequency judgments based on salience or similarity [12]. Despite the supposed benefits of diversifying into foreign markets, investors from all over the world tend to be biased toward investing in domestic equities. Even in a context of decline in barriers to international investment, investor portfolios are less diversified than the standard model of asset location would predict. Investors neglect fundamental principles of portfolio diversification by favoring proximate assets and markets: There is a large literature on the home bias phenomenon highlighting an [over-representation of domestic investments to the detriment of international portfolio diversification [13] - [23]. Our study lies in the tradition of these works on home bias, but it is original because we seek to analyze the influence of geography on the investment strategies of investors according to their investment time horizons measured through their portfolio turnover. In particular, we question the preference of mutual funds for some specific markets. They are considered to be key actors in global stock markets because of their common expectations regarding standards of disclosure, transparency, and their requirements for shareholder value [6] [24] - [27]. A majority of the studies have emphasized that these investors expect increased returns on invested capital in a shorter time period [5] [28] - [32]. Our study focuses on the geographical location of assets managed by worldwide mutual funds and particularly on impatient mutual funds, that is, investors whose portfolio turnover is less than one year. These short-term investors, who are regularly identified by the economic and financial press and accused of favoring volatility in equity markets, often sell their stocks before companies have paid dividends and play on differences in stock prices to extract a short-term profit. In particular, we question the determinants of location of impatient mutual funds by focusing on two main questions: The article is organized into four sections. Section 2 introduces theoretical aspects of the importance of geography in global finance and reviews the importance of the institutional framework for understanding the investment behavior of mutual funds. Section 3 presents a sample of 22, worldwide mutual funds and the practical results of their global behavior on stock markets in and over the period from to Section 4 presents the methodology used to test the preference of impatient mutual funds for certain stock markets. In particular, we demonstrate that impatient mutual funds prefer investing in large stock markets characterized by the same legal tradition and presence of strategic investors in

ownership structures. When Geography and Institutions Help Explain Investor Behavior We question if local specificity of capital markets can play a significant role in explaining the worldwide allocation of mutual fund portfolios. In particular, we make the assumption that the 6 geography countries and the institutional framework legal regimes of countries and shareholder protection are central elements for understanding the investment behavior of mutual funds. We thus refer to two fields of research to demonstrate the centrality of those two factors: Geography of Global Finance Our study contributes to a growing and recent literature on the economic importance of geography in understanding global finance [5] [33] [34]. The main argument in support of the geography of global finance concerns the exceptional development of stock markets, the importance of capital flows, and the weight of institutional investors in those flows [4] [5] [28] [34] [35]. A large number of studies have highlighted the growth of a financial services industry developed around institutional investors [5] [24] [25] [32] [36] [37]. In this article, we refer to studies that question the behavior of mutual funds and in particular the destinations of their flows. Many studies on the home bias have shown that proximity plays an important role in determining investor portfolio choices: In particular, the study [15] on equity holdings by mutual funds for and reveals that mutual funds prefer investing in stocks with high visibility and low transaction costs and are averse to small firms, low-priced stocks, and stocks with low idiosyncratic volatility. Although this study gives evidence of the ability of mutual funds to select stocks, it says little concerning the geographical dimension. We refer to recent studies that highlight the importance of geography for understanding the investment behavior of worldwide mutual funds. In their study, Coval and Moskowitz [38] documents a geographical link between the investments and performance of mutual funds. Their study shows that mutual fund managers earn abnormal returns in their geographically proximate investments. The authors explain the substantial abnormal return by the information mutual funds may have acquired about local companies: The study of Coval and Moskowitz [38] concludes that the extent to which a company is held by nearby investors is positively associated with its future expected returns, attesting to an informational link between geography and investment decisions. They demonstrate that geography helps explain the decisions of mutual fund managers: In particular, they notice important differences between Anglo-Saxon markets and continental European markets that influence the investment strategies of mutual funds. Their study also questions the relationship between European stockholder ownership and the volatility of corporate stock market prices. They document a negative relationship between European stock price volatility and ownership concentration, proving once again the importance of geography. They demonstrated that closed ownership structures promote higher volatility in quoted market prices and that the incursion of global portfolio managers into European stock markets has had significant effects on corporate governance. If all these studies have highlighted the importance of geography in understanding mutual fund behavior on stock markets, very few have asked this question in relationship to the portfolio turnover of mutual funds. The oldest study is by Tesar [14] who found that the turnover for international investments of US and Canadian funds is ten times higher than in domestic shares. However, using data on gross transactions in foreign stocks available in the United States and Canada, Warnock [41] relativized this work by showing that the turnover is slightly higher than abroad. Two recent studies have addressed these issues with two different approaches to the turnover. Dupuy, Lavigne, and Nicet-Chenaf [32] studied the portfolio turnover of 11, mutual funds. They tested the relationship among the type of equity investor, its portfolio turnover, and its geographical origin, measured through its attachment to a specific model of capitalism [42]. They demonstrated that US investors are the most volatile and impatient investors in the world and they compared the proximity of investors from different countries with US investors. Dupuy, Lavigne, and Nicet-Chenaf [32] demonstrated that differences in frequency of securities trading are largely explained by the geographical origin of investors, attesting that geography is central for understanding the behavior of key actors on global stock markets. The most recent study is by Chan and Covrig [43] who analyze the behavior of mutual funds in 29 countries over a year period. The main contribution of this study is to show how the asymmetry of information and familiarity affect the portfolio rebalancing of foreign equities. Mutual funds turn over foreign stocks more frequently than domestic ones. Regarding the familiarity effect, they posit that the closer two countries are to each another, meaning that fund managers are more familiar with the target country, the less frequently the fund managers will

