# Foreign Investors: Analyzing their Behavior towards Deneloping Countries

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***Abstract***
*The world's capital markets enjoy unprecedented breadth and strength. Financial institutions move trillions of dollars of assets around the globe. Cross-border capital flows and foreign holdings of financial assets continue to grow rapidly, linking individual financial markets into an increasingly integrated global one. After a period of relatively narrow fluctuations during 1980-85, global cross-border flows tripled during the past decade to $6.4 trillion, reaching about 14.5 percent of world GDP by 2005.*

*In recent years, one of the most important topics has been foreign investor behavior. Investment return is increasingly more dependent on investor behaviour than on fund performance. It is important to understand better how they operate, what factors are important in their lending and investment decisions. This paper aims to provide information about investor behavior towards developing countries.*

*The assessments about investor behavior through developing countries can be summarized as following. National factors remain very important in determining the supply of international investment from individual countries. Although the regional factors have been far more important than global factors, global factors have increasingly affected on national factors. The market capitalisation and number of listed companies influence capital flows to the developing countries. The corporate factors are more effective than both capital markets factors and country level factors on investor behavior. The most important thing is to change the investor behavior by type of players. Finally, new components such as governance, confidence and transparency are increasingly becoming more effective on investor behavior as a result of global development.*

Keywords: investor behavior, developing countries.

## Introduction

The world's capital markets enjoy unprecedented breadth and strength. Financial institutions move trillions of dollars of assets –stocks, bonds, and other instruments- around the globe. Cross-border capital flows and foreign holdings of financial assets continue to grow rapidly, linking individual financial markets into an increasingly integrated global one. After a period of relatively narrow fluctuations during 1980-85, global cross-border flows tripled during the past decade to $6.4 trillion, reaching about 14.5 percent of world GDP by 2005.

Capital flows are increasingly diversified across borders, global capital markets are becoming more integrated as a result of liberalization and advances in technology, and the current economic environment offers many oppourtunities for growth around the world. The heightened interest of foreign investors in developing countries has led to their increased integration into the global financial system, with benefits for those countries and for the global economy. Some considerable developments in developing countries improve opportunities for foreign investors. Creditworthiness is increasing as a result of external debt restructring in a wide range of countries. Productivity gains are obtained from structural reform and the establishment of confidence in macroeconomic management in developing countries that have undertaken succesful stabilization programs.

In recent years, one of the most important topics has been foreign investor behavior. Investment return is increasingly more dependent on investor behaviour than on fund performance. It is important to understand better how they operate, what factors are key in their lending and investment decisions. This paper aims to provide information about investor behaviour towards developing countries. In order to accomplish this task, this paper is organized as follows. The next section presents the important of investor behavior. Section 3 gives the capital flows to developing countries since 1999. Section 4 analyzes the investor behavior through developing countries. The last section gives a conclusion.

## Importance of Investor Behavior

Analyzing changes in the foreign investor behavior is fundemental to understanding the buildup of strengths and weakness in the global markets. Decisions that key investor make about where to allocate their assets not only affect the prices of financial assets, but also have wide-ranging implications for economic performance and welfare in various countries (Pazarbaşıoğlu and Hardy, 2007).

Investor behavior is one of the three “golden rules”. Investor behavior is essential and an excellent chance for success with investment plan (Shorr, 2007). A better understanding of behavioral process and outcomes is important for financial planners because an understanding of how investors generally respond to market movements should help investment advisors devise appropriate asset allocation strategies for their clients. For companies, identifying the most influencing factors on their investors’ behavior would affect their future policies and strategies. For government, identifying the most influencing factors on investors’ behavior would affect the required legislations and the additional procedures needed in order to satisfy investors’ desires and also to give more support to market efficiency (Al-Tamimi, 2006).

Following two researches suggest that the behavior of an investor is the most important determinant of investing success. One of them was researched by Dalbar which is Boston-based financial research firm, examined real investor returns in equity mutual funds from 1983 through 2004. Table 1 shows that the average investor earns significantly less than the market indices, and investors that time the market actually lose money over the period meausured. Market timers consistently lose money, proving that it is extremely difficult over time to consistently predict and react appropriately to changes in the market. However, investors who systematically invest achieve significantly higher returns, earning an annual return of 6.80 %

compared to a negative return (-3.29 %) of market timers. These results show that investment return is far more dependent on investment behavior than on fund performance.

