

“Firm Characteristics and Foreign Investment in Equity in the Financial Industry in Bangladesh”

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Abstract

The purpose of this study is to examine what firm characteristics variables influence the investment decision of foreign investors in the equity of listed financial companies in Bangladesh. To this end, 238 annual reports (for the years 2014 to 2018) of listed banking and non-bank financial companies have been analyzed. The results show that several firm characteristics variables such as profitability, leverage, firm size, firm age and market-to-book ratio have significant influence on foreign investment in equity of listed financial companies of Bangladesh. These results imply that foreign investors place considerable weight on several firm characteristics variables in making their investment in equity in the listed financial companies in Bangladesh. These findings can be useful to top management of financial institutions and policy makers specifically to attract foreign investors to invest in the equity of listed financial companies in Bangladesh.

Keywords: Firm characteristics, Foreign ownership in equity, Listed companies, Financial Institutions, Bangladesh.

1. Introduction

The inflow of foreign investment in the form of equity in the emerging (International Monetary Fund, 2008) and developing economy (The Independent, 2018) like Bangladesh is crucial for several reasons including the injection of foreign currency and capital (Bekaert and Harvey, 2000; Doidge et al., 2004), to improve the liquidity of

capital markets (Doidge et al., 2004), and to uplift the confidence of local investors in the firm's stock (Bekaert and Harvey, 2000). Moreover, the inflow of foreign currency is considered a blessing to finance the import of machineries and heavy equipment (Bekaert and Harvey, 2000; Doidge et al., 2004; Mangena and Tauringana, 2007), and is critical for the smooth transition from a developing to a developed economy. Considering this importance of the foreign investment in equity, it is imperative to identify what firm specific factors essentially induce foreign investors to invest in the listed financial companies in Bangladesh.

Financial industry has been chosen for the present study on several grounds. First, this industry is subject to intense regulations, complex nature and high level of risk (Levine, 2004), and therefore require strong supports from the sponsor and capable investor. Second, this industry play critical role in an economy by financing short-term to long-term projects of other industries. Finally, substantial foreign investment in the form of equity in the financial industry can contribute positively to improve the liquidity of emerging capital market like Bangladesh.

Prior researches have attempted to find out the effect of various firm specific characteristics such as firm size, return on assets (ROA) and leverage on foreign equity ownership (Kang and Stulz, 1997; Jiang and Kim, 2004; Yeh, 2018). However, the effect of such factors on the foreign investment in equity in the context of financial industry in Bangladesh is almost scarce in the literature. Using the arguments of signaling theory, the present study attempts to demonstrate what aspects of firm characteristics (leverage, liquidity ratio, profitability, market-to-book-ratio, size, and growth) affect the perception of foreign investors in the listed financial companies of Bangladesh.

The remainder of the paper is organized as follows. Section 2 presents discussion on the extant literature and hypothesis development. Section 3 presents methodology of the study. Section 4 shows results and discussion of the findings of the study. Finally section 5 presents conclusion including the limitations of the study and avenues for further research.

2. Literature Review and Hypothesis Development

The differences in the level of access to information, culture, and familiarity with the legal and institutional framework underpin the challenges to foreign investors to invest in the non-home market (Ahearne et al., 2004; Yeh, 2018). Moreover, in several instances foreign investors experience considerable challenges to take part in the important board meeting due to short notice given by the companies in the non-home market (Rashid, 2018). Consequently, majority of the ownership stakes are held by local investors in majority of the emerging markets (French and Poterba, 1991; Ahearne et al., 2004; Mangena and Tauringana, 2007). To trim down the adverse effect of such information disadvantages and cultural differences, foreign investors may concentrate on a number of firm attributes including the firm's profitability, size and level of risks associated with its operation. Moreover, these firm characteristics such as profitability (return on assets), size (total asset), leverage, growth in revenue, and liquidity may provide useful signals to the foreign investors with respect to the firm's ability to alleviate risks associated with operations in the non-home market (Spence, 1973; Yeh, 2018).

According to signaling theory, a signal is an attribute or activity that can change the belief of others (Spence, 1974), and signifies the abilities and purpose of a firm management (Spence, 1974; Certo et al., 2001). As buyers have incomplete information on sellers' performance, they have to find out alterable attributes of sellers that can affect their performance (Bergh and Gibbons, 2011). Accordingly, this theory argues that these signals (observable and alterable characteristics that can affect the conditional probability of performance) tell about the abilities, actions and purpose of a firm's management (Spence, 1973).

