Motivation

Domestic sources of outside finance are limited in many countries, particularly those with emerging markets.

- In response, through capital market liberalization, foreign capital has become an increasingly significant source of finance. ([Henry (2000), Bekaert, Harvey, and Lundblad (2001, 2005)])

But what factors influence whether foreigners provide capital to a country's firms?

- Poor firm-level corporate governance is one factor often mentioned, but it has rarely been investigated in large-scale studies.

We examine: Whether and why investor concern about corporate governance results in fewer foreign holdings.
Motivation

Institutional Investors and Securities Regulators share this concern as well:

- McKinsey and Company 2002 global investor survey: “more than 60% of investors state that governance considerations might lead them to avoid individual companies with poor governance.”
- William Donaldson, Chairman of the U.S. SEC, 2005: “The fundamental issue for everyone involved in financial markets today, regardless of company or country, must be to maintain high standards—legal, regulatory, and ethical—that breed trust and confidence. ...... Capital will flee environments that are unstable or unpredictable—whether that’s a function of lax corporate governance, ineffective accounting standards, a lack of transparency, or a weak enforcement regime. Investors must see for themselves that companies are living up to their obligations and embracing the spirit underpinning all securities laws.”

Questions we ask are:

- Do investors hold fewer shares in foreign firms that are expected to be poorly governed?
- If so, why?
Motivation

Why do we ask these questions?

- From an economic standpoint, a holdings effect is not obvious:
  - Outside investors should take governance problems into account when investing in foreign (or domestic) stocks
  - As such, outside investors will just lower the price they will pay if they fear consumption of private benefits of control
  - So, with price protection, even poorly governed firms should offer an adequate return
  - This raises the question of whether and why governance concerns could manifest themselves in fewer holdings.

- Thus, economically, governance may not matter for foreign investment. But, regulators and institutional investors do claim that governance matters. Does it?

What we do (big picture)

Investigate whether and why corporate governance concerns manifest themselves in fewer foreign holdings

- We look at foreign holdings through the lens of U.S. investors, who collectively hold 47% of the world’s international equity positions.
- We find that U.S. investors do indeed hold fewer shares in firms with ownership structures that are more conducive to governance problems and expropriation by controlling insiders.
What explains our findings?

We argue that information problems faced by foreign investors play an important role in this result:

- Foreign firms with expected governance problems are particularly taxing to investors in terms of information and monitoring costs.
- Foreign investors are likely to be less informed about governance than local investors:
  - Business transactions are often not arm’s length, so one must have intricate social knowledge to learn which firm’s control structures are benign and which ones are malign – probably easier for well connected locals to do this.
  - With worse information, foreign investors face an adverse selection problem (Choe, Kho, and Stulz (2005)) so they underinvest in foreign stocks.
- Poorly governed firms will try to manage earnings or limit disclosure to hide their expropriation activities:
  - Locals may be better at unraveling this than more distant foreigners.

Summarizing, we argue that:

- Foreign investors do not understand the full extent of a local firm’s governance structures and its insiders’ expropriation potential as well as local investors.
- These information problems cause foreigners to hold less of firms that are expected to be poorly governed.
Setting up our tests

Both firm-level and country-level characteristics can be expected to contribute to the information asymmetry problem

- At the firm level:
  - Concentrated family control makes it more likely that information is communicated via private channels
  - Insiders consuming private control benefits have incentives to hide these benefits from outside investors by providing opaque financial statements and managing earnings

- At the country level:
  - High disclosure requirements level the playing field among investors so it is less likely that locals have an information advantage
  - Strongly enforced shareholder protections reduce the value of private benefits of control and thus reduce the importance of information regarding these private benefits
    - In contrast, low disclosure requirements and weak investor protection exacerbate information asymmetry problems
    - Lang, Lins, and Miller (2004) document less analyst coverage when firm- and country-level governance is poor

Thus, information asymmetry problems for foreign investors are likely to be particularly pronounced when both firm-level governance and country-level institutions are weak

Our Tests

- We regress U.S. investment on firm-level governance proxies across all countries and within subsamples of countries segmenting by institutional factors (governance/disclosure)
- We do additional tests of whether firm-level information flow is at the core of our results by substituting information flow variables (earnings management) for governance variables
Data: U.S. Investors’ Security-level holdings

- All U.S. investors' holdings of foreign equities as reported through a mandatory 1997 Treasury/Federal Reserve Board benchmark survey.
  - Basically covers all U.S. holdings of foreign securities as of December 31, 1997. Excludes:
    - Individual holdings of 10% or more in one company.
    - Securities bought through foreign institutions and held by foreign custodians (with no US subcustodian involved).
    - Holdings of anybody who truly wants to avoid the system.
  - 370,000 holdings records spanning 150 countries.
  - Positive US holdings for about 75% of Worldscope firms.
- The security-level data are confidential.
  - Data aggregated to the country level are publicly available and have been used in Ahearne, Griever, and Warnock (2004) and DPSW (2003).
- Our measure is U.S. Investment as a percent of float (shares not held by >5% blockholders - see DPSW 2003)