**Table 1: Average Annual Returns 1984-2003**

| **S & P 500 Index** | **12.9 %** |
|---|---|
| Average Equity Fund Investor | 3.51 % |
| Systematic Equity Fund Investor | 6.80 % |
| Market Timer Equity Fund Investor | -3.29 % |

Source: Dalbar Inc. "Quantitative Analysis of Investor Behavior", 2004.

Note: The Average Fund Investor: This represents the aggregate action of all investors. The Systematic Investor: This represents the investor who invests a fixed dolar amount each month for the entire study period and makes no withdrawals. The market timer Investor: This represents the investor who has bought and sold differently from the Systematic Investor.

Investor behavior can also affect on local market capitalisation. The second research computed the impact of the reallocation of portfolio by institutional investors on local market capitalisation. According to table 2 a one percent reallocation in the portfolio of US institutional investors is likely to have a 34.9 percent impact on Latin America's market capitalisation and a 14.2 percent impact on Asia (Boria, Chicacarini and Tsatsaronis, 1997).

**Table 2: Impact of Institutional Investors' Reallocation of Portfolio on Local Market Capitalisation**

| | Latin America | | | | Asia | | | | Industrial Countries |
|---|---|---|---|---|---|---|---|---|---|
| | Pension Funds | Insurance Companies | Open-end investment Companies | Total | Pension Funds | Insurance Companies | Open-end investment Companies | Total | Total |
| USA | 16.4 | 8.25 | 10.25 | 34.9 | 6.66 | 3.35 | 4.16 | 14.18 | 0.58 |
| Japan | 5.90 | 6.67 | 1.97 | 14.54 | 2.40 | 2.71 | 0.80 | 5.91 | 0.24 |
| Europe | 5.32 | 9.17 | 6.29 | 20.78 | 2.15 | 3.79 | 2.55 | 8.49 | 0.43 |

Source: Borio, Chicacarini, and Tsatsaronis, (1997.)

Note: one percent increase in portfolio allocation to equity as a percentage of stock market capitalisation)

## Capital Flows in Developing Countries

The continued expansion in capital flows has been supported by a benign economic and financial environment. Demand from industrial countries has remained strong, with GDP growth of 3.1 percent in 2006 (up from 2.6 percent in 2005) boosting developing countries'exports. High commodity prices have continued to benefit exporting countries (World Bank, 2007) Current account balances for developing countries as a group continued to improve in 2006, reaching a record 3.1 percent of GDP, up from 2.7 percent in 2005. These balances rose by $247 billion between 2003 and 2006 (Table 3).

The expansion in net capital flows to developing countries continues to keep pace with economic growth, with total (private and offical) flows increasing slightly, from about 5 percent of GDP in 2005 to 5.1 percent in 2006, up from 3 percent in 2001 and equal to the level reached in 1995 before the Asian crisis (World Bank,2007). The composition of capital flows continues to shift from offical to private sources, as net capital inflows from private creditors continue to expand, partially offset by net capital outflows to official creditors. Private debt and equity inflows reached a record $ 647 billion in 2006, up 17 percent from 2005. Equity continued to account for the bulk of capital flows, averaging 70 percent of the total during 2004-2006. Foreign direct and portfolio equity flows reached a record $418 billion in 2006, while net private and official debt flows increased by just $75 billion since 2003. Net official lending declined sharply over the past two years, as principal repayments to official creditors exceeded disbursements by $70 billion in 2005 and $75 billion in 2006 (Table 3).

