

INQUIRE EUROPE RESEARCH PROPOSAL

Do Locals Know Better? A Cross-Country Analysis of the Performance of Domestic and Foreign Money Managers

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Abstract

The goal of this project is to compare the performance of money managers in stocks of firms located in their domestic market to that of foreign money managers. The existing literature shows quite different results, even though this is probably justified by the fact that different papers use different methodologies and samples in terms of time periods and countries analyzed (often just one single country). By using a comprehensive data set of investment funds' equity holdings located in 25 countries for the period 2000-2006, we are able to do a unified analysis of the performance difference between domestic and foreign investors. Our preliminary findings suggest that in the vast majority of countries, domestic investors are not able to outperform foreign investors. We will perform a closer analysis to detect whether some specific stock-, country-, or investor-level characteristics induce any performance differences.

1. Research objectives and literature review

The literature comparing the performance of domestic and foreign investors has found mixed results so far. A first set of papers finds that domestic investors are better than foreign investors when trading in stocks from their local markets. Examples include Choe, Kho, and Stulz (2005) for Korea, Dvorak (2005) for Indonesia, Hau (2001) for Germany, Huang and Shiu (2005) for Taiwan, and Shukla and van Inwegen (1995) for the US. Further, Bae, Stulz, and Tan (2005) find that local stock analysts forecast better than foreign analysts, in particular in opaque markets.

A second set of papers finds the opposite result. Grinblatt and Keloharju (2000) show that foreigners and domestic financial corporations in Finland buy more stocks that perform well over the next 120 trading days than domestic individual investors. Seasholes (2000) finds that foreign investors buy (sell) ahead of good (bad) earnings announcements in Taiwan while domestic investors do the opposite. Froot and Ramadorai (2007) study flows into closed-end funds trading on the NYSE representing 25 foreign countries and conclude that foreigners are better informed than local investors. Froot, O'Connell, and Seasholes (2001) study investment flows into emerging markets and show that foreign investors have some ability to predict returns.

A third set of papers finds no difference between domestic and foreign investors or less clear-cut results. Kang and Stulz (1997) find no difference in performance between domestic and foreign investors in Japan. Agudelo (2006) shows that while locals do most of the informed trades in Indonesia, conditional on the type of investors, foreigners are more likely to be informed

Our research is also related to the literature on the geography, familiarity, and industry concentration of investment strategies in the US market. Coval and Moskowitz (2001) find that fund managers earn substantial abnormal returns in investments within 100 kilometers. Huberman (2001) shows that investors overweight the local Bell Company. Kacperczyk, Sialm, and Zheng (2005) find that funds with holdings concentrated in a few industries perform better. This literature indicates that investors may outperform

where they have an information or knowledge advantage. Hence, extrapolating to an international setting, it suggests that domestic investors might outperform foreign investors.

The diverging results in the literature may be due to the use of different samples (both countries and sample periods) and methodologies. The objective of our research project is to provide a unified analysis of the performance difference between domestic and foreign investors. Our comprehensive dataset of mutual fund holdings allows a consistent analysis of performance across a wide range of stock markets and mutual funds, over a relatively large sample period.

2. Research method, expected form of the results, and the practical value of the project

2.1. Data

The institutional holdings data for our study is drawn from the FactSet/LionShares institutional ownership database, which is the leading information source for global institutional share ownership. FactSet/LionShares data feeds leading financial information providers such as Reuters, MSNMoney and brokers like E-Trade. FactSet/LionShares' data sources are public filings by investors, companies, and security agencies around the world who have discretionary control over assets under management and are frequently required to publicly disclose these.

We use the historical filings of the FactSet/LionShares database. The historical coverage covers the period from January 2000 to December 2005. We take equity securities holdings and handle the issue of different report frequency by institutions from different countries by getting the latest holdings update at each quarter-end. The holdings data comprise institutions located in 25 different countries. Thus, this data set offers a unique worldwide panel data (when aggregated at the country-level) for each quarter of the last six years. In December 2005, FactSet/LionShares has holdings data on more than 35,000 equity securities, for a total market value of US\$ 18 trillion. The holdings are from 5,337 institutions (such as mutual fund companies, pension funds, insurance funds) around the world that more than 20,000 individual funds. To our knowledge, this is the most comprehensive data set on institutional holdings available worldwide. This data set has been used in Ferreira and Matos (2007) to study the revealed preferences of institutional investors and their role in corporations worldwide.

We match the holdings from FactSet/LionShares with the corresponding stock returns from Datastream. This allows us to measure, for each fund, the return obtained in its domestic portfolio (stocks from its own country) and the return in its foreign portfolio (stocks from other countries). Other stock characteristics are drawn from the Datastream/Worldscope database.

