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The European Journal of Finance >

Volume 20, 2014 - Issue 7-9: FIRST CHINESE CAPITAL MARKETS CONFERENCE

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Domestic and foreign institutional investors' behavior in China

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Pages 728-751 | Received 24 Feb 2012, Accepted 28 Feb 2012, Published online: 02 May 2012

⚠ https://doi.org/10.1080/1351847X.2012.671778



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Abstract

This paper compares the investment characteristics between foreign funds operating under Qualified Foreign Institutional Investors (QFIIs) in China and domestic Chinese funds and analyzes the firm-level drivers that influence their allocation choices. The analysis reveals that foreign funds have a preference for a range of sectors such as transportation, metals and non-metals, and machinery, as opposed to industries with a

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QFII and domestic fund investment preferences and will be of value to policy-makers in emerging markets, and China, in particular, in gauging the important drivers of foreign investment.

Q Keywords: Qualified Foreign Institutional Investor corporate governance China stock market

Q JEL Classification: G11 G34

Acknowledgements

We thank anonymous reviewers, Douglas Cumming, Alessandra Guariglia, Wenxuan Hou, Edward Lee (the editors of this special issue), and participants at the 2011 China's Monetary and Exchange Rate Policy Workshop at Bank of Finland, the 2011 3rd Chinese Economic Association (CEA) (Europe) and 22nd CEA (UK) Annual Conference at University College Dublin, the 2011 Durham-EJF Special Issue Conference on the Chinese Capital Market at Durham University, the 2011 Financial Management Association (FMA) Doctoral Student Consortium in Denver for their valuable comments and discussions. Zhihong Yi and Ningyue Liu acknowledge the National Natural Science Foundation of China for its support (Grant No.: 70972130 (2010-2012)).

Notes

Source is the Investment Quota Approval Form of QFIIs issued by State Administration of Foreign Exchange (SAFE), 10 November 2010.

Source is the National Bureau of Statistics of China.

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taxes that are used for the state rulers' own benefit. The high percentage of stateowned shares in Chinese listed firms could be another important factor in portfolio choices of foreign investors in China.

Dahlquist and Robertsson (2001) found that there is a negative relationship between foreign institutional ownership and ownership concentration, implying that foreigners avoid companies with a dominant owner.

This definition can be found in 'Provisional Measures on Administration of Domestic Securities Investments of Qualified Foreign Institutional Investors' issued by CSRC on 5 November 2002, page 1.

A shares in Shanghai and Shenzhen stock exchanges refer to those that are traded in CNY. Currently, only mainlanders and QFIIs are allowed to trade A shares. Some shares in the two mainland Chinese stock exchanges, known as B shares, are traded in foreign currencies. In the past, only non-Chinese were allowed to trade B shares. Starting from March 2001, mainlanders can trade B shares as well. However, they must trade with legal foreign currency accounts. QFIIs are not permitted to invest in B shares.

Insurance companies must have assets in excess of US\$ 10 billion during the latest accounting year and have operated for over 30 years. Commercial banks must be ranked in the world top 100 banks in terms of assets and have assets in excess of US\$ 10 billion during the latest accounting year as well.

Two conditions can be found in 'Provisional Measures on Administration of Domestic Securities Investments of Qualified Foreign Institutional Investors' issued by CSRC on 5 November 2002, page 5.

The qualifying criteria for insurance companies are changed from at least US\$ 10 billion to US\$ 5 billion in assets held in the most recent accounting year.

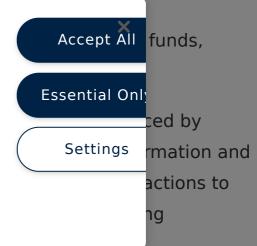
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Wind Info is a financial data provider in Mainland China. It provides large-sized financial database to academic researchers as well as financial organizations, including Merrill Lynch. The studies of Poon and Chan (2008) and Wu, Xu, and Yuan (2009) are examples of recent studies that applied data from the Wind database.

In some cases, investors invest in large number of firms in one industry but hold small number and market value of shares in each firm. Shareholding numbers and market value represent the preference of investors in each industry. Therefore, we also report the number of shares (in %) and the number of market value (in %) for each industry.

The companies in the finance and insurance sector will not be examined in the later sections. This is due to data limitations. A number of indicators used in this paper do not exist in this industry, for example, current ratio and quick ratio, as there are no current assets and current liability terms in banks' balance sheets. Kang and Stulz (1997) also employed the data from non-financial Japanese firms.

Strategic investor is another form of foreign institutional investors with access to China's market. They invest A shares through negotiations and initial public offerings rather than trading under the QFII scheme. Most strategic investors acquire interests in Chinese banks. For example, Temasek, through its wholly owned subsidiary Asia Financial Holdings, acquired a 10% interest in Bank of China in August 2005. Meanwhile, Temasek is also a member of QFIIs.

