Do Institutional Investors React to International Politics?[†]

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Abstract

This study explores whether foreign policy disagreements with the world's most influential nation, the United States, affect overseas portfolio investment decisions of U.S. institutional investors. Employing bilateral disagreement measures derived from contrasting voting decisions at the United Nations (UN) General Assembly, we find strong empirical evidence affirming this connection. We find a drop in U.S. institutional ownership in non-U.S. firms if the country they are listed in undergoes a downturn in their political relations with the U.S. Our results are further substantiated through difference-in-differences analyses centered around two disruptions in bilateral relations: France and Germany's opposition to the U.S.-initiated Iraq incursion in January 2003 and the presidential election of Donald Trump in November 2016. Furthermore, our research unveils that this reduced U.S. institutional ownership primarily originates from investors' reluctance to allocate capital to firms generating operating income in the U.S. Lastly, we discover that political tensions between the U.S. and a foreign nation adversely affect the valuation of firms based in that foreign country through the divestment actions by U.S. institutional investors.

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1. Introduction

The literature has amassed a comprehensive list of firm characteristics determining international equity investments. Investors tend to favor firms in countries that are geographically, culturally, or ideologically proximate (Coval & Moskowitz, 1999; Grinblatt & Keloharju, 2001; Huberman, 2001; Chan et al., 2005; Portes & Rey, 2005; Kempf et al., 2023). They are more inclined to invest in countries with better governance (Gelos & Wei, 2005; Li et al., 2006; Alderighi et al., 2019), as well as in better-governed firms within a specific country (Aggarwal et al., 2005; Ferreira & Matos, 2008; Leuz et al., 2009). Investors also tend to own shares in firms that have issued American Depository Receipts (ADRs), which could represent a proxy for strong investor protection or a reduction in information asymmetry (Kang, 1997; Ahearne et al., 2004; Edison & Warnock, 2004; Ferreira & Matos, 2008). Conversely, they are likely to hold fewer shares in firms with a dominant owner (Dahlquist & Robertson, 2001), high inside ownership (Kho et al., 2009), or a significant control-ownership disparity (Giannetti & Simonov, 2006; Kim et al., 2011). Additionally, investors tend to avoid holding shares in countries with low transparency (Bradshaw et al., 2004; Gelos & Wei, 2005) or inferior accounting standards (Aggarwal et al., 2005).

In this study, we introduce another determinant: international politics. We propose that bilateral foreign policy disagreements with the United States, the world's most influential nation, can influence the geographic preferences of U.S. institutional investors when identifying their investment targets. Our hypothesis draws from well-established literature highlighting the adverse effects of political differences on bilateral trade (Dajud, 2013) and the critical role of political alliances in shaping foreign aid distribution (Alesina & Dollar, 2000). Given the U.S.'s longstanding status as both the world's largest importer and the leading provider of foreign aid, combined with the existing literature on the impacts of political differences on bilateral trade and foreign aid, we postulate that a country's foreign policy

disagreements with the U.S. could have substantial effects on its exports and the amount of foreign aid it receives. This, in turn, could influence the future cash flow projections for firms in these countries, consequently altering institutional investors' assessments of these firms' expected returns. The outcome of this would likely be a portfolio rebalance, wherein U.S. institutional investors, having a heightened awareness of U.S. disputes with other countries, would reallocate their investments away from the implicated firms.

Using a sample of 27,692 firm-year observations from 42 non-U.S. countries along with bilateral disagreement measures derived from contrasting voting patterns in the United Nations (UN) General Assembly, we find a drop in U.S. institutional ownership in non-U.S. firms if the country they are listed in undergoes a downturn in their political relations with the U.S. To alleviate potential endogeneity concerns, we employ two quasi-natural experiments based on France and Germany's opposition to the U.S.-led Iraq invasion in January 2003 and the election of Donald Trump as U.S. President in November 2016. We find results consistent with that of our baseline findings.

To further validate our baseline findings, we perform a placebo test that examines non-U.S. institutional ownership as opposed to U.S. institutional ownership. We expect non-US institutions to have less understanding of how the U.S. government might respond to political disagreements, thereby making them less prone to adjust their investments based on such conflicts. Consistent with this expectation, we discover that a country's bilateral foreign policy disagreement with the U.S. does not significantly impact non-U.S. institutional ownership of firms in that country.

Our analyses, incorporating two moderating variables, substantiate the premise that U.S. institutional investors' reluctance to invest in countries undergoing foreign policy disputes with the U.S. is primarily rooted in their pessimistic projections of future cash flows for firms in these nations. The two moderating variables represent firms that generate operating income in

the U.S. and firms that maintain political connections with their government. We postulate that firms with U.S. operating income are most susceptible to shocks triggered by political disagreements with the U.S. and that firms with political connections are likely to receive government support during such crises. Consistent with these expectations, we find that the influence of political disputes on U.S. institutional investment decisions is more evident in firms generating U.S. operating income and less pronounced in firms possessing political connections with their government.

Finally, we probe whether political discord has an impact on firm valuation by triggering U.S. institutional investors' divestment. Through path regression analyses, we ascertain that the indirect impact of political disagreement on the market value of target firms through divestment exists, independent of its direct effect.

We contribute to the literature in two ways. First, we advance our knowledge of the firm characteristics that attract foreign equity investments. To date, no prior study has explored the impact of international politics on foreign institutional ownership at an individual firm level. This is the first study proving empirical evidence that U.S. institutional ownership in non-U.S. firms drops if the country they are listed in undergoes a downturn in their political relations with the U.S. Second, our work extends the literature examining the impact of foreign policy disagreements. Previous studies have primarily focused on the implications for trade and foreign aid, with scant attention given to its effects on international capital flows. A notable exception is a study by Gupta and Yu (2007), which demonstrates a significant decline in bilateral portfolio investment flows between the United States and other countries when political relations deteriorate. Our study advances the work of Gupta and Yu (2007) by employing firm-level data as opposed to country-level aggregate data. This approach allows us to dissect the traits of firms that are most susceptible to or shielded from international political shocks. In addition, there are several other distinctive aspects of our research. Unlike Gupta

and Yu (2007), who bundle equity and bond investments together, we focus solely on equity investments. Furthermore, while Gupta and Yu (2007) employ flow data, we utilize ownership data in our analysis.