2.2. Comparison of performance

We start by computing the monthly return (denominated in US\$) on the domestic portfolio (R_{ij}^d) and on the foreign portfolio (R_{ij}^f) of fund i in country j . We next average across all funds holding assets in country j (obtaining R_j^d and R_j^f). We then compare the time-series means of these two time series of domestic and foreign returns.

We consider several alternative for the R_j^d and R_j^f return series: raw returns; excess returns; and risk-adjusted returns using four different factor models, namely the domestic market model, the domestic four-factor Carhart (1997) model, the global market model, and the global four-factor Carhart model.

The appendix presents preliminary results based on the Jan-2000 through Dec-2005 sample period. While in the majority of countries domestic investors are able to generate higher returns than foreign investors, the difference is in general not statistically significant. The only two exceptions are Belgium and Canada where domestic investors earn significantly higher excess returns. However, the difference becomes insignificant when we compare returns adjusted for the four-factor Carhart model, suggesting that the higher returns of domestic investors are due to higher risk-taking in small, value, or momentum stocks. Hence, our preliminary results suggest that overall there is no difference in the performance of domestic and foreign investors.

We plan to extend the analysis in several directions. First, we will extend the sample to December 2006. Second, we will consider alternative ways to measure performance, including the Portfolio Change Measure of Grinblatt and Titman (1993) and the characteristic-based adjustment of Daniel, Grinblatt, Titman, and Wermers (1997). Third, we will consider other aggregations of domestic and foreign portfolios, such as the geographic area (e.g. Europe, North America), Developed/Emerging markets, High/Low accounting standards. Fourth, we will split the sample according to the type of stock: high/low size, high/low book-to-market, high/low momentum, with/without ADR, included/not included in the MSCI index, high/low analyst coverage. Fifth, instead of classifying investor as domestic or foreign, we will analyze other classifications such as close/distant investors, same/different geographical region, same/different language. These different angles of analysis will give a closer look at the potential performance differences and allow us to understand the determinants of those potential differences. As discussed above, our preliminary results suggest that domestic investors in some countries may be better than foreigners at picking small, value, or momentum stocks in which they have an informational advantage over foreigners.

2.3. Practical value of the project

Our study will determine whether domestic fund managers are able to better pick stocks from their own stock market than foreign fund managers. If we find no difference, this will imply that, for example, a French investor wanting to diversify his portfolio into US stocks can do it efficiently both through a French-based or a US-based mutual fund. On the other hand, if we find significant differences and further identify the determinants of the performance differences, then we will be able to provide advice to investors worldwide on what is the best way to obtain the full benefits of international diversification.

3. References

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4. Proposed timetable

Date	Task
Sep-2007	Final data collection
Dec-2007	Main results and first draft
Jan-Jul-2008	Paper circulation and revisions
Aug-2008	Journal submission

Appendix: Country-Level Performance of Domestic versus Foreign Portfolios of Mutual Funds

This table presents time-series means of monthly portfolio returns. The columns represent: (1) returns of domestic portfolios; (2) returns of foreign portfolios; (3) t statistic for the difference between the returns of domestic and foreign portfolios with boldface denoting significance at the 5% level. The sample period is from Jan-2000 to Dec- 2005.

