Do Foreign Investors Improve Market Efficiency?
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Executive Summary

A key purpose of financial markets is to allocate capital to the real sector efficiently. Historically, domestic investors have performed this role; the importance of foreign investors was lower, due to factors such as capital controls, asymmetric information, and home bias.
While empirical work has shown benefits of aggregate foreign capital flows, considerably less is known about the economic mechanisms driving firms' efficiency changes. Do foreign investors improve the informational and real efficiency of individual firms? What types of investors and markets see the highest such gains? How important are foreign relative to domestic investors ?

Marcin Kacperczyk, Savitar Sundaresan, and Tianyu Wang aim to answer these and other questions by analyzing foreign institutional investors' impact on stock price informativeness.

Whether and how foreign investors affect the price informativeness of stocks is not obvious. On the one hand, foreign investors may be less able or less inclined to research domestic stocks, so their impact might be small. On the other hand, foreign investors may exhibit less home bias and consequently — conditional on market participation — they might be more informed about domestic stocks, in which case their impact would be large.

The researchers construct a rich panel data set on institutional equity ownership worldwide. The sample covers almost 24,000 firms from 40 developed and emerging countries, 2000-2016. They supplement the data with macroeconomic, market, and accounting information. Following the literature, they define stock-level price informativeness as the predicted variation of cash flows using market prices — a welfare-based measure, which is relevant for real outcomes.

They take advantage of the following institutional regularity: stocks that are added to the global MSCI index subsequently experience a strong increase in foreign ownership. The event generates an economically meaningful and reasonably exogenous variation in foreign ownership, which they exploit using the difference-in-differences estimation. The exclusion restriction is that price informativeness is not driven by forces other than index reconstitutions, which they believe is economically plausible. They use a multivariate regression approach, in which we can also use time-varying firm characteristics and various fixed effects, across firms, time, countries, and industries.

The researchers find that prices of stocks that are added to the index become more informative about future fundamentals relative to a control sample of stocks. Further, the exogenous change in foreign ownership is predictive of future increases in capital expenditures, but not in R&D. They assess the robustness of their MSCI inclusion results by using alternative measures of price informativeness —

specifically, post-earnings-announcement drift (PEAD), price nonsynchronicity, and the variance ratio. The results remain statistically and economically significant.

Finally, the researchers test whether index inclusion indeed generates improvements in information environment and find that increased foreign ownership leads to higher market liquidity, thus reducing asymmetric information in the market; an increase in analyst coverage, which leads to improvement in information production; and better market risk sharing, resulting in reduced cost of capital in the market. At the same time, they find no evidence of improved firm governance due to increased foreign ownership.