The structure of this paper is as follows. Section 2 discusses the related literature and develops our hypotheses. Section 3 discusses the data and the sample selected. Section 4 presents our findings. Finally, Section 5 draws conclusions from the paper.

2. Literature review and hypotheses development

2.1. Literature review

Our study is related to the body of literature examining the effect of political differences on bilateral trade. For example, Dixon and Moon (1993) investigate if U.S. exports can be explained by the similarity in foreign policy orientation between the U.S. and each of the countries considered. Using a measure of similarity based on voting agreements in the United Nations, they find a positive correlation between foreign policy orientation similarity and U.S. exports. Dajud (2013) broadened this investigation by incorporating more countries, finding that political differences, measured by voting differences at the United Nations General Assembly (UNGA), significantly affect bilateral trade. Furthermore, Morrow, Siverson, and Tabares (1998) explore whether trade flows increase between states with shared interests. Their findings show that shared interests, measured by the *tau* correlation of alliance portfolios for a pair of states, enhance trade between such dyads.

Our study is also related to the body of literature examining the relationship between political differences and foreign aid. A notable example is Alesina and Dollar (2000), who examine the patterns of foreign aid allocation from a range of donors to recipient countries. Their findings suggest that political and strategic considerations significantly influence foreign aid direction, equaling the influence of the recipient countries' economic needs and policy

performance. Factors such as a shared colonial history and political alliances emerge as key determinants in foreign aid allocation. However, the direction of causality can be reversed. For example, Wang (1999) finds that the U.S. has successfully utilized foreign aid programs to induce foreign policy compliance in the UN on issues that are vital to America's national interests. Similarly, Lai and Morey (2006) provide empirical evidence that higher dependence on U.S. foreign aid is likely to increase the UN voting alignment of non-democratic states with the U.S.

The literature also finds that the voting patterns in the UNGA are closely linked to the lending behaviors of the International Monetary Fund (IMF) and the World Bank. For example, Dreher and Sturm (2012) showed that countries are more likely to vote with the G7 nations in the UNGA after receiving World Bank non-concessional loans or obtaining non-concessional IMF programs. In a related study, Dreher and Jensen (2007) discovered that countries that are closer allies of the United States and other G7 nations are more likely to receive IMF loans with fewer conditions attached.

This study is directly related to the study exploring the connection between foreign policy disagreements and international capital flows. The only existing study we know on this issue is the work by Gupta and Yu (2007). Their findings indicate that international portfolio investments to and from the U.S. are lower for countries that more frequently oppose the U.S. stance in the United Nations. Additionally, foreign direct investment inflows into the U.S. from these countries decrease, while the U.S. foreign direct investment inflows into these dissenting nations remain unaffected.

2.2. *Hypotheses development*

According to World Bank data, the U.S. holds the position of the world's largest importer. In 2020, it accounted for 13.06% of global imports, marking a slight decrease from its 1990 share

of 15.05%. The United Nations Office for the Coordination of Humanitarian Affairs (UNOCHA) also reported that the U.S. government is the largest provider of humanitarian aid globally in 2022. The U.S. expenditure amounted to 12.3 billion USD, significantly surpassing the 3 billion USD disbursed by Germany, the second largest donor.

Considering such status, combined with the existing literature on the impacts of political differences on bilateral trade and foreign aid, we postulate that a country's foreign policy disagreements with the U.S. could have substantial effects on its exports and the amount of foreign aid it receives.

In addition, the worsening prospects of exports or foreign aid receipts can influence the future cash flow projections of companies situated in these countries. This, in turn, can change institutional investors' assessments of the expected returns on these companies' stocks. The likely consequence would be a portfolio rebalance, with institutional investors diverting their investments away from the affected firms. Given their keen understanding of U.S. disputes with other countries, we anticipate that U.S. institutional investors would exhibit greater sensitivity to these changes compared to their counterparts in other countries. This leads to our main hypothesis.

Hypothesis: *U.S. institutional ownership in non-U.S. firms drops if the country they are listed in undergoes a downturn in their political relations with the U.S.*

3. Sample construction and key variables

3.1. Sample construction

Our final sample includes 27,692 firm-year observations from 2,320 non-U.S. firms across 42 countries over the period from 2000 to 2019. We require that these firms have no missing data for firm- and country-level control variables. Additionally, we consider only those firms that

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maintain foreign institutional ownership exceeding 20% at least once during our sample period. Financial firms (SIC 6000-6999) are excluded from our final sample. Appendix A offers the count of unique firms per country and the distribution of firm observations by year.

3.2. *Key variables and data sources*

3.2.1. *U.S. institutional ownership*

We measure *U.S. Institutional Ownership* by calculating the proportion of shares held by U.S. institutions in a given firm to the total number of adjusted outstanding shares at the end of each calendar year. In line with Ferreira and Matos (2008), we incorporate all types of stock holdings: ordinary shares, preferred shares, American Depositary Receipts (ADR), Global Depositary Receipts (GDR), and dual listings. We obtain the institutional ownership data from the FactSet/LionShares database, a leading information source for global institution ownership. FactSet/LionShares collates global equity holdings from a variety of sources, including fund reports, regulatory authorities (such as 13F reports in the United States), fund associations in different countries, and directly from fund management companies. The FactSet/LionShares database also identifies the countries of the institutions, enabling us to ascertain ownership by U.S. institutions.