Prior researches have examined the effect of several firm characteristics on foreign ownership in equity in the context of developed economies. For example, Kang and Stulz (1997) used leverage, current ratio, return on assets (ROA), beta, residual variance, market value of equity, and book-to-market ratio as proxy for firm characteristics in Japanese firms. Dahlquist and Robertsson (2001) replaced ROA with return on equity (ROE) in examining the relationship between the variables in

the context of Swedish firms. Covrig et al. (2006) employed debt-equity ratio and turnover in addition to the variables studied by Kang and Stulz (1997) using the data of 11 developed countries. Consistent with several of these prior studies, the present study uses profitability (ROA), leverage, market-to-book ratio, firm size, and growth in revenue to represent the firm characteristics variables.

With respect to the effect of profitability (measured by ROA) on foreign ownership in equity, prior studies showed a positive association between the variables. For example, Kang and Stulz (1997) demonstrated that foreign investors in Japan preferred to invest in firms with higher profitability (ROA). Dahlquist and Robertsson (2001), Covrig et al. (2006), Mangena and Tauringana (2007), and Rashid (2020) also confirmed a positive association between profitability and foreign ownership in equity. Accordingly, the uniformity of the association between firm's profitability and the extent of foreign investment in equity documented by several studies implies that foreign investors takes the firm's profitability as a useful signal in deciding where to invest funds in the oversea market. The findings of prior studies and the arguments of signaling theory motivate the present study to hypothesize a positive association between profitability and foreign ownership in equity. Therefore, the first hypothesis of the study is:

H1. Foreign ownership in equity is higher in firms with higher profitability.

Leverage increases the agency costs of a firm (Roll et al., 2009) and affects its credit worthiness adversely (Kao et al., 2018). Moreover, higher leverage is associated with the risk of incurring bankruptcy costs and underinvestment (Myers, 1977). In regard to the effect of leverage, majority of the prior studies (e.g., Kang and Stulz, 1997; Jiang and Kim, 2004) documented a negative association between the extent of leverage and foreign ownership in equity. However, financial industry is substantially different from other non-financial industry in terms of the effect of the extent of leverage on several aspects of firm performance. More specifically, higher leverage is welcomed in the financial industry as financial companies heavily rely on the depositors' money to lend and invest in large projects. Accordingly, to a certain level leverage is expected to have a positive effect on both the performance and perception

of foreign investor in the financial companies. However, as prior studies revealed mixed results with respect to the effect of leverage on foreign investment in equity, the present study does not assume any directional relationship between the variables. Rather, this study assumes a significant association between the variables. Therefore, the second hypothesis of the study is:

H2. Leverage ratio has significant effect on foreign ownership in equity.

The relationship between book value and market value of equity also provides useful information to investors and has been examined in the prior studies. Kang and Stulz (1997), Dahlquist and Robertsson (2001), and Jiang and Kim (2004) employed book-to-market ratio and documented an inverse relationship between book-to-market ratio and foreign ownership in equity. This result implies that foreign investors choose to invest in firms with low book-to-market ratio (Kang and Stulz, 1997; Dahlquist and Robertsson, 2001). In other words, firms whose market value of equity is greater than the book value of equity are preferable to foreign investors. These motivate the present study to hypothesize a positive association between market-to-book ratio and foreign ownership in equity. Therefore, the third hypothesis of the study is:

H3. Foreign ownership in equity is higher in firms with high market-to-book ratio.

With respect to the effect of firm's size (measured by total assets) on foreign ownership in equity, majority of the prior studies (e.g., Kang and Stulz, 1997; Dahlquist and Robertsson, 2001; Jiang and Kim, 2004; Mangena and Tauringana, 2007; Rashid, 2020) documented a significant positive association between the variables. For instance, Dahlquist and Robertsson (2001) demonstrated that larger firms are more attractive to the foreign institutional investors in Sweden. Moreover, larger firms are expected to have the ability to make heavy investment (Muttakin et al., 2015) along with extensive access to external sources for financing their activities (Muttakin et al., 2015; Kao et al., 2018). These favorable treatments by the supplier of funds can affect firm's performance positively (Muttakin et al., 2015; Kao et al., 2018). These motivate the present study to hypothesize a positive association between firm size and foreign investment in equity. Therefore, the fourth hypothesis of the study is:

H4. Foreign ownership in equity is higher in larger firms.

Changes in revenue over time are an important indicator of a firm's management capability. Consequently, a positive growth in revenue is expected to have a favorable effect on the capacity utilization rate of a firm and its ability to absorb of fixed overheads (Brush et al., 2000; Amidu, 2007). Accordingly, a positive change in revenue over time is expected to affect the perception of foreign investors positively. Unfortunately, the effect of revenue growth on foreign ownership in equity has not been studied extensively in the extant literature. However, in line with the arguments provided above, the present study hypothesizes a positive association between revenue growth and foreign investment in equity. Therefore, the fifth hypothesis of the study is:

H5. Foreign ownership in equity is higher in firms with higher growth in revenue.