**Table 3: Net Capital Flows to Developing Countries, 1999-2006 ($ Billions)**

| | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006e |
|---|---|---|---|---|---|---|---|---|
| **Current Account Balance** | -19.1 | 34.4 | 12.1 | 60.5 | 101.9 | 113.6 | 256.4 | 348.5 |
| **as % of GDP** | -0.3 | 0.6 | 0.2 | 1.0 | 1.5 | 1.4 | 2.7 | 3.1 |
| *Financial Flows* | | | | | | | | |
| **Net Private and official flows** | 209.6 | 181.1 | 191.1 | 174.2 | 262.0 | 385.9 | 480.7 | 571.0 |
| **Net private flows (debt + equity)** | 195.6 | 187.0 | 164.5 | 169.2 | 274.1 | 412.5 | 551.4 | 646.8 |
| **Net equity flows** | 189.6 | 179.9 | 176.6 | 162.9 | 184.3 | 257.7 | 347.5 | 418.8 |
| **Net FDI inflows** | 178.0 | 166.5 | 171.0 | 157.1 | 160.0 | 217.8 | 280.8 | 324.7 |
| **Net portfolio equity inflows** | 11.6 | 13.4 | 5.6 | 5.8 | 24.3 | 39.9 | 66.7 | 94.1 |
| **Net debt flows** | 20.0 | 1.2 | 14.5 | 11.3 | 77.7 | 128.2 | 133.2 | 152.2 |
| **Offical Creditors** | 14.0 | -5.9 | 26.6 | 5.0 | -12.1 | -26.6 | -70.7 | -75.8 |
| **Private Creditors** | 6.0 | 7.1 | -12.1 | 6.3 | 89.8 | 154.8 | 203.9 | 228.0 |
| **Balancing item** | -158.1 | -170.4 | -122.4 | -60.2 | -69.1 | -95.5 | -345.4 | -286.5 |
| **Change in reserves** | -32.4 | -45.1 | -80.8 | -174.4 | -294.7 | -404.0 | -391.7 | -633.1 |

Source: World Bank, 2007.

## Analyzing of Investor Behavior towards Developing Countries

Capital outflows from a country are generally modeled as depending on the economic conditions within that country, conditions in the world economy, and conditions in candidate recipient countries. National and global factors have been and remain very important in determining the supply of international investment from individual countries (IMF, 2007). Table 4 shows the relationship among capital outflows, global, regional and type factors. According to table, the regional factors have been far more important than global factors since 1974. In the sub-period from 1996-2005, the regional factors predominate, but the total predictive power is significantly higher than the sum of that attributable to identified factors in the subperiod from 1974-96. This suggests that there has been some strengthening of the interaction between regional and global factor.

**Table 4: The Effect of Global, Regional and Type Factors on Capital Outflows in a Panel Data Regression, 1974-2005.**

| | Total | Worldwide factor | Regional Factor | Type factor |
|---|---|---|---|---|
| **1974-2005** | 0.236 | 0.012 | 0.222 | 0.000 |
| **1996-2005** | 0.170 | 0.002 | 0.095 | 0.000 |

Source: (IMF, 2007)

Building an international portfolio may lead to bigger rewards, but also to greater risks. A key risk category international portfolio management faces is the country risk. The country risk is associated with economic, financial, social, political and geographical factors, reflected in variables such as main macroeeconomic indicators (GDP, inflation, exchange rate) debt service ratios, and events such as energy shortages, natural disasters, wars, etc. According to the business literature, other factors that discourage international portfolio investment are associated with the characteristics of stock markets across countries, which can be perceived as additional source of risk. For example, investors are less keen on markets that are shallow, lack liquidity and hold a high level of concentration as such markets would be more vulnerable to shocks and manipulative actions. These characteristics are commonly found in the stock markets of small and emerging countries (Gottschalk, 2001).

Montiel and Reinhart (2001) indicate that market capitalisation and number of listed companies do influence portfolio flows to the emerging economies. Other markets' characteristics, such as patterns of share ownership and degree of government regulations, are also believed to be considered by investors when taking investment decisions (Gottschalk, 2001).

Investment behavior is affected by a broad spectrum of factors. Table 5 shows that percentage of investors who think that factors is very important for investment decision. The quality of market regulation and infrastructure is highly significant, along with enforceable property rights and downward pressure on corruption. In addition, investors support a single global accounting standard.

**Table 5: Important factors in investment decision (%)**

| | | |
|---|---|---|
| Corporate Factors | Accounting disclosure | 71 |
| | Shareholder equality | 47 |
| Capital market factors | Market regulation and infrastructure | 43 |
| | International Accounting standards | 42 |
| | Market liquidity | 37 |
| Broad country level factors | Property rights | 46 |
| | Pressure on corruption | 32 |
| | Insolvency and bankruptcy regulation | 32 |
| | Fiscal environment | 31 |
| | Banking system | 30 |

Source: McKinsey Global Investor Opinion Survey on Corporate Governance, 2002.