3.2.2. *Foreign policy disagreements*

Our bilateral foreign policy disagreement variables are based on the voting patterns between two countries at the UNGA, the only international arena where we can know more than 150 countries' opinions on various agendas regarding global issues.

Signorino and Ritter's (1999) S-score is a widely recognized method for measuring dyadic indicators of voting similarity between states at the UNGA. This measure essentially involves counting the number of identical or opposite votes between two countries. A notable limitation

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of the S-score is that it attributes variations in voting patterns solely to changes in preferences, disregarding the possibility that these changes might stem from shifts in the UNGA's agenda. An illustrative example of this issue can be seen in the S-score's tracking of relations between the U.S. and USSR/Russia. The S-scores suggest that the U.S. and Russia had more contentious relations in the mid-2000s than the U.S. and the USSR ever did during the Cold War. This counterintuitive result occurred because, in the early 1970s, the group of seventy-seven took control of the UNGA's agenda, introducing numerous resolutions on UN supra-nationalism and North-South issues, on which the USSR and the U.S. held similar positions (Voeten, 2000).

Given this drawback, we utilize an alternative measure that Bailey et al. (2017) proposed: the distance in ideal points, which is less sensitive to shifts in the UN's agendas. These ideal points are estimated using a dynamic ordinal spatial model, capturing a state's relative position with respect to the U.S.-led liberal order. By measuring political preference along a single dimension, this approach minimizes the effect of agenda shifts and idiosyncratic votes. Additionally, by making use of resolutions that were identical across years, it helps to render the preference estimates comparable over time. In this study, we label this measure as *Foreign Policy Disagreement I*, which is defined as the absolute value of the difference between two ideal points. A large value of *Foreign Policy Disagreement I* indicates poor bilateral political relations between the U.S. and a foreign country.

$$Foreign\ Policy\ Disagreement\ I = log\ (1 + abs(IdealPoint_{US,t} - IdealPoint_{c,t}))$$

Another drawback of the S-score comes from the fact that UNGA votes are not entirely exogenous. Since the mid-1980s, U.S. law has required the U.S. State Department to report how countries vote in the UN on issues that are regarded as important to U.S. interests. It has also required the United States Agency for International Development (USAID) to use countries' voting records on these issues as a criterion for disbursing aid (Carter & Stone, 2015).

This introduces the possibility that UNGA votes might be influenced by U.S. aid disbursement decisions. Indeed, prior studies have found that the U.S. government has influenced important votes by using aid disbursement as a lever (Wang, 1999; Dreher et al., 2008; Carter & Stone, 2015). This can be problematic for our study, as we are trying to estimate the causal effect of foreign policy disagreements on US institutions' holdings.

Accordingly, we devise a new measure called *Foreign Policy Disagreement II*, which considers only those votes that the U.S. government has not categorized as important. This metric is defined as the difference between the number of non-important votes cast by a country at the UNGA opposing US votes and the number of identical non-important votes, all scaled by the total number of non-important resolutions passed each year. A large value for *Foreign Policy Disagreement II* signifies poor bilateral political relations between the U.S. and the foreign country under consideration.

$$Foreign\ Policy\ Disagreement\ II = log\ (1 + \frac{No.\ of\ Opposite\ Votes_t - No.\ of\ Same\ Votes_t}{No.\ of\ Total\ Votes\ in\ a\ year_t})$$

As noted earlier, the raw UNGA voting data is available from the U.S. Department of State.[5] The ideal point estimates can be accessed from Harvard Dataverse.[6]

3.2.3. *Control variables*

In our regression analysis, we control for firm-specific and country-specific characteristics likely to be correlated with US institutional ownership. Firm-level accounting data are obtained from Worldscope, and country-level control variables are collected from the World Development Indicators.[7]

Following Ferreira and Matos (2008), we control for firm-specific characteristic variables such as the natural logarithm value of a firm's market capitalization (*Firm Size*), book-to-market equity ratio (*Book-to-Market*), return on equity (*ROE*), ratio of total debt (*Debt/Assets*), dividend yield (*Dividend Yield*), cash holdings (*Cash Holdings*), proportion of closely held shares (*Inside Ownership*), annual growth of sales (*Sales Growth*), a dummy variable that equals 1 if firms issue ADRs (including Level I) and 0 otherwise (*ADR*).

Our country-specific characteristic variables include corporate governance at the country level (*Governance*); the country's annual GDP growth rate (*GDP Growth*); the log value of GDP per capita for a country (*GDP per capita*); the sum of total trade inflow and outflow to and from the U.S. for each country divided by the sum of total import and export of the US to the rest of the world (*Trade Share*); The difference between the annual gross sales of foreign stocks by foreigners to U.S. residents and the annual gross purchases of foreign stocks by foreigners from U.S. residents, divided by the sum of annual gross sales and purchases of foreign stocks by foreigners to and from US residents (*Investment Share*). Appendix B provides detailed definitions for the variables we use in the analysis.

3.3.   *Summary statistics*

Table 1 reports the descriptive statistics of the main variables in our baseline model for the sample of 27,692 firm-year observations. They have distributions consistent with Ferreira and Matos (2008), with two exceptions. The mean value of *U.S. Institutional Ownership*, 11.7%, is significantly larger than the mean value of US institutional ownership reported in Ferreira and Matos (2008), which is 1.7%. This difference arises because we only consider firms with more than 20% of foreign institutional ownership for at least one year during our sample period. Additionally, our mean value of *Firm Size*, 20.788, is also larger than the mean value of firm

size reported in Ferreira and Matos (2008), which is 12.0. This discrepancy is due to our method of not scaling dollars into millions before taking logs.

