Does persistence pay off?

What drives the persistence of the portfolio flows of international investors?

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The portfolio flows of institutional investors have been found to be highly persistent across countries and individual investment funds. In addition, these same flows have been found to positively predict future country and industry returns. Are these two facts related? Is the positive predictability of returns driven by the persistence of country flows? If so, what is the mechanism?

This paper investigates the source of persistence in emerging market equities and hopes to shed light on the mechanism by which flows predict returns. The idea is as follows: a possible source of persistence at the country level (across investment managers) is persistence in trades at the level of the individual manager. Individual managers may move into stocks slowly to accommodate less than complete liquidity. Traders pay more if they buy rapidly, since rapid purchases are a signal of information. Some degree of individual trader persistence should be expected if the trader is (or believes he is) informed. Own-manager, own-country persistence in flows is one possible cause of price predictability.

Cross-Manager Persistence

A second possible source of persistence of flows at the country level is cross-manager persistence in same-country flows. Here, managers begin purchasing a given country at different times, inducing persistence in the aggregate country flows, even if there were no persistence at all in own-manager flows. While market makers may be able to predict own-manager flow from looking at past flows for that manager, cross-manager flows may be more difficult to predict. As a result, cross-manager persistence may be important in driving future prices.

A third possible source of persistence of flows at the regional level is persistence across countries. Here, the same manager may start purchasing one country after purchasing another (this is referred to as own-manager, cross-country persistence). In addition, a different set of managers may start purchasing one country after another group has been purchasing a different country (this we refer to as cross-manager, cross-country persistence). If these cross-country sources of persistence are important, then contagion effects would seem to be present.

Flow Components

This paper employed the decomposition methodology of Froot and Tjornhom (2002), which separates the persistence of aggregated country flows into four components: (i) own-country, own-fund persistence (which might arise from informed trading within each country by individual funds); (ii) own-country, cross-fund persistence (which might arise from asynchronicities across funds); (iii) cross-country, own-fund persistence (which might arise from asynchonicities within a fund), and; (iv) cross-country, cross-fund persistence (which might arise from other reaction lags—such as contagion—across both countries and funds). Evidence was found that all four components are positive in emerging markets. For developed countries, virtually all persistence comes from the two own-country factors. The results in emerging countries differ strongly; there, approximately 10% to 20% of total persistence is attributable to cross-country effects (components iii and iv). The findings for emerging markets are consistent with stories of contagion, which suggest that demand shifts move predictably from one country to another.

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For developed markets, on the other hand, contagion is unimportant, but cross-manager, own-country asynchronicities are strongly present. Neither of these results can easily be explained by individual manager-informed trading or wealth effects.

In conclusion, cross-manager asynchronicities for a single country are strong and worthy of additional study. ▮