Country name	Raw Return			Excess Return (Ret-Rf)			Alpha 1-l (local market model)			Alpha 4-l (local 4-factor Carhart model)			Alpha 1-g (global market model)			Alpha 4-g (global 4-factor Carhart model)		
	R ^d	R ^f	t-stat	R ^d	R ^f	t-stat	R ^d	R ^f	t-stat	R ^d	R ^f	t-stat	R ^d	R ^f	t-stat	R ^d	R ^f	t-stat
AUSTRIA	0.017	0.015	1.01	0.015	0.013	1.01	-0.005	-0.009	1.75	-0.003	-0.005	0.62	0.015	0.013	1.01	-0.001	-0.001	0.13
AUSTRALIA	0.013	0.012	0.72	0.011	0.010	0.72	0.001	0.000	0.99	0.000	-0.002	1.47	0.012	0.011	0.71	0.009	0.008	1.03
BELGIUM	0.008	0.002	2.16	0.006	0.000	2.16	-0.005	-0.012	2.70	-0.003	-0.007	1.48	0.006	0.001	2.21	-0.008	-0.013	1.41
CANADA	0.010	0.000	2.35	0.008	-0.002	2.35	0.003	-0.009	3.16	0.000	-0.004	1.15	0.010	0.000	2.53	0.009	0.007	0.31
SWITZERLAND	0.001	0.002	-0.82	-0.001	0.000	-0.82	-0.004	-0.003	-0.82	-0.005	-0.002	-1.61	0.000	0.001	-0.85	-0.009	-0.005	-1.84
GERMANY	-0.001	0.000	-1.09	-0.003	-0.002	-1.09	-0.001	0.000	-1.06	-0.001	0.000	-1.02	-0.001	0.000	-1.05	-0.014	-0.013	-0.29
DENMARK	0.003	0.006	-0.84	0.001	0.004	-0.84	-0.008	-0.005	-0.68	-0.006	0.003	-2.41	0.002	0.005	-0.83	0.000	0.002	-0.26
SPAIN	0.008	0.006	1.24	0.006	0.004	1.24	-0.001	-0.003	1.64	-0.001	-0.002	0.43	0.007	0.005	1.24	-0.003	-0.004	0.09
FINLAND	0.009	-0.004	1.29	0.007	-0.005	1.29	0.008	-0.004	2.30	-0.006	-0.002	-1.17	0.004	-0.009	1.47	0.012	0.019	-0.59
FRANCE	0.000	0.002	-1.62	-0.002	0.000	-1.62	-0.003	-0.002	-1.72	-0.004	-0.003	-0.78	0.000	0.002	-1.61	-0.006	-0.005	-0.27
GREECE	0.036	0.029	1.26	0.035	0.028	1.26	0.005	0.000	0.77	0.015	-0.004	3.59	0.006	0.003	0.45	0.025	0.007	2.18
HONG KONG	-0.001	-0.002	0.60	-0.003	-0.004	0.60	-0.002	-0.003	0.61	-0.004	-0.004	0.51	-0.001	-0.002	0.60	-0.008	-0.010	0.73
IRELAND	0.016	0.013	1.23	0.014	0.011	1.23	0.006	0.002	1.30	0.005	0.000	1.51	0.015	0.012	1.22	0.001	-0.001	0.56
INDIA	0.017	0.011	1.52	0.015	0.009	1.52	-0.004	-0.006	0.83	0.000	0.000	-0.11	0.015	0.009	1.66	0.000	-0.004	0.72
ITALY	0.005	0.003	0.81	0.003	0.001	0.81	-0.001	-0.002	0.76	-0.002	-0.003	0.90	0.003	0.002	0.82	-0.004	-0.002	-0.77
JAPAN	-0.007	-0.007	-0.10	-0.009	-0.009	-0.10	-0.002	-0.002	0.08	0.003	0.002	0.27	-0.008	-0.008	-0.10	-0.004	-0.004	-0.20
NETHERLANDS	-0.001	-0.003	1.95	-0.003	-0.005	1.95	-0.002	-0.004	1.94	0.001	0.000	1.15	-0.001	-0.003	1.93	-0.013	-0.014	0.54
NORWAY	0.011	0.012	-0.16	0.009	0.010	-0.16	-0.004	-0.003	-0.33	0.000	0.000	-0.03	0.009	0.009	-0.20	-0.001	0.001	-0.72
POLAND	0.038	0.037	0.35	0.037	0.036	0.35	0.001	-0.002	0.73	-0.002	-0.002	0.13	0.004	0.002	0.61	-0.004	-0.004	0.02
PORTUGAL	0.008	0.006	0.33	0.006	0.005	0.33	0.000	-0.002	0.47	0.002	0.000	0.25	0.004	0.002	0.35	0.003	0.000	0.47
SWEDEN	-0.002	-0.004	0.65	-0.004	-0.006	0.65	-0.004	-0.006	0.66	-0.005	-0.004	-0.33	-0.003	-0.005	0.64	-0.002	0.000	-0.51
SINGAPORE	-0.002	0.000	-0.26	-0.004	-0.002	-0.26	-0.007	-0.005	-0.20	-0.007	0.016	-2.64	-0.003	0.001	-0.45	-0.012	0.017	-2.62
UNITED KINGDOM	0.002	0.000	1.59	0.000	-0.002	1.59	-0.001	-0.003	1.58	0.000	-0.003	2.72	0.001	-0.001	1.61	-0.003	-0.002	-0.78
UNITED STATES	0.000	-0.002	0.64	-0.002	-0.004	0.64	0.002	0.001	0.65	0.001	0.001	-0.24	-0.001	-0.002	0.66	0.002	0.002	0.12
SOUTH AFRICA	0.014	0.010	0.90	0.012	0.008	0.90	-0.004	-0.008	0.77	-0.003	-0.004	0.27	0.012	0.008	0.89	0.001	-0.005	0.86