Do Foreign Investors Improve Informational Efficiency of Stock Prices?

Evidence from Japan

Wen He
School of Accounting
Australian School of Business
The University of New South Wales
Sydney, NSW 2052, Australia
Tel: +61 2 9385 5813
Fax: +61 2 9385 5829
Email: wen.he@unsw.edu.au

Jianfeng Shen
School of Banking and Finance
Australian School of Business
University of New South Wales
Sydney, NSW 2052, Australia
Tel: +61 2 93854581
Fax: +61 2 93856347
Email: jianfeng.shen@unsw.edu.au

Abstract

This study investigates the impact of foreign investors on the informational efficiency of stock prices in local markets. Using a large sample of Japanese firms over the period 1975 to 2004, we find that prices deviate less from a random walk for stocks with more active trading by foreign investors. This relation is robust to controls for local institutional trading and stock liquidity. We further show that changes in foreign investor trading predict changes in price efficiency in the next period, but not the vice versa. Finally, we find that prices are more informative about future earnings for stocks with more active trading by foreign investors. Collectively, these results suggest that foreign investors help improve price efficiency in the local stock market.

JEL classification: G14; G15
Keywords: Foreign investors; Foreign investor trading; Price efficiency; Institutional investors; Japan

December 2010

1 Corresponding author.