

# How Important are Foreign Ownership Linkages for International Stock Returns?

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## Summary

What drives stock price variation in international securities? A large literature debates the relative importance of country and industry forces in affecting variation in stock returns and international diversification. We recast this debate in terms of another important driver of stock returns: international ownership. We add to the literature by: a) providing a new and intuitive measure to capture stock linkages, b) documenting the importance of foreign ownership on a large and systematic scale, and c) decomposing and empirically analyzing the channels through which ownership matters.

In order to capture a stock's connectedness to foreign securities, we construct a measure of the foreign equity returns of the stock's shareholders. Because the ownership return captures the returns of other stocks held by Samsung shareholders outside of Korea, it is a measure of foreign ownership linkage. Using detailed holding data from the Lionshares Holdings database, we are able to capture ownership for 8,791 firms domiciled outside of the United States.

We document that foreign ownership returns are important for driving cross-sectional variation in returns. For stocks with more than five percent foreign ownership, a one percent increase in the ownership return is associated with an economically large 0.395 increase in a firm's stock return, even after controlling for the local market and industry movements. International ownership linkages are not explained by omitted country/industry variations, wealth effects or other explanations like liquidity, investment style, or fund flows.

With an investor habitat, investors move capital in and out of related securities in a correlated fashion. Consistent with this explanation, we find that stocks with common ownership have strong related changes in institutional ownership. Our paper provides micro-level evidence on the association between foreign institutional investors and international stock price co-movement.

We briefly examine the practical diversification implications of our findings. If a fund adds a security with high ownership linkage to their fund, the average beta of that security with the fund portfolio is 77 percent higher than if the fund were to add a security with low ownership linkage. While the level of foreign ownership is also important, the magnitude of ownership linkages is more economically important. Since investors hoping to obtain diversification cannot easily escape the effects of other foreign investors in a firm's investment habitat, investment locales transcend country and industry boundaries.