<Insert Table 1 here>

4. Results

4.1. Baseline findings

To investigate whether bilateral political relation influences the level of U.S. institutional ownership in non-U.S. firms (*U.S. Institutional Ownership*), we use the following model:

$$U.S. Institutional\ Ownership_{i,t}$$
$$= \alpha + \beta_1 Foreign\ Policy\ Disagreement_{c,t} + \beta_2 X_{i,t} + \beta_3 Y_{c,t} + \Phi_i + \theta_t$$
$$+ \varepsilon_{i,t}$$

where the indices *i, c* and *t* correspond to firm, country, and year, respectively. Φ_i and θ_t represent firm and year fixed-effects, and $\varepsilon_{i,t}$ represents a firm-time specific error term, which is clustered at the firm level. With firm fixed-effects, we control for time-invariant unobserved firm-specific characteristics that might influence U.S. institutional ownership in non-U.S. firms. $X_{i,t}$ represents firm-specific characteristics, including *Firm Size*, *Book-to-Market*, *ROE Debt/Assets, Dividend Yield, Cash Holdings, Inside Ownership, Sales Growth* and *ADR*. $Y_{c,t}$ includes country-level covariates such as *Governance*, *GDP Growth*, *GDP per capita*, *Trade Share* and *Investment Share.*

We present findings in Table 2 that indicate both *Foreign Policy Disagreement I* and *Foreign Policy Disagreement II* have a negative and statistically significant relationship with our outcome variable—*U.S. Institutional Ownership*. This suggests that the level of U.S. institutional ownership in non-U.S. firms is adversely influenced by disagreements in foreign

policy. This finding adds to the existing literature by underscoring the relevance of bilateral political ties in determining foreign institutional investor ownership levels. The impact of bilateral political relations is also economically significant. For example, in Models (1) and (2), a one-standard-deviation increase in *Foreign Policy Disagreement I* (*Foreign Policy Disagreement II*) is associated with an 11.8% (11.3%) decrease in *U.S. Institutional Ownership*, relative to the mean value of *U.S. Institutional Ownership*.[8]

The results of our firm-level control variables are consistent with the existing literature. For example, larger firms have higher U.S. institutional ownership (Kang, 1997; Dahlquist & Robertson, 2001; Ferreira & Matos, 2008), while firms that are closely held receive relatively less attention from U.S. institutions (Leuz et al., 2009; Doidge et al., 2006; Ferreira & Matos, 2008). Also, U.S. institutional investors prefer to invest in firms with higher book-to-market ratios or firms that are cross-listed in the U.S. (Ferreira & Matos, 2008). U.S. institutions also seem to deviate away from firms with higher sales growth. Country-level variables, however, are not comparable to the existing literature. This is because we include firm fixed effects, while existing studies do not.

<Insert Table 2 here>

4.2. Exogenous shocks to political relations

With the inclusion of firm fixed effects and a comprehensive set of time-varying firm and country-level controls, it is unlikely that our baseline results are heavily influenced by endogeneity issues. However, to further eliminate the potential for reverse causality or omitted variable bias, in this section, we use shocks that directly disrupt bilateral political relations but

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[8] Based on the summary statistics in Table 1, the economic impact of *Foreign Policy Disagreement I* and *Foreign Policy Disagreement II* on *U.S. Institutional Ownership* is calculated as (-0.050×0.275)/0.117 = -0.118 and (-0.105×0.123)/0.117 = -0.113, respectively, where the standard deviations of *Foreign Policy Disagreement I* and *Foreign Policy Disagreement II* are 0.275 and 0.123 respectively and the mean value of *U.S. Institutional Ownership* is 0.117.

are inherently exogenous to U.S. institutional ownership in the respective country.

4.2.1. France and Germany's opposition to the U.S.-led Iraq invasion

One such exogenous shock occurred in January 2003 when France and Germany opposed the U.S.-led invasion of Iraq. U.S. government officials strongly disapproved of this position, especially towards France. For example, the Secretary of State, Mr. Powell, in a television interview, once mentioned that France would suffer consequences for opposing the United States. Moreover, the U.S. House of Representatives cafeteria started to call French fries and French toast "freedom fries" and "freedom toast." Cogan (2004) describes this circumstance as the break of the Big Three alliance of the twentieth century – the U.S., the U.K., and France.

Germany had been a steadfast ally of the U.S. after World War II. The tensions that arose between Germany and the U.S. due to the Iraq invasion marked an unusual divergence (Kirkwood-Tucker, 2004). Rumsfeld, the U.S. Secretary of Defense at the time, commented, "You're thinking of Europe as Germany and France. I don't. I think that's old Europe." A 2003 Gallup survey revealed that only 34% of Americans viewed France favorably, down from 79% in 2002. Similarly, Germany's favorability dropped from 83% in 2002 to 49% in 2003.".[9]

The opposition of France and Germany to the U.S.-led invasion of Iraq has notably strained political relations between the U.S. and both nations. However, it is improbable that such a stance was prompted by any decline in U.S. institutional ownership in these countries or prompted by a third factor affecting both. This feature allows us to estimate the effect of deteriorated bilateral political relations on U.S. institutional ownership while minimizing endogeneity concerns.

Column (1) of Table 3 presents the outcome of a difference-in-differences (DiD) regression. Here, we contrast the variation in U.S. institutional ownership levels between the

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[9] https://news.gallup.com/poll/1624/perceptions-foreign-countries.aspx

end of 2002 and 2003 for French or German firms with that of matched firms in other major Western countries that maintained strong political relations with the U.S. by sending troops to Iraq (the United Kingdom and Australia). We use control group firms from U.K. or Australian firms that have pre-treatment year propensity scores closest to those of France or German firms in the treatment group. The matching firms are identified without replacement, and propensity scores are estimated using all control variables listed in Table 2, excluding those that perfectly predict the treatment (e.g., *GDP per capita*, *Trade Share*, and *Investment Share*). We include only those firms in our analysis for which U.S. institutional ownership data is available for both years.

