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TACKLING SOCIETAL CHALLENGES

This is a monthly series on SMU research which aims to create significant impact by addressing these five societal challenges: Economies & Financial Markets, Social Fabric & Quality of Life, Boundaries & Borders, Sustainability, Innovation & Technology.

In this issue, SMU researchers offer insights on tackling the societal challenge of interpreting economies & financial markets.

Common ownership of companies can be beneficial

Companies can glean more information from their own firm's stock price if their large shareholders also hold stakes in rivals

Associate Professor Holly Yang

In recent years, financial regulators around the world have been sounding alarm bells on a phenomenon known as "common ownership", which refers to shareholders holding shares in companies that compete in the same sector. They fear that such corporate cross-ownership hurts competition as companies will have fewer incentives to invest in new products or services, or to win market share from competitors, if they know that their large shareholders also own significant stakes in their rivals.

What's more, as institutional investors own a portfolio of firms, they usually aim to maximise the value of their whole portfolio, rather than that of an individual investee company. As such, sometimes these investors may make decisions that may not be optimal for individual firms within the portfolio.

For example, institutional investors often vote for mergers despite negative acquirer announcement returns because they also hold substantial stakes in the target company and make up for the losses from the acquirers with the gains from the targets.

However, new research from Associate Professors Holly Yang and Young Jun Cho from Singapore Management University's (SMU) School of Accountancy found that common ownership of industry peers helps institutional investors acquire industry insights and produces exclusive information that managers can obtain from stock price movements. Managers can then use this information to make better operational and investment decisions.

"Overall, our results suggest that cross-ownership of peer firms induces more efficient corporate decisions by helping prices better reflect investors' private information," says Prof Yang.

Gaining industry insights through price

The SMU study is based on the theory of financial markets, which suggests that managers can glean information from stock price about their own firms, as stock price contains information from traders that managers do not have.

While researchers often assume that information generally flows from the company to the market, this theory suggests that information can also go in the other direction.

According to the SMU research, this information flow is enhanced when cross-ownership is concentrated in a set of firms in the same industry. This sometimes enables management of affected companies to gather more easily industry insights from price movements, leading to better decision making and more accurate profit forecasts.

"The traditional view is that managers always have more information, but that's not necessarily true. A manager may have more firm-specific information but less industry-specific information. Institutions, by investing in multiple peer firms in the same industry, may have information about demand from product markets or strategic issues relating to the firm's competitors," explains Prof Yang.

"As a result, they are likely to have a better understanding of industry trends and the overall competing landscape. This information is reflected in stock prices through institutional trading."

For example, when digital photos replaced films and smartphones replaced cameras in the early 2000s, Fujifilm was not only able to identify new business lines using its existing photo film technologies, but also invest heavily in R&D to diversify away from its traditional film production business.

On the other hand, Kodak failed to react fast enough to the threat of new technology and eventually filed for bankruptcy in 2012. A common owner of these two industry leaders at that time would be able to identify the different management strategies adopted by the two rivals and use that information to their advantage in their trades.

Such industry insights matter to firms and investors since corporate decisions are determined not only by internal information on firm fundamentals but also by external factors, such as industry prospects, says Prof Yang.

For example, if Softbank's holdings in AI firms allows them to generate industry insights and leads to more investments in driverless cars, then the share price of automobile stocks are likely to go up. Car manufacturers are then likely to increase their capital expenditures in similar projects as this information is also priced into their shares. Likewise, they may also revise their earnings projections to reflect their expectations of product demand.

The SMU study breaks new ground on the ongoing debate over whether common ownership is desirable or not in financial markets. A lot of the recent discussion on the topic has focused on anti-trust issues, and there have even been suggestions of imposing a limit on the percentage of shares institutional investors can hold in a particular industry, or restricting them to owning only one company in each industry.

Says Prof Yang: "While it's premature to say whether common ownership is net beneficial to the society, our findings shed light on one of the benefits of cross-ownership that hasn't been explored."