While QFII restricts investments to be =10% of the total outstanding shares of the company, the strategic investor facility requires that investments be at a minimum 10% of the total outstanding shares.

Winsorizing or winsorization is the transformation of statistics by transforming extreme values in the statistical data and is named after the engineer-turned-biostatistician

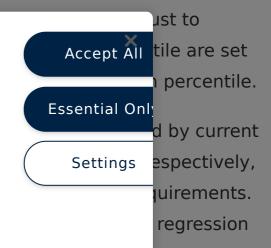
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of foreign ownership on several explanatory variables is significantly positive in 1 of 16 years. Therefore, we believe that it is almost non-significant.

Source from P/E Ratio Global Stock Markets Analysis and Technical Outlook, 7 November issued on 18 November 2007 by The Market Oracle http://www.marketoracle.co.uk/. A high P/E ratio signifies high expectations on the growth. Many developed countries have low P/E ratios, but they also have low GDP growth, while developing countries may have higher market valuations as well as stronger GDP growth, in particular, the high P/E ratio and strong GDP growth in China.

Consistent with a number of studies examining developed markets (Dahlquist and Robertsson 2001; Aggarwal, Klapper, and Wysocki 2005), our approach focuses primarily on contemporaneous relationships. Given the emerging nature of the market, the low level of foreign ownership and the limited channels of corporate participation, we would expect there to be no potential for endogeneity in our study.

Hausman (1978) designed a test to indicate the appropriateness of the FEM versus the REM and decided which is a better one. The null hypothesis states the REM as the correct form, while the alternative is the FEM.

For one of the groups, we find that there is no statistically significant indicator. In this case, we choose the indicator with the higher overall R² to join the final model because we hope to test the impact of a comprehensive range of firm-level characteristics on the investment decisions of foreign institutional investors.

The percentage relative spread measures the over- and under-investment of funds by calculating the difference between the firms' allocated weight and the Chinese market weight for each firm.

Dahlguist and Robertsson (2001) compared the portfolio of foreign investors with the

Swedish portfolio

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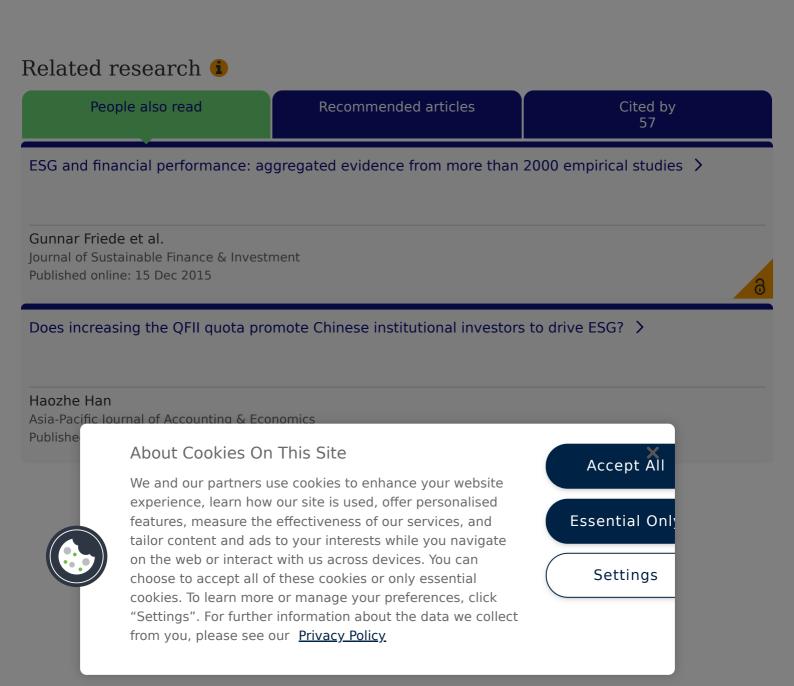
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market capitalization of all the firms held by funds) as an alternative method to track

funds' portfolio holdings. The results are consistent with those using the relative spread as the dependent variable. The results are available from the authors upon request.

Pearson correlations between duality of chairman and CEO, percentage of independent directors and the number of directors, and number of supervisors are all below 0.10.

The opposite signs for the ownership of state-owned shares and the Z index are not conflicting. The Z index equals the number of shares held by the largest circulating shareholder divided by the number of shares held by the second largest circulating shareholder. It stresses the control power of the largest shareholders. Even for the firm with a high percentage of state-owned shares as the largest shareholder, the Z index will be still small as long as the number of shares held by the second largest shareholder is also large.



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