The result shows that the coefficient of the interaction term, *Treatment Group* × *Treatment Period*, is negative and statistically significant. This suggests that U.S. institutions respond to an abrupt deterioration in bilateral political relations with the U.S. by reducing their investments in French or German firms. The result is also economically significant. The coefficient of -0.011 means that the opposition to the U.S.-led Iraq invasion dropped *U.S. Institutional Ownership* in French or German firms by 1.1%p, representing a 9.4% drop relative to the mean value of *U.S. Institutional Ownership* (11.7%).

4.2.2. Trump's election

Another external shock we consider is the election of Donald Trump as the U.S. President on November 8, 2016. Considering that Hillary Clinton was ahead in nearly every nationwide and swing-state poll, Trump's victory was unexpected. This makes it improbable that the election outcome was correlated with U.S. institutions' overseas equity investments. Furthermore, given Trump's frequent criticisms of China on numerous issues, including trade imbalance, currency manipulation, and intellectual property theft, before the 2016 election, his win signaled a potential deterioration in U.S.-China relations upon his inauguration.

Column (2) of Table 3 displays the results of a difference-in-differences (DiD) regression. In this analysis, we compare the variation in U.S. institutional ownership levels between the end of 2016 and 2017 for Chinese firms to that of matched firms in other Asia-Pacific countries: Australia, Japan, and Korea. It is important to note that we intentionally exclude 2018 from the post-treatment period. The reason for this exclusion is the onset of the U.S.-China trade war in 2018, which could alter firm fundamentals and confound our findings. Matching firms are selected using the same methodology detailed in the preceding section, and our analysis continues to incorporate only those firms for which U.S. institutional ownership data is available across both years.

The result shows that the coefficient of the interaction term, *Treatment Group × Treatment Period*, is negative and statistically significant at the 10 percent level. This suggests that U.S. institutions respond to an abrupt deterioration in bilateral political relations with the U.S. by reducing their investments in Chinese firms. The result is also economically significant. The coefficient of -0.018 means that the inauguration of Trump as the U.S. President dropped *U.S. Institutional Ownership* in Chinese firms by 1.8%p, representing a 15.4% drop relative to the mean value of *U.S. Institutional Ownership* (11.7%).

<Insert Table 3 here>

4.3. Placebo tests: non-US institutional ownership

To further substantiate our baseline results, we conduct a placebo test, examining non-U.S. institutional ownership in non-U.S. firms instead of focusing on U.S. institutional ownership in non-U.S. firms. We expect non-U.S. institutions (including domestic institutions) to possess a limited understanding of potential U.S. government responses to political disagreements, thereby making them less prone to modify their investments in reaction to such conflicts.

Table 4 presents the results for non-U.S. institutional ownership. Models (1) and (2) show

that a country's bilateral foreign policy disagreement with the U.S. does not significantly impact non-U.S. institutional ownership of firms in that country. The coefficients of *Foreign Policy Disagreement I* and *Foreign Policy Disagreement II* are both statistically insignificant, suggesting that non-U.S. institutions do not react to bilateral political relations with the U.S.

<Insert Table 4 here>

4.4. Moderating factors

In this section, we examine two moderating factors to support the argument that U.S. institutional investors' reluctance to invest in countries undergoing foreign policy disputes with the U.S. is primarily rooted in their pessimistic projections of future cash flows for firms in these nations.

4.4.1. Operating income in the US

The first moderating variable focuses on firms with U.S.-based operating income. We theorize that these firms are most vulnerable to disruptions stemming from political disagreements with the U.S. and, thus, more likely to face reduced investments from U.S. institutions. To test this notion, we first extract firms with U.S. operating income from WorldScope segments data and then define a dummy variable, *U.S. Operating Income*, which equals 1 if the firm reports U.S. operating income for the year and 0 otherwise.

Table 5 shows the results of a regression model where we include interaction terms between *U.S. Operating Income* and our political relation variables. The results show that institutions holdings respond negatively to worsening bilateral political relations only for firms with U.S. operating income. The coefficients on the interaction terms are negative and statistically significant, while the coefficients on the political relations variables in isolation are insignificant. This evidence supports our argument that the reticence of U.S. institutional

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investors to invest in nations embroiled in foreign policy disagreements with the U.S. primarily emanates from their negative projections of future cash flows for firms in these nations.

<Insert Table 5 here>

4.4.2. Politically connected firms

The second moderating factor we consider is the extent to which firms have political ties with their home government. Faccio (2006) finds that politically connected firms are significantly more likely to be bailed out during economic distress than similar non-connected firms. In line with this, we hypothesize that firms with strong political ties may be insulated during times of diplomatic tensions with the U.S., due to the possibility of receiving governmental support. Consequently, we posit that any adverse reactions from U.S. institutions toward these firms could be less pronounced.

We create a dummy variable, *Politically-Connected,* using the replication data of Faccio (2006), available at the Open Inter-university Consortium for Political and Social Research (OpenICPSR). This variable takes a value of 1 if a firm is politically connected and zero otherwise. A company is identified as being connected with a politician if at least one of its large shareholders (anyone controlling at least 10 percent of voting shares) or one of its top officers (CEO, president, vice-president, chairman, or secretary) is a member of parliament, a minister, or is closely related to a top politician or party.

However, the lists of politicians for the *Politically-Connected* variable are based on the information during the first half of 2001. Consequently, the variable's validity during the post-2001 period hinges on the continuation of the 2001 government's rule. To address this, we check governmental transitions after 2001 and limit our analyses to the period during which the 2001 government was still in power. Taking Australia as an instance, it underwent a change in its prime ministerial leadership in 2008, the first government change since 2001. Therefore,

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our analyses for Australian firms consider only the period up to 2007.

