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“Friend or foe? Bilateral political relations and the portfolio allocation of foreign institutional investors”

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Summary

Goal

- Paper studies **bilateral country-level political relations** and their **effects on individual investor behavior**
  - Measures strength of bilateral ties using political distance between countries' UN voting patterns (Bailey, Strezhnev & Voeten, 2017)
  - Prior studies find effects on aggregate country-level flows…
  - … but less understanding of the exact channels

- Investor behavior **reveals channels** behind the macro effect
  - Investor reputational concerns in their home countries
  - Information costs
  - Risk of overt discrimination; e.g. dividend restrictions

Paper deploys micro firm-level data

- > 10 million observations
  - 9 home/origin/investor geographies
  - 23 target/destination/host geographies
- Allows for three sets of interacted fixed effects
  - Strengthens claim to causal effect at the investor level
- Strong effect at the investor level identified in panel regressions
  - 1 s.d. increase in bilateral political distance associated with $^{2}/_{3}$ s.d. decrease in portfolio shares devoted to target geographies

Comments

Reputational channel

- Paper setup that the sign of reputational issues is ambiguous:

On the one hand, local politicians who renege on commitments with foreign investors face adverse consequences such as domestic backlash from their own voters (Jensen (2003, 2006)), and lower levels of future foreign investment (Jensen (2008)). On the other hand, foreign investors may face domestic reputational costs themselves by investing in a country that is perceived to be less friendly back home (Kose et al. (2016)).

- Test (Section 3.2, Table 6) finds that politically exposed firms are more sensitive to deteriorating bilateral relations:

foreign investors [...] shun stocks from the host country disproportionately more when issued by firms that are more exposed to political risk

- But why does this show a reputational effect, rather than a decrease in exposure to increasing political risk?

Publicly-listed vs. privately-held firms

- Seems sample focusses on publicly-listed target firms?
  - Not clear in the paper, at the moment

- If so, which direction do you expect a bias compared to the full universe of firms? I can think of two opposing effects:
  - If publicly-listed targets are easier to divest/sell $\Rightarrow$ greater sensitivity
  - If publicly-listed targets are less exposed to political risk $\Rightarrow$ less
  - Any way to tease these apart and sign any bias?

Role of FX risk (1/2)

- As well as political risk, **investors could be exposed to FX risk**
  - Sample includes BRICS and other developing countries

- Panel regressions control for (log) level of exchange rate and the historical volatility of the exchange rate.
  - These do not necessarily capture FX risk
  - May be speculative attacks on a currency peg, with both variables constant… until the peg collapses
  - Example: UK £ in "Black Wednesday" (16 September 1992)

Role of FX risk (2/2)

- Suggest a subset analysis to confirm FX risk doesn't drive results

- Ideally where there is no FX risk:
  - **Investors & firms within EMU countries**
  - These are currently treated as 1 block

- Second-best: where there is less FX risk due to close economic ties but (maybe) still considerable political risk
  - **EMU vs. Hungary?**

Test of information asymmetry

- Currently use Amihud's (2002) illiquidity measure to proxy for individual **firm opacity**
  - Typically illiquidity measures excel at capturing trading costs

- It is a **loose proxy for information asymmetry across borders** between target firms and origin investors
  - More generally, any market microstructure measure will capture opacity perceived by all investors trading the firm on that exchange…
  - … while we care about (some) foreign investors

- Any more precise measures? E.g. news coverage of foreign target firms by the media in investors' countries of origin?

Wrapping up

Conclusion

- Most of my suggestions concern robustness checks
- Suggest clarity and/or further tests on the reputational channel
- Suggest clarity on the external validity of public targets
- Nice paper - good luck!

Thank you!

Bibliography

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