



# **THE QUIET REVOLUTION: FOREIGN OWNERSHIP AND CORPORATE GOVERNANCE**

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# Outline

*The Big Question: The relationship between the rise in foreign ownership and changes in corporate governance.*

- I. Documenting the rise in foreign ownership
- II. Explaining the non-corporate governance related causes of the rise
- III. Understanding the causal pathways going both directions in the interaction between the rise in foreign ownership and corporate governance
- IV. Conclusion: A quiet revolution may have started

# Cross-border Share Ownership in 1993

	U.S. Issuer Equity	Non-U.S. Issuer Equity	Total
equity market capitalization	\$5.2 trillion (37%)	\$8.9 trillion (63%)	\$14.1 trillion
holdings by U.S. Investors	\$4.9 trillion (93%)	\$.3 trillion (6%)	\$5.2 trillion
holdings by non-U.S. Investors	\$.3 trillion (3%)	\$8.6 trillion (97%)	\$8.9 trillion

# Cross-border Share Ownership in 2015

	U.S. Issuer Equity	Non-U.S. Issuer Equity	Total
equity market capitalization	\$25.1 trillion (41%)	\$36.7 trillion (59%)	\$61.8 trillion
holdings by U.S. Investors	\$20.5 trillion (75%)	\$6.8 trillion (25%)	\$27.3 trillion (44%)
holdings by non-U.S. Investors	\$4.6 trillion (13%)	\$29.9 trillion (87%)	\$34.5 trillion (56%)

# Documenting the Rise of Foreign Ownership Over the Last 20 Years

## *Key Facts:*

- Proportion of non-U.S. equities in U.S. investor stock portfolios more than **quadrupled**
- Proportion of U.S. equities in the portfolios of non-U.S. investors has also more than **quadrupled**
- Results are replicated on the more granular country-to-country comparisons
- By 2015, **38% of the capitalized value** of all the world's publicly traded issuers was held by investors from a country different from that of the issuer

# Forces Driving Cross-Border Equity Holdings: Seeking Higher Returns

*Means to reallocate savings from countries rich in savings relative to their investment opportunities to ones poor in this regard*

- Investor from the savings-rich country can earn a higher return
- *Drives Investment in one direction*



# Forces Driving Cross-Border Equity Holdings: Reducing Risk

*Means to reduce portfolio risk by achieving more extensive diversification*

- The more issuers in a portfolio differ from each other in the forces that determine their cash flows, the more risk is reduced through the “cancelling out effect”
- Issuers from different countries differ from each other in this respect more than ones within a single country do
- Drives Investment in both directions





# The “Ideal Portfolio” of the Passive Investor

*Under perfect conditions, **each** utility maximizing passive portfolio investor **anywhere in the world** would hold the “world index”*

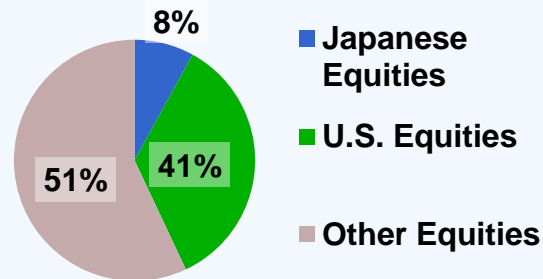
- Her portfolio would be a market-capitalization-weighted mix of all the publicly traded issuers in the world.
- This would minimize risk for any given level of expected return
- The investors of savings-rich countries would simply have larger portfolios relative to the total market capitalization of their issuers



# Consequences of Every Investor Holding the “Ideal Portfolio”

*Every investor's equity portfolio would contain shares of issuers of different countries roughly in proportion to the countries' respective total market capitalizations.*

- A U.S. and a Japanese passive investor, for example, would each have a portfolio with about 8% in Japanese equities and 41% in U.S. equities.



# Consequences of Every Investor Holding the “Ideal Portfolio”- Cont’d

*Every publicly traded corporation in the world would be foreign owned.*

- Each U.S. corporation would, for example, have 56% of its shares owned by non-U.S. investors (compared to 13% today).
- Each Japanese corporation would have 92% foreign ownership (compared to 18% today), including 44% of its ownership coming from U.S. investors (compared to 9% today).