Table 6 presents the results. The coefficients on the interaction terms between the *Politically-Connected* variable and the two political relation variables are positive, statistically significant at the 10% level, and larger in absolute terms than the coefficient on the political relation variables when considered in isolation. This indicates that the U.S. institutions' negative reaction against political misalignment with the U.S. is more than offset for firms with political connections.

<Insert Table 6 here>

4.5. Firm valuation

In this study, we investigate if political tensions between the U.S. and a foreign nation adversely affect the valuation of firms based in that foreign country through the divestment actions by U.S. institutional investors. We utilize path regression analyses to distinguish the indirect impact of political discord on firm valuation through divestment from its direct effect on valuation that occurs irrespective of divestment.

Table 7 reports the result. In Panel A, we employ *Foreign Policy Disagreement I* as our measure of political tension, while in Panel B, we use *Foreign Policy Disagreement II*. We use Tobin's *Q* as a measure of firm value. From our analyses, we have three noteworthy findings. First, we find evidence in support of my conjecture. We find that political tension negatively affects firm value through the divestment of U.S. institutional investors. This effect is consistently noted in both panels, where the coefficient is negative and statistically significant. Second, we find mixed results on the direct effect of political tension on firm value. The coefficient is negative when using *Foreign Policy Disagreement I*, but turn positive when using *Foreign Policy Disagreement II*. Third, consistent with the existing literature, we find a positive relationship between *U.S. Institutional Ownership* and firm value in both panels (Ferreira &

Matos, 2008).

<Insert Table 7 here>

5. Conclusion

In this study, we explore whether bilateral foreign policy disagreements with the United States, arguably the world's preeminent nation, can shape the geographic preferences of U.S. institutional investors when selecting investment targets. Drawing on a sample comprising 27,692 firm-year observations from 42 non-U.S. countries and bilateral disagreement measures sourced from divergent voting patterns in the United Nations (UN) General Assembly, we observe a decline in U.S. institutional ownership in non-U.S. firms when there is a deterioration in the political ties between the host country of the firm and the U.S. This conclusion is further supported through supplementary analyses using quasi-natural experiments and a placebo test.

Our analysis of moderating variables reveals that the effects of political disputes on U.S. institutional investment decisions are more prominent in firms with U.S. operating income, but less so in firms that maintain political ties with their domestic governments. This lends credence to the notion that U.S. institutional investors' hesitancy to invest in nations experiencing foreign policy discord with the U.S. predominantly stems from their cautious expectations of future cash flows for firms in these countries. Additionally, our path regression analyses uncover that political tensions between the U.S. and a foreign nation adversely affect the valuation of firms based in that foreign country through the divestment actions by U.S. institutional investors.

We offer two notable contributions to the current literature. First, we delve deeper into understanding which specific firm attributes attract foreign equity investors. To date, prior research has not examined how international politics influence foreign institutional ownership at the discrete firm level. Our study is the first in proving empirical evidence that U.S.

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institutional ownership in non-U.S. firms drops if the country they are listed in undergoes a downturn in their political relations with the U.S. Second, our work broadens the literature examining the impact of foreign policy disagreements. While earlier research has predominantly concentrated on its ramifications for trade and foreign aid, our work shifts the spotlight to its influence on international capital flows, an area previously underserved in the literature.

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Table 1: Summary Statistics

	N	Mean	SD	Min	P25	P50	P75	Max
U.S. Institutional Ownership	27.692	0.117	0.156	0.000	0.025	0.071	0.140	0.997
Non-U.S. Institutional Ownership	27.692	0.165	0.124	0.000	0.073	0.142	0.233	1.000
Foreign Policy Disagreement I	27.692	0.984	0.275	0.102	0.807	0.989	1.095	1.625
Foreign Policy Disagreement II	27.692	0.322	0.123	0.013	0.230	0.322	0.410	0.649
U.S. Operating Income	19,518	0.097	0.296	0.000	0.000	0.000	0.000	1.000
Politically-Connected	27,440	0.018	0.132	0.000	0.000	0.000	0.000	1.000
Tobin's Q	27,690	0.456	0.583	-2.629	0.071	0.355	0.738	6.132
Firm Size	27.692	20.788	1.827	16.427	19.524	20.790	22.066	24.950
Book-to-Market	27.692	0.696	0.653	0.049	0.298	0.506	0.851	3.975
ROE	27.692	0.081	0.272	-1.177	0.025	0.109	0.193	0.904
Debt/Assets	27.692	0.209	0.170	0.000	0.051	0.196	0.324	0.674
Dividend Yield	27.692	0.020	0.023	0.000	0.000	0.015	0.031	0.111
Cash Holdings	27.692	0.175	0.174	0.002	0.055	0.117	0.229	0.861
Inside Ownership	27.692	0.297	0.237	0.000	0.080	0.268	0.479	0.910
Sales Growth	27.692	0.163	0.428	-0.583	0.000	0.078	0.204	2.949
ADR	27.692	0.357	0.479	0.000	0.000	0.000	1.000	1.000
Governance	27.692	1.105	0.687	-0.858	0.775	1.400	1.602	1.970
GDP Growth	27.692	0.027	0.030	-0.091	0.013	0.023	0.038	0.252
GDP per capita	27.692	10.225	0.937	6.094	10.109	10.580	10.749	11.685
Trade Share	27.692	0.045	0.053	0.000	0.010	0.023	0.049	0.208
Investment Share	27.692	0.015	0.066	-0.266	-0.013	0.007	0.036	0.598

Table 2: Foreign Policy Disagreements and U.S. Institutional Ownership in non-U.S. Firms

This table reports the results of *OLS* regressions of U.S. institutional ownership in non-U.S. firms (*U.S. Institutional Ownership*) on foreign policy disagreement variables (*Foreign Policy Disagreement I* and *Foreign Policy Disagreement II*), firm and country-level covariates, firm fixed effects, and year fixed effects. The *t*-statistics in parentheses use robust standard errors clustered at the firm level. *, **, and *** indicate significance at the 1, 5, and 10 percent levels, respectively.