rebalance those foreign holdings. They observe that the churn rates are higher for the stocks of companies located in countries that have more asymmetric information and are less familiar to fund managers. Law and Finance Literature The recognition that geography matters leads implicitly to the assertion that the institutional framework laws and their enforcement is central to understand the behavior of investors². A large number of academic works have emphasized the importance of legal systems for understanding differences among countries in terms of stock market development, financing of companies, and standards of corporate governance [44] - [46]. It is recognized that laws and the quality of their enforcement are determinants of 1 the level of development of financial markets, 2 the number of listed companies on stock markets, 3 the ownership concentration in publicly traded firms, 4 the rate of initial public offerings IPOs , or 5 dividend policies, to name just a few examples. The commercial legal systems of most countries derive from specific legal traditions, including, on the one hand, the English common law, and, on the other hand, the French and German traditions deriving from Roman law, with Scandinavian countries forming their own tradition. La Porta et al. In particular, civil law countries exhibit the lowest aggregate anti-director rights score, an index that measures how strongly a legal system favors minority shareholders against managers or controlling shareholders in the corporate decision process³. Common law countries afford the best legal protection to shareholders because they allow investors to vote by mail, never block shares before shareholder meetings, and require only a small share of capital to call an extraordinary shareholder meeting. Although common law countries protect investors better than countries with civil law traditions, German civil law and Scandinavian countries have the best quality of law enforcement, the French civil law system has the worst⁴. Similar to Shleifer and Vishny , La Porta et al. In countries with poor shareholder protection, the largest firms have controlling shareholders, attesting that concentration of ownership is an adaptation to poor legal protection. Mutual funds, which are usually minority shareholders, can exchange stocks only that are not held by strategic investors who can be a family, the state, etc. The Mutual Funds Industry: A Geographically Concentrated Industry Our study covers a sample of 22, international mutual funds investing in 35 countries⁶. Mutual funds are the largest category of institutional investors in financial markets, the major actors on international stock markets [25] and their assets have grown explosively in most countries around the world during the s and the s. The data on mutual funds are drawn from the Thomson One Banker Ownership TOBO database, the leading information source for registering international capital flows and investor equity portfolios across international stock markets. The database provides data for analysts, investment bankers, portfolio managers, and researchers and covers the portfolios of approximately 40, institutional investors from We have selected the largest worldwide mutual funds, i. In accordance with many prior studies on mutual funds, we have restricted our analysis to equity mutual funds. Our sample is composed of equity funds that invest 1 a part of their assets in foreign markets they are not domestic mutual funds ; 2 in all types of company in terms of capitalization; 3 in all types of industry. The data indicate that the mutual funds industry is geographically concentrated in two geographic areas North America and Europe , which accounted for Over the period of analysis , which includes the US subprime crisis, there was a decline in the European share of mutual fund managers: However, there was strong growth in the proportion of funds in two other geographical areas, Asia and Latin America: If we now examine where mutual funds invest, in relation to their country of origin, it is difficult to observe a geographical diversification of their portfolios. Origin of mutual funds by countries. Thomson one banker ownership, Thomson financial, Mutual funds invest as a priority in their own geographic area and especially when they originate from areas with well-developed financial markets Table 2. For South American funds, the relative weakness of the capital invested in their domestic area can be explained by the proximity of the North American market. When we turn to the analysis of where impatient mutual funds invest, we find the same configuration as in Table 1: However, the aim of the study is not to Table 2. Where do Mutual Funds MF invest: Instead, we investigate what kind of country is selected by mutual funds, and especially by impatient mutual funds, when they decide to invest abroad. We now test the following two propositions: These propositions are first tested with two control variables: An Empirical Study In our empirical study we question whether some countries attract more impatient investors and why. We then investigate what kind of criteria geographical and institutional can explain the presence of impatient mutual funds in some specific markets. In

the econometric analysis we consider the US market as a localization reference and we question the investment behaviors of worldwide mutual funds. The empirical analysis involves two steps. First, we question the degree of relationship among investor portfolio turnover, their choices of location in 35 countries⁸, and their portfolio size considered as a control variable portfolio size is labelled EQUITY ASSET. The aim is to question if some markets are preferred by impatient mutual funds and to determine what the characteristics of these markets are.