# **Non-Corporate-Governance Impediments to a Global Market for Securities**

- Information concerning a country's issuers concentrated at home
- Currency exchange risks
- Taxes and regulations

# National Concentration of Information Impediment: Passive Investors

A totally passive uninformed investor whose only strategy is diversification will only choose stocks the market pricing of which she has basic faith in



This faith arises from familiarity



Familiarity with own country's issuers and markets creates a home bias in her portfolio composition

# National Concentration of Information

## Impediment: Speculative Investors

- A speculative investor stock picks based on her individual beliefs concerning an issuer's future cash flows relative to its share price.
- For the investor to expect to do better than the market, these beliefs must be based on specialized information not possessed by most other participants.
  - ↳ Calls for concentrating buying and selling in equities of issuers about which they start with natural information advantages.
- A speculative investor's natural information advantages with respect to issuers of her own country creates home bias

# National Concentration of Information Impediment: Explaining the Rise of Foreign Ownership

- Familiarity and information advantages come from the traditionally lower cost of acquiring information about the forces that affect the future cash flows of domestic issuers versus those that affect foreign issuers
- This cost differential has diminished vastly in the last 20 years



- Erosion of this impediment is likely an important factor in explaining the rise of foreign ownership



# **National Concentration of Information Impediment: Predicting the Future**

- **Effects of the reduced cost differential not yet fully felt**
- **Learning how to effectively use newly available cheap information takes time**



Requires feedback on reliability of sources and on the importance of different kinds of information

- **Same technological changes are slowly creating a more uniform social and economic culture globally**



Occurs through effect on mass media, marketing, education, scholarly research, and direct personal interaction



Is reducing the disadvantage of understanding the forces affecting the future cash flow of a foreign issuer



# Currency Exchange Risk Impediment

*Future changes are likely to occur in the value of the investor's domestic currency relative to a basket made up of the currencies of other nations of the world. This creates a risk for holding foreign shares.*



DOMESTIC



FOREIGN

# Currency Exchange Risk Impediment – Continued

*Domestic equities do not pose this risk and so its presence discourages cross border holdings*

- The importance of this impediment has been shrinking, however,
  - Taking on the risk through cross border investing constitutes a hedge against the effect of the same fluctuations on the future consumption of goods and services from abroad
  - Consumption from abroad has been growing with the internationalization of trade
  - Currency futures are more complete and less expensive
  - Euro has eliminated the risk within its zone

# Tax and Regulation Impediment

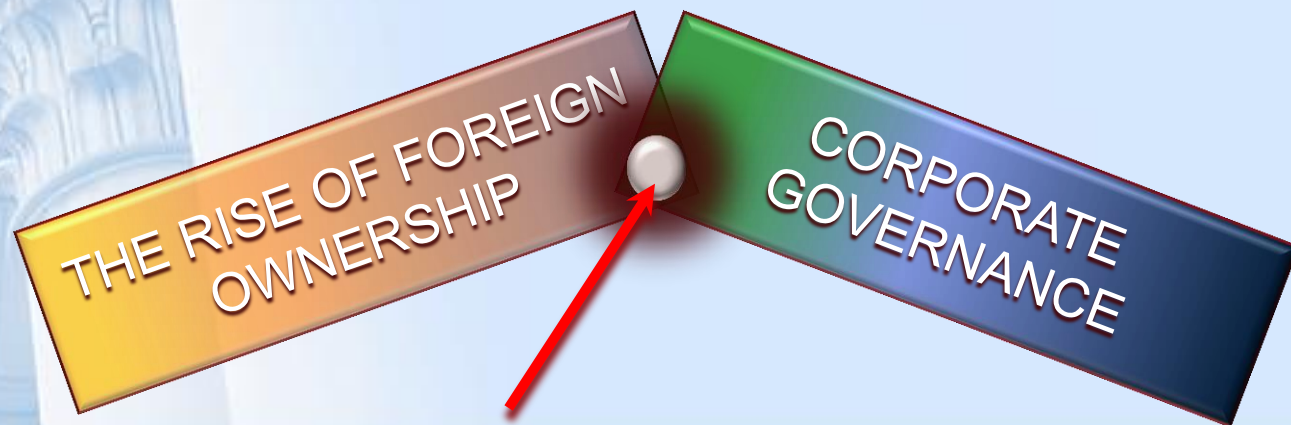
*Currency control and tax measures can severely discourage cross border investment*

- Those imposed by many of the world's advanced economies after WWII were largely dismantled by the 1980's
- Competition for financial services make them unlikely to return
- Still important, though, because the rise of the emerging market countries, most notably China

*Aspects of issuer disclosure and broker/dealer regulation also discourage cross border equity investing, but competition for markets may be leading to their erosion*