The effect of firm age (*FAGE*), as a firm characteristics variable, has also been addressed in the prior literature. For instance Zou et al. (2016) documented a significant positive association between firm age and foreign investment in equity. However, Miletkov et al. (2014) showed a significant negative effect of firm age on foreign equity ownership using the sample of 58,287 firm years from 130 countries. Surprisingly, the significant effect of firm age disappears while the regression result is presented separately for banking companies. Therefore, the present study does not assume any directional relationship between the variables. Rather, the study assumes a significant relationship between the variables. Accordingly, the sixth hypothesis of the study is:

H6. Firm age has significant effect on foreign ownership in equity.**3. Methodology of the Study****3.1 Sample and Data**

Financial sector in Bangladesh comprises of bank, non-bank financial institutions (NBFIs) and insurance companies. However, the diversified nature of insurance companies (e.g., life insurance, general insurance) makes it difficult to gather

information required to measure the selected variables of the study. Accordingly, the study focuses only on the listed banking companies and NBFIs. There are 30 banks and 23 NBFIs listed in the Dhaka Stock Exchange (DSE, 2020). The study attempts to include all the bank and non-bank financial companies listed in the Dhaka Stock Exchange (DSE) for the years 2014 to 2018. However, the primary assessment of the annual reports revealed that some of these companies do not disclose information in their annual reports required to meet the needs of the current study. These necessitate the elimination of several companies from the list of sample. This elimination makes the final sample size of the study 238 firm years (149 bank and 89 NBFIs) which covers about 90% of the population [$238 / \{(30+23)*5\} = 89.81\%$]. The study collects all data from the annual reports of sample companies. Share price data have been collected from Dhaka Stock Exchange.

3.2 Empirical Models and Variable Definition

To test the hypotheses (1 to 5), the study estimates the following ordinary least squares (OLS) regression model:

$$FOREIGN = \beta_0 + \beta_1 ROA + \beta_2 LEV + \beta_3 MTB + \beta_4 FSIZE + \beta_5 GROWTH + \beta_6 FAGE + \varepsilon_1$$

Where *FOREIGN* represents foreign ownership in equity and is measured as the proportion of shares owned by foreign investors in equity in the firm's capital structure (Kang and Stulz, 1997; Mangena and Taurigana, 2007; Yeh, 2018). All the variables used in the regression model are defined in Table 1.

Table 1: Description of variables included in the regression model

<i>Variable</i>	Definition
<i>FOREIGN</i>	Foreign ownership in equity, measured as the percentage of shares owned by foreign investors
<i>ROA</i>	Return on assets, measured as the ratio of net profit after tax to total assets
<i>LEV</i>	Leverage, measured as the ratio of total debt scaled by total assets
<i>MTB</i>	Market-to-Book ratio, measured as the ratio of year-end market value of equity to year-end book value of equity
<i>FSIZE</i>	Firm size, measured by natural logarithm of book value of firm's assets

<i>GROWTH</i>	Firm's growth, measured as percentage change in annual revenue. Annual revenue is measured as the sum of interest income and other investment income reported in the operating income section by banks and NBFIs.
<i>FAGE</i>	Firm age, measured by the natural logarithm of the number of years since the inception of firm

4. Results and Discussion

Table 2 shows descriptive statistics for all the variables used in the regression model. The average foreign investment in equity is 5.23% with minimum 0% to a maximum of 58.46% (with a substantial standard deviation of 11.83%). The proportion of foreign investment is considerably low as compared to other parts of the globe. For example, Dahlquist and Robertsson (2001) reported that 32.40% of ownership stake are held by foreign investors in the Swedish capital market. Yeh (2018) showed a 13.47% foreign equity ownership in Taiwan and Neupane et al. (2016) reported a 12.45% in India. The figure for standard deviation indicates a wide dispersion of foreign investment in the listed financial companies in Bangladesh. The proportion of foreign investment is comparatively higher in the non-bank financial institutions (NBFIs) (6.93%) as compared to banking institutions (4.22%).

Table 2. Descriptive statistics for variables used in the models.

