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Foreign Fund Flows and Asset Prices: Evidence from the Indian Stock Market

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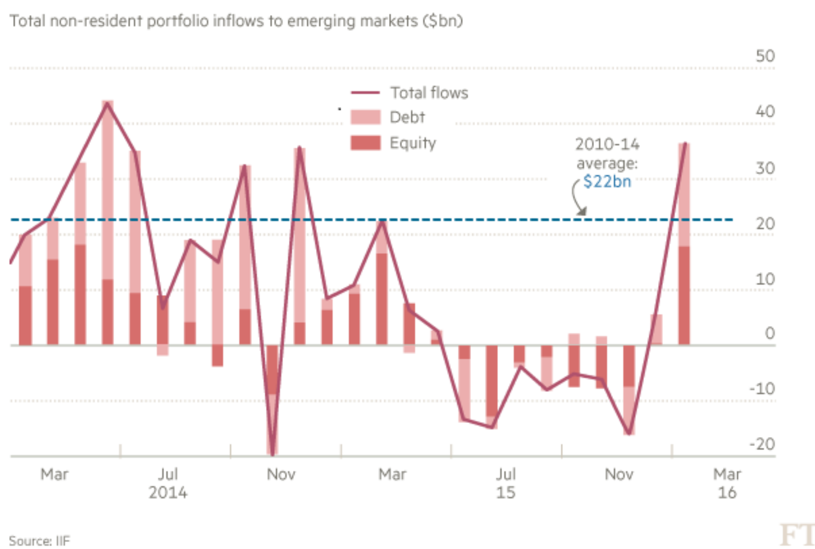
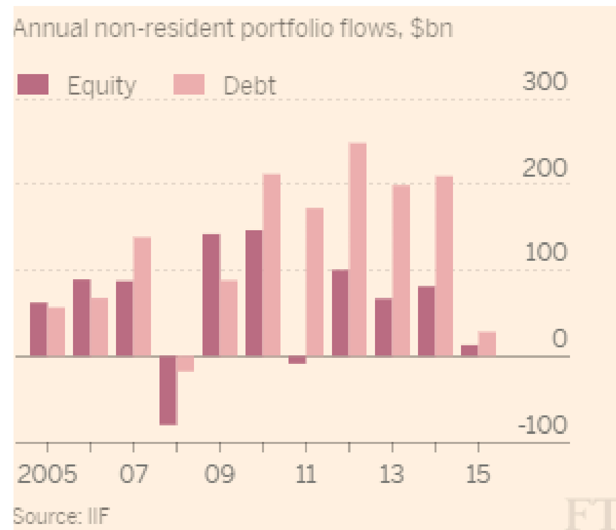
What is the Impact of FII Flows on Stock Prices in Emerging Markets?

- Given the importance of FII to emerging markets, the question of how their flows impact prices has received considerable attention.





- In India, FII have moderate fraction of ownership (6-11%) but account for 20% of trading volume (from Table 1).

- Capital is crucial to growth, but the stability of that capital is also relevant.

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Image Sources: Financial Times January 4, 2016 and March 29, 2016

Innovations in FII Flows

This paper uses *daily stock-level* data on FII to examine the impact of unexpected FII on Indian stock prices.

1. Define $FII\ Net_{it} = \frac{FII\ Buys_{it} - FII\ Sells_{it}}{Rupee\ Volume\_it}$

2. Regress $FII\ Net_{it}$ on:
   - $\mathrm{FII\ Net}_{\mathrm{it}-1}$
   - lagged stock returns
   - stock characteristics: firm fixed effects, size, turnover, retail ownership, institutional ownership
   - lagged market variables: aggregate FII, VIX (levels and changes), S&P500 returns, NIFTY return, NIFTY volatility
3. Use residuals ("innovations") to define innovation portfolios.

Tests exploit cross-sectional variation in unexpected FII flows.

