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Domestic and foreign institutional investors' behavior in China

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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 requirement for local knowledge. The portfolios of domestic Chinese funds are distributed more evenly than those of the foreign funds. The comparative analysis indicates that foreign funds invest in firms that are significantly different from those favored by domestic funds in terms of size, profit, and compensation of management. Finally, we find that when making investment decisions, foreign funds tend to rely on some corporate governance indicators, which is not consistent with the results obtained from previous studies examining developed markets. In particular, foreign funds have a preference for firms with a high percentage of state-owned shares, while the reverse is

the case for domestic funds. These empirical findings highlight the differences between 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.

Keywords:

Qualified Foreign Institutional Investor | corporate governance | China stock market

JEL Classification:

G11 | G34

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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.

International Monetary Fund, World Economic Outlook Database, October 2010.

China's two domestic stock exchanges, Shanghai Stock Exchange and Shenzhen Stock Exchange, were established in December 1990 and July 1991, respectively.

Source is the CSRC from 26 January 2011.

Stulz (2005) indicated that home bias can be caused by the agency problem of state-ruler discretion, meaning that state rulers can expropriate investors by regulations and taxes that are used for the state rulers' own benefit. The high percentage of state-owned 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.

Other categories of institutional investors include pension funds, charitable funds, donation funds, trust companies, and government investment companies.

Naughton (2007) indicated that the Chinese stock market is heavily influenced by changes in government policy, along with limitations on individual firm information and shareholder control. Chinese market fluctuations are better explained as reactions to government policy changes rather than as reactions to changes in underlying fundamentals of individual companies.

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 Charles P. Winsor (1895–1951). Winsorized estimators are usually more robust to outliers than their unwinsorized counterparts. All data below the 1st percentile are set to the 1st percentile, and data above the 99th percentile are set to the 99th percentile.

The current ratio and the quick ratio are calculated as current assets divided by current liabilities and current assets minus inventory divided by current liabilities, respectively, and measure the ability of the company to meet its short-term payment requirements. In the study of Kang and Stulz (1997), the coefficient on current ratio in the regression 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 R^2 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.

Dahlquist and Robertsson (2001) compared the portfolio of foreign investors with the Swedish market portfolio. Kang and Stulz (1997) also adopted Japanese market portfolio as a benchmark to analyze the investment of foreign investors.

Given the fact that the natural logarithm of total assets and the natural logarithm of capitalization are so highly correlated (Pearson), we do not include them in a single

regression. To resolve the problem of multicollinearity, we regress the two variables in two separate regressions. As a sensitivity test, we employ the investment level of institutional investors (the percentage of market capitalization of each firm in the total 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.