Variables	Full sample (N=238)				Bank (N=149)				Non-Bank Financial Institution (N=89)			
	Mean	SD	Min	Max	Mean	SD	Min	Max	Mean	SD	Min	Max
<i>FOREIGN</i>	5.23	11.83	0	58.46	4.22	11.50	0	58.46	6.93	12.24	0	51.05
<i>ROA</i>	0.91	1.13	-5.96	3.63	0.76	0.77	-4.25	1.83	1.16	1.52	-5.96	3.63
<i>LEV</i>	0.92	0.14	0.69	1.96	0.95	0.16	0.87	1.96	0.86	0.06	0.69	0.96
<i>MTB</i>	1.14	0.83	-0.45	7.71	0.91	0.72	-0.45	7.71	1.54	0.86	0.09	4.58
<i>Fsize</i>	16880	15398	622	99795	25382	13505	1143	99795	2647	2138	622	10916
<i>GROWTH</i>	9.31	16.63	-44.25	87.64	6.89	9.98	-14.99	32.46	13.36	23.46	-44.25	87.64
<i>FAGE</i>	23.21	6.58	14	37	24.08	7.14	14	37	21.76	5.26	14	37

In regard to the firm characteristics variables, the average return on assets (ROA) is 0.91% with a minimum of -5.96% to a maximum of 3.63% (with massive standard deviation of 1.13). The figure for ROA demonstrates a very low profitability of the

listed financial companies of Bangladesh. Akin to the foreign investment in equity, the average profitability of NBF (1.16%) depicts a better position as compared to the banking institutions (0.76%). The mean value of leverage is 0.92 indicating a very high leverage of the financial companies in the market (with minimum 0.69 to maximum 1.96). These results indicate the possibility of bankruptcy of some companies as their liabilities are substantially greater than their assets. With respect to the industry difference, banking companies (0.95) are found with greater leverage than NBF (0.86). The average market to book (MTB) ratio is 1.14 which implies that the market value of equity, on average, is still greater than the book value of equity.

The picture of MTB ratio is also identical to ROA (on average) in terms of the difference between the sectors. With respect to the firm size (measured by the book value of total assets), the results show an average of BDT 16,880 crore with a minimum of BDT 622 crore and a maximum of BDT 99,795 crore. However, the average firm size of the banking companies (BDT 25,382 crore) is substantially large (about 10 times) as compared to the NBF (BDT 2647 crore). The average growth in revenue is 9.31% with 6.89% in the banking companies and 13.36% in NBF. This result indicates the supremacy of NBF over the banking institutions in terms of revenue growth. The average firm age of both the sectors is very close (24.08 years in banking companies whereas 21.76 years in NBF) to each other with insignificant variations.

Table 3 displays the correlation matrix among the variables used in the regression model. As can be seen in the Table, the matrix demonstrated that leverage, firm size, and firm age have significant association with foreign ownership in equity. For instance, leverage has significant (at 1% level of significance) positive association with foreign ownership in equity. However, the nature of relationship is negative and significant with firm size and firm age. Interestingly, ROA, revenue growth and MTB ratio do not display any significant association with foreign equity ownership.

Table 3. Pearson's correlation matrix.

<i>FOREIGN</i>	<i>FOREIGN</i>	<i>ROA</i>	<i>LEV</i>	<i>MTB</i>	<i>FSIZE</i>	<i>GROWTH</i>	<i>FAGE</i>
	1						
<i>ROA</i>	-.093	1					
<i>LEV</i>	.392**	-.557**	1				
<i>MTB</i>	.095	.201**	-.262**	1			
<i>FSIZE</i>	-.156*	-.012	.034	-.196**	1		
<i>GROWTH</i>	-.066	.325**	-.156*	.178**	-.082	1	
<i>FAGE</i>	.240**	-.070	.164*	-.061	.275**	.017	1

** Correlation is significant at the 0.01 level (2-tailed).

* Correlation is significant at the 0.05 level (2-tailed).

Table 4 presents the OLS regression results of firm characteristics variables and foreign ownership in equity. The coefficient of ROA is positive and statistically significant ($\beta = 2.575$, $p < 0.01$) which is in line with the hypothesis of the study. This result is consistent with several prior studies (e.g., Kang and Stulz, 1997; Dahlquist and Robertsson, 2001; Jiang and Kim, 2004; Mangena and Tauringana, 2007) which implies that foreign investors prefer to invest in companies with higher ROA.

With respect to the second hypothesis of the study, the result shows a highly significant positive relationship between the variables as the coefficient of leverage is positive and statistically significant ($\beta = 51.960$, $p < 0.01$). This result signifies that the second hypothesis of the study that there is a significant association between leverage and foreign ownership in equity is confirmed. This result is inconsistent with the findings of several prior studies (e.g., Kang and Stulz, 1997; Jiang and Kim, 2004). This result also supports the argument that high leverage is welcomed in the financial companies considering its favorable influence on the ability of a company to meet the needs of borrowers.