Chapter 2 : Home Bias and High Turnover Reconsidered - CORE

It is a stylized fact of international finance that foreign equities are underweighted (the home bias) but overtraded (the high turnover). Since stylized facts drive research, theoretical models.

Decomposing International Portfolio Flows. Dataset on capital controls QQ4, 19 countries Burger, J. Analyzing International Bond Portfolios. IMF Economic Review forthcoming. Global Cross-Border Equity Portfolios. Journal of International Money and Finance Workbook available at [http: Journal of International Economics](http://Journal of International Economics) Current Account Sustainability and Relative Reliability. University of Chicago Press, pgs Quarterly Journal of Economics 4: Bond Market Development in Developing Asia. Peterson Institute for International Economics. Developing Housing Finance Systems. International Encyclopedia of Housing and Home, Vol 4. Reducing the currency mismatch: Local currency bond markets and financial stability. Markets and Housing Finance. Journal of Housing Economics Ingredients of a Well-Functioning Capital Market. Local Currency Bond Markets. IMF Staff Papers International Portfolio Allocation Burger, J. Investment in Global Bonds: Economic Policy 30 Journal of Accounting Research 50 5: Dataset on cross-listing and float. Emerging local currency bond markets. Foreign Exposure through Domestic Equities. Finance Research Letters 9: American Economic Review 7: Is home bias in assets related to home bias in goods? Review of Financial Studies 22 8: Financial globalization, governance, and the evolution of the home bias. Journal of Accounting Research Foreign participation in local currency bond markets. Review of Financial Economics Drawing on American Experience: Investors Fared with their Allocations to International Equity? Canadian Investment Review 16 2: Review of Economics and Statistics 84 3: Information costs and home bias: Firm-level access to international capital markets: Emerging Markets Review 4 1: Home bias and high turnover reconsidered. Federal Reserve Bulletin 87 The geography of capital flows. Emerging Markets Quarterly 5 1: Central Bank of Chile. Surges, Stops, Flight and Retrenchment. Journal of International Economics 88 2: Macroeconomic Review X 2 , Oct Sudden flight and true sudden stops. Review of International Economics 19 3: International capital flows and U. Additional analysis of East Asian and petrodollar flows in Kodres, L. The Impact of Petrodollars on U. Current Account Reversals in Industrial Countries: Clarida ed G7 Current Account Imbalances: Journal of Policy Reform 8 2: Financial centers and the geography of capital flows. International Finance 6 1: Two Myths About the U. How Dangerous Is U. The Risk of a Sudden Spike in U. Capital Raising in Emerging Economies. Journal of Financial Economics East Asian Reserves Accumulation and U. The Impact on U. A simple measure of the intensity of capital controls. Journal of Empirical Finance 10 1: Dataset updated through Aug Warnock, F. Exchange rate dynamics and the welfare effects of monetary policy in a two-country model with home product bias.

Chapter 3 : Home bias and high turnover reconsidered

The Tesar-Werner home bias and high turnover puzzle is not evident when more up-to-date and higher quality estimates of cross-border holdings are used. Turnover rates on foreign equity portfolios are much lower than previously reported, and are roughly comparable to domestic turnover rates.

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Chapter 4 : FRB: IFDP paper - number

It is a stylized fact of international finance that foreign equities are underweighted (the home bias) but overtraded (the high turnover). Since stylized facts drive research, theoretical models are now developed to explain the puzzling coexistence of home bias and high turnover, first presented in.

Chapter 5 : CiteSeerX " Home Bias and High Turnover Reconsidered

The Tesar and Werner () finding of very high turnover rates on foreign equity portfolios is based on an underestimation of cross-border equity positions. Foreign turnover rates calculated using information from comprehensive benchmark surveys on cross-border holdings are much lower than.

Chapter 6 : Measures of Equity Home Bias Puzzle - Munich Personal RePEc Archive

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Chapter 7 : CiteSeerX " calendrierdelascience.com HOME BIAS AND HIGH TURNOVER RECONSIDERED

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Chapter 8 : Equity home bias puzzle - Wikipedia

Home Bias and High Turnover Reconsidered Francis E. Warnock (April , latest version December).

Chapter 9 : Research - Frank Warnock

HOME BIAS AND HIGH TURNOVER RECONSIDERED}, year = {} Share. OpenURL. Abstract. NOTE: International Finance Discussion Papers are preliminary materials.