Dependent Variable: *U.S. Institutional Ownership*	(1)	(2)
Foreign Policy Disagreement I	**-0.050*****	
	(-3.06)	
Foreign Policy Disagreement II		**-0.105*****
		(-3.37)
Firm Size	0.030***	0.030***
	(18.47)	(18.45)
Book-to-Market	0.012***	0.012***
	(6.89)	(6.82)
ROE	-0.004	-0.005
	(-1.41)	(-1.47)
Debt/Assets	0.008	0.008
	(1.03)	(0.97)
Dividend Yield	0.035	0.038
	(0.85)	(0.92)
Cash Holdings	0.004	0.003
	(0.43)	(0.42)
Inside Ownership	-0.060***	-0.060***
	(-10.47)	(-10.44)
Sales Growth	-0.006***	-0.006***
	(-4.38)	(-4.35)
ADR	0.024***	0.024***
	(7.52)	(7.38)
Governance	-0.049***	-0.044***
	(-5.55)	(-5.15)
GDP Growth	0.079**	0.086**
	(2.33)	(2.53)
GDP per capita	-0.013*	-0.012*
	(-1.85)	(-1.65)
Trade Share	-0.891***	-0.827***
	(-4.44)	(-4.23)
Investment Share	-0.012	-0.014*
	(-1.53)	(-1.87)
Year Fixed Effects	Yes	Yes
Firm Fixed Effects	Yes	Yes
No. of Observations	27,692	27,692
R-squared	0.858	0.858

Table 3: Shocks to Foreign Policy Disagreements and U.S. Institutional Ownership

This table reports the results of two difference-in-differences (DiD) regressions that examine the effect of shocks to foreign policy disagreements on U.S. institutional ownership. Model (1) examines the effect of French and German opposition to the U.S.-led Iraq invasion, whereas Model (2) examines the effect of Trump's election as the U.S. President. Model (1) uses the firms in France and Germany as treatment group firms and 2003 as the treatment year. Model (2) uses firms in China as treatment group firms and 2017 as the treatment year. Both models include firm and country-level covariates, firm-fixed effects, and year-fixed effects. The *t*-statistics in parentheses use robust standard errors clustered at the firm level. *, **, and *** indicate significance at the 1, 5, and 10 percent levels, respectively.

Dependent Variable:	(1)	(2)
U.S. Institutional Ownership	Iraq Shock	Trump Shock
Treatment Group × *Treatment Period*	**-0.011****	**-0.018***
	(-2.20)	**(-1.98)**
Firm Size	0.011*	0.003
	(1.78)	(0.30)
Book-to-Market	0.010***	0.002
	(2.64)	(0.27)
ROE	0.012	0.005
	(1.64)	(0.32)
Debt/Assets	0.077**	0.067
	(2.55)	(1.11)
Dividend Yield	0.065	0.366*
	(0.69)	(1.82)
Cash Holdings	0.039	-0.012
	(0.77)	(-0.35)
Inside Ownership	0.000	-0.106***
	(0.02)	(-2.74)
Sales Growth	0.007	-0.004
	(0.89)	(-1.03)
ADR	0.022**	-0.017***
	(2.35)	(-3.70)
Governance	-0.027	-0.249*
	(-0.76)	(-1.85)
GDP Growth	-0.744**	0.296
	(-2.29)	(0.33)
Year Fixed Effects	Yes	Yes
Firm Fixed Effects	Yes	Yes
Sample Period	2002-2003	2016-2017
Treatment Group	France and Germany	China
Control Group	Australia and the U.K.	Australia, Japan, and S. Korea
No. of Observations	516	268
R-squared	0.976	0.938

Table 4: Foreign Policy Disagreements and Non-U.S. Institutional Ownership

This table reports the results of *OLS* regressions of non-U.S. institutional ownership in non-U.S. firms (*Non-U.S. Institutional Ownership*) on foreign policy disagreement variables (*Foreign Policy Disagreement I* and *Foreign Policy Disagreement II*), firm and country-level covariates, firm fixed effects, and year fixed effects. The *t*-statistics in parentheses use robust standard errors clustered at the firm level. *, **, and *** indicate significance at the 1, 5, and 10 percent levels, respectively.

Dependent Variable: *Non-U.S. Institutional Ownership*	(1)	(2)
Foreign Policy Disagreement I	**-0.008**	
	(-0.51)	
Foreign Policy Disagreement II		**-0.008**
		(-0.28)
Firm Size	0.023***	0.023***
	(14.16)	(14.16)
Book-to-Market	-0.001	-0.001
	(-0.71)	(-0.72)
ROE	0.003	0.003
	(0.96)	(0.96)
Debt/Assets	-0.022***	-0.022***
	(-2.71)	(-2.72)
Dividend Yield	0.158***	0.158***
	(3.61)	(3.61)
Cash Holdings	0.003	0.003
	(0.38)	(0.38)
Inside Ownership	-0.117***	-0.117***
	(-18.70)	(-18.71)
Sales Growth	0.000	0.000
	(0.17)	(0.17)
ADR	0.011***	0.011***
	(3.42)	(3.41)
Governance	0.006	0.006
	(0.60)	(0.68)
GDP Growth	0.102***	0.103***
	(3.42)	(3.42)
GDP per capita	-0.022***	-0.022***
	(-3.21)	(-3.15)
Trade Share	0.041	0.042
	(0.23)	(0.24)
Investment Share	-0.006	-0.006
	(-0.69)	(-0.72)
Year Fixed Effects	Yes	Yes
Firm Fixed Effects	Yes	Yes
No. of Observations	27,692	27,692
R-squared	0.737	0.737

Table 5: Moderating Effect of Operating Income in the U.S.