Table 4: OLS regression result of the relationship of foreign ownership in equity with firm characteristics variables

Variable	Expected sign	Dependent variable= Foreign ownership in equity			
		Coefficient	t-stat	Significance	VIF
ROA	+	2.575***	3.639	.000	1.603
LEV	+	51.960***	8.803	.000	1.531
MTB	+	2.394***	2.983	.003	1.125
FSIZE	+	-5.085***	-4.331	.000	1.142
GROWTH	+	-.091**	-2.235	.026	1.145
FAGE	+	.438***	4.463	.000	1.114
Constant	?	-31.382***	-3.886	.000	
Observations		238			
R^2		0.353			
Adjusted R^2		0.336			
F		20.908***			
Durbin-Watson		2.144			

*** Significance at the 1% level.

** Significance at the 5% level.

* Significance at the 10% level.

The third hypothesis of the study assumes a positive association between market-to-book ratio and foreign ownership in equity. The regression results showed a significant positive association ($\beta = 2.394$, $p < 0.01$) between the variables. This result implies that foreign investors place much weight on market-to-book ratio for investing in the Bangladeshi financial companies.

In respect of the fourth hypothesis, the coefficient of firm size displays a significant negative association ($\beta = -5.085$, $p < 0.01$) with foreign ownership in equity which goes against fourth hypothesis of the study. The nature of the relationship between firm size and foreign ownership implies that foreign investors do not prefer to invest in firms with large size. The underlying cause of such result might be that when a firm becomes excessively large, it may have to diversify its operations excessively which may enhance its agency and bureaucratic costs (Choi et al., 2007; Kao et al., 2018).

Unfortunately, the coefficient of growth demonstrates a significant inverse association with foreign ownership in equity, which is contrary to the fifth hypothesis of the study. So, *H5* is not confirmed indicating the failure of revenue growth to provide a valid signal to foreign investors in making investment decision in the equity of listed financial companies in Bangladesh. With respect to the effect of firm age, the results exhibit a significant positive coefficient implying that foreign investors choose to invest in old aged and familiar firms. Accordingly, the sixth hypothesis that firm age has significant effect on foreign investment in equity in the listed financial industry in Bangladesh is confirmed.

The model explains significant explanatory variations in foreign ownership in equity as the value of Adjusted R^2 of the model is 0.336 indicating that 33.60% of the variations have been explained by the model. Moreover, the model fit very well and significant since its F values is positive ($F= 20.908$) and significant at 1% level. The model is also free from the effect of multicollinearity since its VIF are all below 10 (the minimum value is 1.114 and the maximum value is 1.603) (Greene, 2008; Field, 2009). Table 4 also shows a value of 2.144 for Durbin-Watson statistic. The value of Durbin-Watson statistic between 1 and 3 implies that the values of the residuals are independent, and thus robust the reliability of the results.

5. Conclusion

The aim of the study was to examine the effect of firm characteristics variables on foreign ownership in equity in the listed financial companies of Bangladesh. The results of the study confirmed a significant influence of several firm characteristics variables on foreign ownership in equity. While a number of findings of the present study are consistent with several prior studies, some are contradictory with several other studies. For example, profitability (ROA) and market-to-book ratio are significantly and positively associated with foreign ownership in equity which is consistent with several prior researches (e.g., Kang and Stulz, 1997; Dahlquist and Robertsson, 2001; Jiang and Kim, 2004; Covrig et al., 2006; Mangena and Tauringana, 2007). However, in respects of other firm characteristics variables such as leverage and firm size, the study reveals contradictory results with prior researches. The underlying reasons for

such unexpected results may be attributed to the differences in the context in which the firms are operated.

The findings of the present study can be critical from the theoretical, practical and policy perspectives. The confirmation of a significant positive influence of ROA, leverage, and MTB ratio on foreign investment in equity indicates the preeminence of the arguments of signaling theory. From practitioners' viewpoints, the results can be used to maintain several firm characteristics in the directions suggested by the results of the study specifically to attract foreign investors. Policy makers can recommend firms to maintain particular figures and ratio within a relevant range to qualify for several transactions and sanctions.

The findings of the study must be interpreted in the light of a number of limitations. First, the study considers companies only from financial sectors. Further researches may be conducted by focusing on the annual report data of manufacturing sectors. Second, the study includes only the firm characteristics variables. Other firm-specific variables such as board characteristics may also affect the perception of foreign investors.

Despite these limitations, the present study expects to enrich the extant literatures on firm characteristics and foreign investment in equity by focusing on the listed financial companies of Bangladesh.

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