Trading Activity of Foreign Institutional Investors and Volatility

Discussion at NIPFP-DEA Conference

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August 2010

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  - Second, using stock-specific investor-classified volume.

Related Literature

- This is an important question, focus of a longstanding debate! Closely related to another question.
- Why do FII flows forecast equity returns?
    - Price pressure. FIIs trade in a manner that pushes prices away from fundamental value.
    - Information. FIIs are better informed than domestic investors about movements in fundamental value.
- Answers to these questions get us to the heart of the debate – are FIIs a *stabilizing* or *destabilizing* influence in emerging equity markets?
- Essentially the same question that the authors are asking.

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  - But important methodological lessons have emerged.

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  - **Source of volatility:** Separate the fundamental components of returns from non-fundamental components when analyzing the effects of FIIs on returns.
  - **Volume and returns:** Can't assume volume and returns arise independently, since they are equilibrium outcomes.

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    - Re-estimate the specifications after incorporating these points.
  - Second: The authors need to work harder on exposition...would greatly help the reader (or discussant)!
- I will focus my detailed suggestions on the first of these issues.

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  - **Suggestion:** Expected and unexpected trading activity can be better identified if stock returns also used in the decomposition, rather than fitting a univariate time-series model for volume.
    - Note: Bessembinder and Seguin (1992) don't do this, but the literature has moved very far since then.

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- The specifications employed in the paper seem to use rupee volume, which may be trending over the sample period.
  - **Suggestion:** Normalize aggregate (stock-specific) rupee volume by index (stock) market capitalization to avoid spurious or unbalanced regressions.

A Few Smaller Suggestions

1. Why are the specifications estimated separately for FIIs, DIIs etc?
    1. Descriptive statistics show that volume from these different market participants is correlated.
    2. So, any specification explaining volatility should include all measures simultaneously. Otherwise omitted variable bias affects the results.
2. It would be useful to see the volume and volatility measures simply plotted against each other in the aggregate study.
    1. This is a useful visual check to see the relationship you are fitting.

A Few Smaller Suggestions

3. I didn't clearly understand the trading process underlying the counterparties referred to in the second section of the paper. Do you know who initiates the trade?
4. The standard errors need to be nonparametric (or at least robust) since there are jumps, volatility clustering etc.
    1. Are they? If not, statistical significance is in doubt.