Following table shows that determinants of foreign investment for US and Japanese. During the 1980's US and Japanese multinationals were attracted by some similar country characteristics: low wage inflation, low country risk, good infrastructure, and an educated labor force. Both group of investors displayed a persistent, being strongly attracted to locations with significant past investment. Japanese firms started the decade as somewhat more fluid, but as their investment levels surged, they became much more persistent. Overall, US firms were more influenced by domestic market conditions and moved contrary to changes in host country trade intensity (Moody and Sirinavasan, 1998).

**Table 6: Determinants of Foreign Investment for US and Japanese**

| **Determinants of Foreign Investment** | **US (1972-1992)** | **Japanese (1981-1990)** |
|---|---|---|
| Market Size | Important | Not important |
| Cost of Investment | Not Major İnfluence | Not major influence |
| Corporate Tax Rate | Nor Major İnfluence | Not major influence |
| Cost of Labour | Sensitive | More sensitive |
| Trade propensity | Large GDP and low volumes of trade | Great trade propensity |
| Stock of past FDI | Greater Sensitivity | Greater sensitivity |
| Primary school enrollment ratio | Sensitive | More sensitive |
| Country Risk | İnfluential | More influential |
| Infrastructure | Sensitive | More senstitive |

Source: Moody and Sirinivasan (1998)

Table 7 displays the national factors that are seen by investors as important in their decision-making process *in Sub-Saharan Africa*. They range from purely economic factors, such as growth performance and exchange rate prospects, to institutional, such as private ownership, to more political ones (e.g. political stability).

**Table 7: National Factors Underlying Investors'Behavior in Sub-Saharan Africa**

| **Macro** | **Structural** | **Institutional** | **Sectoral** | **Political** | **Others** |
|---|---|---|---|---|---|
| Growth performance; Other macroeconomic variables; Economic policy coordination; Exchange rate prospects | Soundness of domestic financial system; regional economic integration; availability of natural resources; transport and telecom Networks | Private ownership; Common regional regulation and supervision in banking; development of stock exchange | Low cost, volume-driven primary sectors | Political stability | Levels of corruption; Bureaucracy; motivated labour force; donor support for portfolio investment |

Source: Gottschalk, 2001, based on Bhinda, Griffith-Jones, Leape and Martin (1999)

Gottschalk (2002) aimed to provide information and insights into lenders and investors' behavior and their attitudes towards developing countries. Gottschalk interviewed with international financial players based in London, New York, Chicago and other US financial centers.

Table 8 summarized the results about recent characteristics of the different types of players.

**Table 8: Lenders and Investors' Recent Traits**

| | Pension Funds | Global Investment Funds | Dedicated Investment Funds | Banks |
|---|---|---|---|---|
| Lending/Investment Strategies | Contrarians | Momentum Strategies | Contrarians | Increasing within country lending and declining cross-border lending |
| Allocation Decision | Consultants play a major role | Top-down approach | Bottom-up approach | Top-down approach |
| Degree of Risk Aversion | Moderate | High | Moderate | High |
| Role of Information | Important | Moderate | Crucial | Important |
| Use of Models | Little | Yes | Little | Some do. |
| Herding Behavior | Below average | Yes | Below average | yes |
| Constraints on investing EM | Some OECD countries face restrictions on foreign investment | Lack of liquidity and information asymmetry | Tend to be equity investors that are facing problems in investing in EM stock markets that increasingly lack depth and breath | Lack of lender of last resort, PSI initiatives and orderly debt workouts, problems with personal security. |

Source: Gottschalk (2002).

According to the 2002 Global Investor Opinion Survey, corporate governance is at the heart of investment decisions. Investors state that they put corporate governance on a par with financial indicators when evaluating investment decisions. An overhelming majority are prepared to pay a premium for companies exhibiting high governance standards. Premiums averaged 12-14% in North America and Western Europe; 20-25% in Asia and Latin America; and over 30 % in Esatern Europe and Africa.

**Table 9: Important of governance relative to financial issues**

| | **Less Important** | **Equally Important** | **More Important** |
|---|---|---|---|
| **Eastern Europe** | 15 | 45 | 40 |
| **Latin America** | 16 | 66 | 18 |
| **Asia** | 18 | 61 | 21 |
| **North America** | 43 | 50 | 7 |
| **Western Europe** | 44 | 41 | 15 |

Source: McKinsey Global Investor Opinion Survey on Corporate Governance, 2002.