Data: Corporate Governance

- Firm-level governance
  - Obtain 1996 (mostly) control structure for non-financial firms covered by Worldscope from Western Europe (Faccio and Lang 2002), Emerging Markets (Lins 2003) and Japan (Claessens, Djankov and Lang 2000)
  - Focus on ultimate Family/Management control rights and seek to measure whether managers are, in effect, in full control of the firm
  - Nominal effective control measure:
    - total control rights held by Fam/Mgmt group
  - Relative effective control measures when Fam/Mgmt control exceeds:
    - median level of Fam/Mgmt control for the country
    - control rights held by any other blockholder (BH)
    - 50% of total control rights (majority control)
Data: Corporate Governance

Country-level governance/information
- LLS 2004 variables:
  - Disclosure Requirements
  - Securities Regulation - combines Disclosure, Liability Standards, and Public Enforcement
  - English legal origin
  - Antidirector Rights

Data: Information Flow

Firm-level information flow variables:
- Two Earnings Management proxies:
  - Time-series median magnitude of accruals relative to the cash flow from operations (Haw, Hu, Hwang, and Wu 2004 and Wysocki 2004)
  - Compute average of three different proxies capturing a wide range of earnings management activities (Leuz, Nanda, Wysocki 2003)
    - Magnitude of total accruals - time-series median of the absolute value of accruals scaled by the contemporaneous operating cash flow
    - Smoothness of earnings relative to cash flows - time-series standard deviation of operating income over the time-series standard deviation of operating cash flows
    - Correlation of accounting accruals and operating cash flows - simple time-series correlation of changes in the accruals and operating cash flows.
Specifics of Our Empirical Tests

Final Sample is 4411 firms from 29 countries
- Sample average U.S. Investment as a percent of float is 6.4%
- Estimate Tobit models: U.S. Investment (% of float) is dependent variable
- Nominal and relative effective managerial control measures are our variables of interest.
- Include controls for:
  - \(X_{LIST}\) = An indicator variable that takes on the value one if the firm's equity is listed on a U.S. exchange either directly or as a Level II or Level III ADR.
  - MSCI Membership = An indicator variable that takes on the value one if the firm's equity is a component of the MSCI World Index.
  - Firm size = The log of total assets measured in thousands of U.S. dollars.
  - Leverage = The ratio of total debt to total assets.
  - Book to Market = The book value per share over the fiscal year-end market price.
  - Dividend Yield = Dividends per share over the fiscal year-end market price.
  - Industry Controls = Industry indicator variables as classified by Campbell (1996).
  - Country Controls = Indicator variables for a firm's country of domicile (used in all but one model).

Results

Is there a relationship between foreign investment and governance?
- At the firm level?
  - Across all countries, weak evidence that U.S. investment is lower when managers have effective control
- At the firm and country level?
  - Yes, strong results showing U.S. investors have significantly fewer holdings in firms with a combination of poor expected firm-level and country-level corporate governance
    - Indicates that foreign investors particularly avoid foreign firms when information problems are greatest
Results

- Is there a relationship between foreign investment and earnings management?
  - If firm-level information problems are at the core of our results, proxies for information flow (earnings management) should be negatively associated with U.S. investment when substituted for governance variables
- Do we see this at the firm and country level?
  - Yes, strong results showing U.S. investors have significantly fewer holdings in firms with high earnings management scores where securities regulation is weak (results are similar for low SH protection, low Disclosure, and non-English origin countries)
    - Even though these tests directly focus on information flows, the quality of the information flows is largely driven by country-level institutions and firm-level governance.
    - Thus, we prefer to use governance variables for our main analyses and view the earnings management findings as supplementary.

Conclusions and Implications

- Our paper provides compelling evidence for a large sample across many countries that foreigners invest less in poorly governed firms.
- We show that this finding is not simply a matter of a country's economic development, but appears to be directly related to a country's legal institutions and information rules.
- We show that information problems faced by foreign investors play an important role in this result. Foreign investment in firms that appear to engage in more earnings management is lower in countries with poor information frameworks and legal institutions.
- Overall, our results suggest that country-level improvements in disclosure and governance practices and firm-level improvements in governance or information flows are likely to attract more U.S. investment. To the extent that this attracts more total investment into a country, it implies that the home bias may be attenuated with such governance and information flow improvements.