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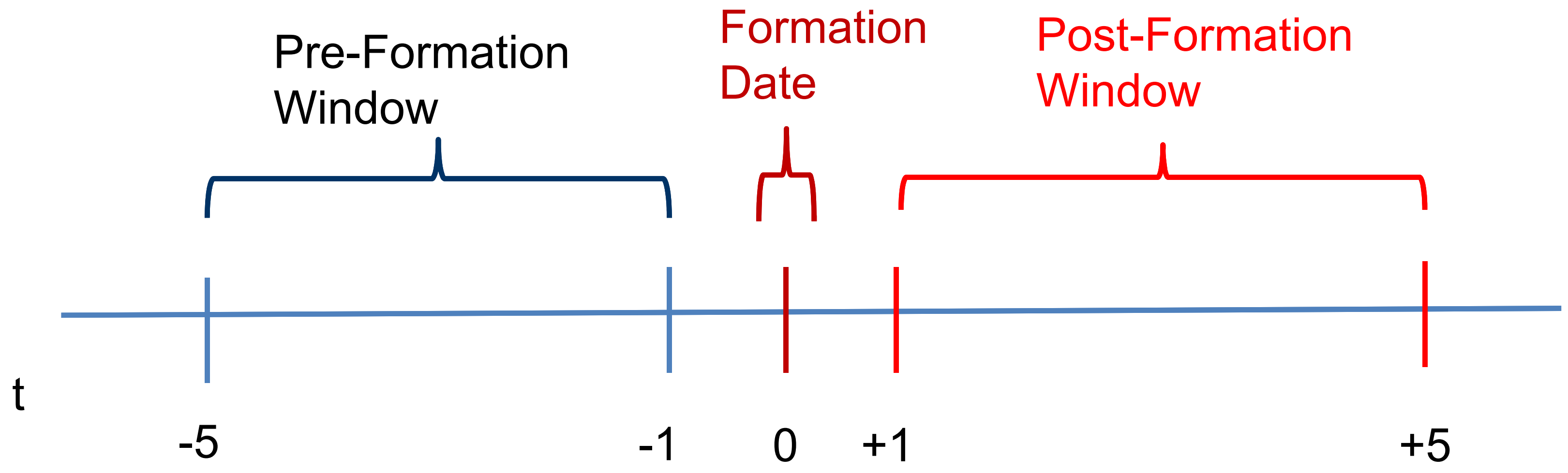
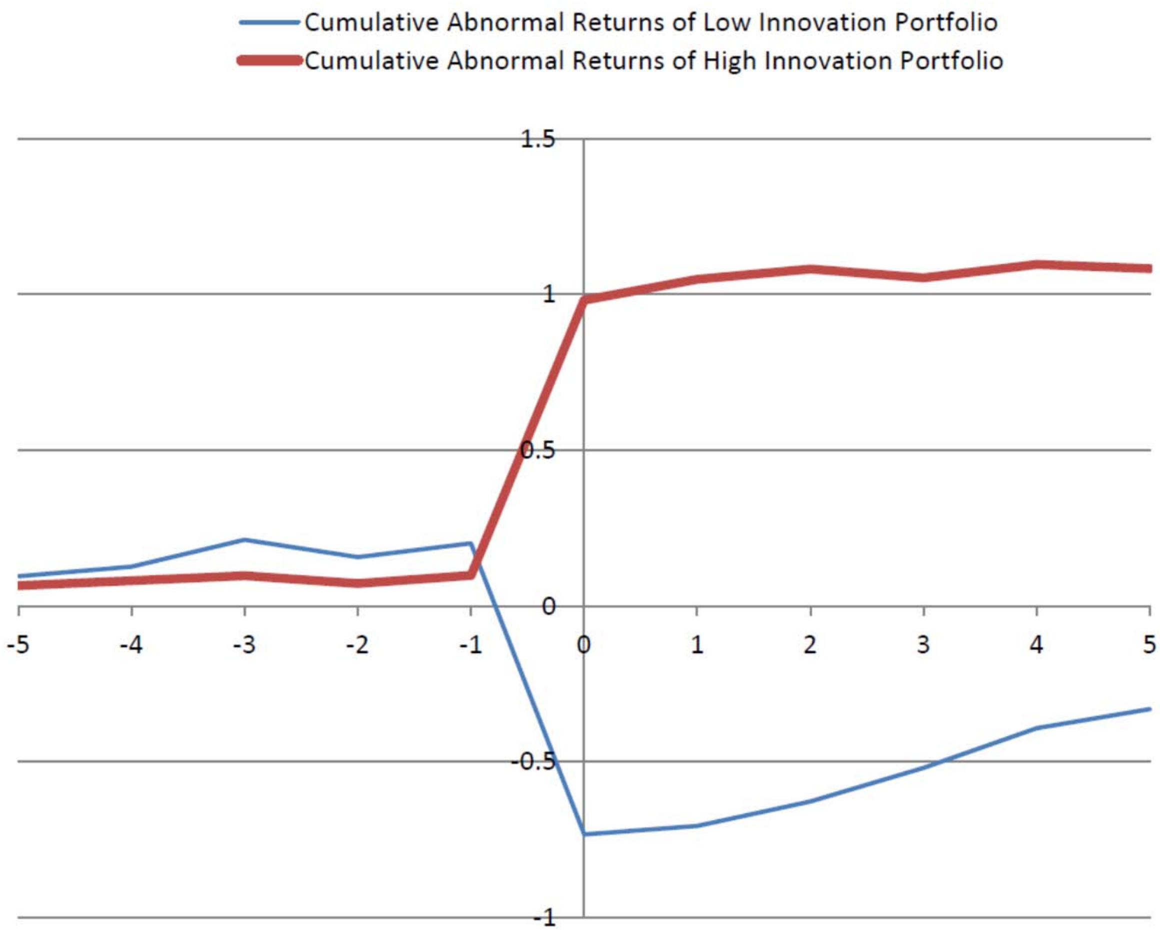
Portfolio Formation and Post-Formation Returns



Main Findings (Figure 3)



The asymmetry is interesting! Several potential explanations:

1. Unexpected purchases are informed; sales less so.
2. Non-linearities missing in the expected flow regressions (e.g., more extreme response to negative S&P 500 returns).
3. Potential impact of other non FII trading volume. If some ”high innovation” portfolios are due to low trading by others, reversals could be more sluggish.

Interpretation

- **Benchmark.** Is the impact of FII different from the impact of other investors?

- **Expected Flows.** Are there important differences between expected and unexpected FII?
  - Policymakers are concerned with both.
  - Analysis of expected flows might also allow some comparison with Lou (2012).

Other Thoughts

- **Index additions/deletions.** Taper tantrum tests are informative. Index changes could offer a view of the impact of an exogenous shock to rebalancing needs at a stock-level.

- **Reversal speed.** The reversal results are conditioned on a 5-day window. Particularly relevant when considering the size tests because it might be that reversals take longer in small and illiquid stocks.

- **Alternative FII measure.** Considering scaling by shares outstanding so that variation comes mainly from FII, rather than other investors' trading.

Conclusions

- Well-executed analysis of an economically important question.
- Daily stock-level data allow for more precise tests than prior studies.
- Reading the paper made me want to learn even more!
  - Is there something special about unexpected FII?
  - Comparison with other investor groups
  - Comparison with expected foreign institutional investor flows