# The Interaction of Foreign Ownership and Portfolio Supportive Corporate Governance (“PSCG”)

*In exploring the interaction between the rise of foreign ownership and corporate governance, the focus will be on just this one dimension*



# Defining PSCG

*Starting point: in an efficient market, share price reflects an unbiased prediction of cash flows to be received by the holder including the effects of the issuer's corporate governance regime on the level of diversions*

- First cut would suggest that the quality of the quality of an issuer's corporate governance should have no effect on the extent of portfolio share ownership
  - poor governance shares would have lower expected cash flows to the portfolio holders
  - but they would be priced commensurately lower and so would be equally attractive to buy
- But information asymmetry between control SHs and potential portfolio purchasers at the time of a sale → “lemons” problem
- Expectation of diversion constraints is a solution



## An Initial Observation

- Most publicly traded firms outside of the U.S. and the U.K. have **control shareholders**.
- Control shareholders in turn are very likely to be of the **same nationality as the issuer**.

*Thus, under current conditions, at least, the small free float makes it impossible to get anywhere near the pattern of cross border share holding implied by everyone holding the “ideal portfolio”*

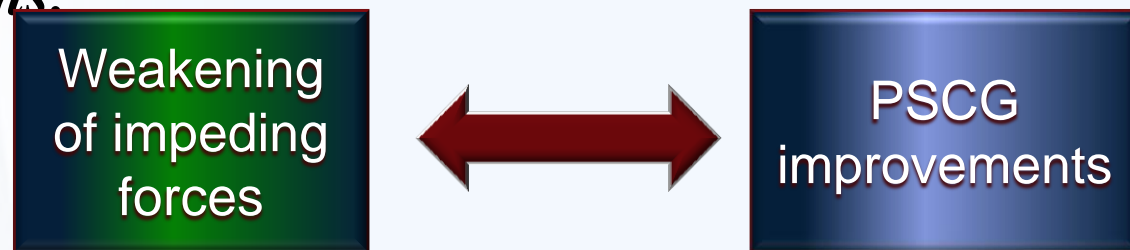
*You can't have more foreign portfolio SHs without more portfolio SHs more generally*

# The Interaction of the Weakening of Impeding Forces and Corporate Governance Causal Pathways

*The foreign demand for a country's shares is determined by:*

- Strength or weakness of the non-corporate-governance forces impeding globalization
- The PSCG quality of the country's issuers

*Moreover, pathways of causation between the weakening of the impeding forces and PSCG improvements run in both directions.*





# Pathway I

**Weakening of  
impending forces--**

**Greater potential increase  
in foreign holdings from a  
given PSCG improvement**

**Greater incentives for poor  
PSCG jurisdictions, or their  
issuers acting individually,  
improve PSCG to tap what is  
now a larger potential pool  
of capital abroad**

- **Evidence that strong effective country corporate and securities disclosure laws are positively related to**

- bigger, deeper K mts and lower ownership concentration generally:
- more foreign ownership specifically
- direction of causation logically from laws to effect

**Evidence that effective individual firm diversion effects are positively related to**

- more foreign ownership
- direction of causation is at least partly from constraints to effect

# Pathway II

**Greater Foreign Holdings**

**Countries with weak corporate governance improve PSCG for reasons independent of the weakening of the forces impeding cross border holdings**

- I. **“Ideological convergence” around a “shareholder-oriented” model**
- II. **Increased trade putting competitive pressures on firms following less efficient models**
- III. **Increase in country wealth → more retirement funds**
- IV. **Less fear of gov’t expropriation makes less concentrated ownership safer**

# Pathway III

Weakening of impeding forces

Greater foreign holdings of low PSCG issuers

Larger foreign share ownership more successful at pressuring PSCG Improvements

**Again, evidence that effective individual diversion constraints and indicators of good governance related to greater foreign ownership**

**Reasons to think more ownership → greater constraints**

Foreign institutions from rich countries have experience that leads to higher expectations and are less enmeshed than domestic shareholders in relationships with control shareholders

Evidence that foreign institutions in fact act aggressively

**How foreign shareholders exert influence**

threaten to sell

where control is less than 50%, vote at margin can be a threat

# Conclusion

- Last few decades may well be the start of a **Quiet Revolution**
- Study of forces behind increase in foreign ownership so far suggest much more to come: learning by doing
- Reinforcing interaction between foreign ownership and governance will lead to significant governance improvements
- Caveat: countries that impose barriers to foreign ownership can opt out of this process