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Financial integration can lead to greater risks for stock investors

The deepening of global and regional financial integration is amplifying the transmission of financial shocks in Asia

Professor Chow Hwee Kwan

Boosted by freer flows of global capital and technological advancements, cross-border linkages between stock markets around the world have been strengthening in recent years. In particular, the growing use of electronic trading – which increases the speed of international financial transactions – and the deregulation of equity markets is accelerating this trend.

This phenomenon can be seen in the case of China, where the partial opening of the country's stock markets to foreign investors and the gradual shift toward market-determined exchange rates has led to Chinese equity markets being increasingly integrated into the global financial system. The impact of this integration was seen in August 2015, when Asian bourses fell sharply following the plunge in Chinese stock prices after a change in the renminbi exchange rate regime was announced. More recently, in January 2016, the suspension of trading in Chinese stocks triggered a widespread correction in global equity markets. This shows that, as countries become more financially integrated, there is a corresponding rise in the cross-border transmission of equity market shocks.

Furthermore, a study by Professor Chow Hwee Kwan from Singapore Management University's (SMU) School of Economics found that, following the global financial crisis, such "volatility spillovers" are not temporary shocks that occur as a result of contagion, but rather persisted after the crisis. Her research also showed that the susceptibility of individual Asian bourses to volatility transmitted from other markets is linked to its degree of openness, and that equity markets in the region are becoming more important emitters of financial shocks since the global financial crisis.

In particular, Prof Chow's study provides evidence that compared to the pre-crisis period, stock markets in Asia have become more susceptible to spillovers from China and less so to spillovers from Japan after the crisis. Prior to the crisis, volatility in the Asian equity markets appears to be more affected by the gyrations in the Japanese market compared to the Chinese market. However, the level of influence on Asian stock markets from the Chinese market has risen to that of Japan. Meanwhile, spillovers from the United States remain higher than those from China and from Japan in both the pre- and post-crisis periods.

The study used "spillover indexes" that obtain an overall picture of shock transmissions in Asian stock markets. It focused on the benchmark indices of 10 Asian economies: China, Hong Kong, Indonesia, Japan, Korea, Malaysia, the Philippines, Singapore, Taiwan, and Thailand. The S&P500 and FTSE100 indexes were also included to reflect the region's integration with global markets. The computed "spillover indexes" provide measures of inward and outward transfers of shocks for each individual equity market, giving us a pattern of cross-border volatility transmissions. A comparison of shock transmissions before and after the global financial crisis is then carried out.

Mitigating the risk of openness

While deeper financial integration brings about significant economic benefits – such as portfolio diversification for investors and risk sharing across countries – it also exposes domestic financial markets to international financial transactions, resulting in higher risks of financial instability. Indeed, recurring financial and currency crises in the past few decades has raised the question of whether developing countries should continue to promote financial openness, says Prof Chow.

In Asia, the level of openness varies widely across different groups of economies. Unsurprisingly, as global financial centres, Japan, Hong Kong, and Singapore are fully integrated with global markets, while at the other end of the spectrum, China is making efforts to gradually open its markets. Initiatives to strengthen financial cooperation and integration are also ongoing in the region. For instance, ASEAN countries are working to integrate their capital markets, including efforts to facilitate cross-listing of securities and cross-border settlement.

Prof Chow noted that Singapore's financial sector has thrived on its openness and, as such, imposing measures such as capital controls to mitigate the impact of financial shocks is not feasible. "The susceptibility to financial shocks and increase in volatility transmission are key challenges which our financial market regulators have to face. Should there be a sudden and large scale outflow of capital, having currency swap lines will help ease liquidity crunches," she says.

Over the longer term, she believes that financial stability can be achieved by adopting policies that build resilience and boost confidence in Singapore, such as by maintaining a high level of official reserves and employing policies that mitigate systemic risk in the financial sector. In view of her research, Prof Chow said that firms and individuals will need to take into account the greater volatility in the stock markets when crafting their investment strategies. "Market participants may have to take a longer term view of their investments. Various derivative products that offer protection against market volatility will also become more useful."

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