Note: Governance defined as effective boards of directors; broad disclosure, and strong rights and equal treatment for shareholders. Financial Issues: Profit performance and growth potential

Confidence in the economy and the capital markets is a critical driver of economic and financial fluctations and of the business cyclical. When confidence increases, investors want to invest at prevailing prices. When confidence decreases, spending and risk-taking tend to fall. The State Street Confidence Index provides an objective quantative measure of global risk tolerance of the world's sophisticated investors. Regional components measure separetely the risk appetites of institutional investors in North America, Europe and The Asia-Pacific region. The index is based on financial theory that assigns precise meaning to changes in investor risk appetite, or the willingness of investors to allocate their portfolios to equities. The more of their portfolio that institutional investors are willing to devote to equities, the greater their risk appetite or confidence. Global Investor Confidence fell by 0.3 points to a level of 82.6 in October 2007. Leading the decline were North American institutional investors, whose confidence fell sharply from 102.8 to 89.2. In Europe, confidence increased from 82.9 to 83.6 while whose confidence declined from 87.4 to 85.7 in Asia (Table 10).

**Table 10: Investor Confidence Index, Regional Data**

| **2006** | **Global** | **N. Amer.** | **Europe** | **Asia** | **2007** | **Global** | **N. Amer.** | **Europe** | **Asia** |
|---|---|---|---|---|---|---|---|---|---|
| Jan. | 77.0 | 89.8 | 73.7 | 82.9 | Jan. | 85.2 | 94.9 | 92.2 | 85.0 |
| Feb. | 72.1 | 83.3 | 78.9 | 80.7 | Feb. | 90.6 | 101.9 | 92.5 | 82.5 |
| March | 81.9 | 91.5 | 94.4 | 77.9 | March | 99.3 | 114.5 | 87.3 | 85.0 |
| April | 83.0 | 93.1 | 96.4 | 78.5 | April | 93.0 | 102.6 | 90.5 | 81.7 |
| May | 86.3 | 99.0 | 93.9 | 78.8 | May | 92.1 | 100.1 | 94.4 | 85.8 |
| June | 90.5 | 106.7 | 86.5 | 80.2 | June | 97.7 | 107.0 | 98.1 | 84.0 |
| July | 83.3 | 98.1 | 85.4 | 81.1 | July | 86.3 | 95.5 | 87.1 | 79.7 |
| August | 83.5 | 96.0 | 88.4 | 86.6 | August | 99.6 | 117.1 | 86.6 | 84.9 |
| Sep. | 80.7 | 92.8 | 88.9 | 90.7 | Sep. | 88.7 | 102.8 | 82.9 | 87.4 |
| **Oct.** | **82.9** | **93.2** | **95.5** | **95.2** | **Oct.** | **82.6** | **89.2** | **83.6** | **85.7** |
| Nov. | 82.2 | 90.7 | 90.2 | 99.7 | Nov. | | | | |
| Dec. | 88.0 | 98.2 | 97.0 | 90.1 | Dec. | | | | |

Source: State Street, 2007.

In additon, country transparency affects international portfolio investment. Gelos and Wei (2002) investigate the effect of transparency in developing countries on the level of investment by international institutional investors. They found that low transparency tends to depress the level of international investment. Low transparency in a developing country leads to an increase in the herding behavior by international investors. Funds seem to react less strongly to news about country fundementals in less transparent countries. During crises, funds flee non-transparent countries and invest in more transparent ones.

## Conclusion

In last decades, investor behavior has been one of the most important topics. Investment return is increasingly more dependent on investor behaviour than on fund performance. This paper aims to provide information about investor behavior and their attitudes towards developing countries. Some considerable developments in developing countries improve opportunities for foreign investors and the heightened interest of foreign investors in developing countries has led to their increased integration into the global financial system. The assessments about investor behavior through developing countries can be summarized as following. National factors remain very important in determining the supply of international investment from individual countries. Although the regional factors have been far more important than global factors, global factors have increasingly affected on national factors. The market capitalisation and number of listed companies influence capital flows to the developing countries. The corporate factors are more effective than both capital markets factors and country level factors on investor behavior. The most important thing is to change the investor behavior by type of players. Finally, new components such as governance, confidence and transparency are increasingly becoming more effective on investor behavior as a result of global development.

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