This table reports the results of *OLS* regressions of U.S. institutional ownership in non-U.S. firms (*U.S. Institutional Ownership*) on foreign policy disagreement variables (*Foreign Policy Disagreement I* and *Foreign Policy Disagreement II*), a U.S. operating income dummy (*U.S. Operating Income*), their interactions, firm and country-level covariates, firm fixed effects, and year fixed effects. The *t*-statistics in parentheses use robust standard errors clustered at the firm level. *, **, and *** indicate significance at the 1, 5, and 10 percent levels, respectively.

Dependent variable: U.S. Institutional Ownership	(1)	(2)
Foreign Policy Disagreement I × *U.S. Operating Income*	**-0.050****	
	(-2.11)	
Foreign Policy Disagreement I	-0.022	
	(-1.31)	
Foreign Policy Disagreement II × *U.S. Operating Income*		**-0.127*****
		(-3.27)
Foreign Policy Disagreement II		-0.036
		(-1.23)
U.S. Operating Income	0.035	0.031**
	(1.52)	(2.19)
Firm-level Controls	Yes	Yes
Country-level Controls	Yes	Yes
Year Fixed Effects	Yes	Yes
Firm Fixed Effects	Yes	Yes
No. of Observations	19,518	19,518
R-squared	0.883	0.883

Table 6: Moderating Effect of Politically Connected Firms

This table reports the results of *OLS* regressions of U.S. institutional ownership in non-U.S. firms (*U.S. Institutional Ownership*) on foreign policy disagreement variables (*Foreign Policy Disagreement I* and *Foreign Policy Disagreement II*), a politically-connected firm dummy (*Politically-Connected*), their interactions, firm and country-level covariates, firm fixed effects, and year fixed effects. The *t*-statistics in parentheses use robust standard errors clustered at the firm level. *, **, and *** indicate significance at the 1, 5, and 10 percent levels, respectively.

Dependent variable: *U.S. Institutional Ownership*	(1)	(2)
Foreign Policy Disagreement I × *Politically-Connected*	**0.132***	
	(1.68)	
Foreign Policy Disagreement I	-0.044**	
	(-2.25)	
Foreign Policy Disagreement II × *Politically-Connected*		**0.184***
		(1.80)
Foreign Policy Disagreement II		-0.064*
		(-1.93)
Firm-level Controls	Yes	Yes
Country-level Controls	Yes	Yes
Year Fixed Effects	Yes	Yes
Firm Fixed Effects	Yes	Yes
No. of Observations	11,320	11,320
R-squared	0.917	0.917

Table 7: Foreign Policy Disagreement, U.S. Institutional Ownership, and Firm Value

These tables report the results of path regressions of foreign policy disagreement variables (*Foreign Policy Disagreement I* and *Foreign Policy Disagreement II*) on U.S. institutional ownership in non-U.S. firms (*U.S. Institutional Ownership*) and on Tobin's *Q*. Panel A examines the effect of *Foreign Policy Disagreement I,* whereas Panel B examines the effect of *Foreign Policy Disagreement II.* *, **, and *** indicate significance at the 1, 5, and 10 percent levels, respectively. Standard errors are clustered at the firm level.

Panel A

	Indirect Effect	Direct Effect	Total Path Effect
U.S. Institutional Ownership $\rightarrow$ *Tobin's Q*		0.432***	0.432***
Foreign Policy Disagreement I $\rightarrow$ *Tobin's Q*	-0.025***	-0.039**	-0.065***

Panel B

	Indirect Effect	Direct Effect	Total Path Effect
U.S. Institutional Ownership $\rightarrow$ *Tobin's Q*		0.473***	0.473***
Foreign Policy Disagreement II $\rightarrow$ *Tobin's Q*	-0.092***	0.136***	0.044

Appendix A: Number of firms by country and by year

The following table shows the number of unique firms from each country and the number of firm observations by year.

Country	No. of Unique Firms		Year	No. of Firm Observations
Argentina	6		2000	633
Australia	147		2001	778
Austria	23		2002	953
Belgium	24		2003	978
Brazil	46		2004	1,129
Canada	293		2005	1,292
Chile	5		2006	1,421
China	136		2007	1,476
Czechia	2		2008	1,473
Denmark	19		2009	1,573
Finland	38		2010	1,578
France	101		2011	1,650
Germany	136		2012	1,592
Greece	21		2013	1,391
Hungary	7		2014	1,581
India	74		2015	1,658
Indonesia	10		2016	1,671
Ireland	65		2017	1,682
Israel	67		2018	1,621
Italy	45		2019	1,562
Japan	167		**Total**	**27,692**
Luxembourg	22			
Malaysia	25			
Mexico	17			
Netherland	94			
New Zealand	10			
Norway	35			
Peru	3			
Philippines	13			
Poland	12			
Portugal	8			
Russia	34			
Singapore	41			
South Africa	41			
South Korea	97			
Spain	38			
Sweden	49			
Switzerland	61			
Thailand	10			
Turkey	17			
United Arab Emirates	3			
United Kingdom	258			
Total	**2,320**			

Appendix B

The following table defines the variables used in the study.

Variable	Definition
U.S. Institutional Ownership	The sum of holdings of U.S. institutions in a firm's stock (including ordinary shares, preferred shares, American Depositary Receipts (ADRs), Global Depositary Receipts (GDRs), and shares of dual listed stocks) divided by the total number of adjusted outstanding shares at the end of each calendar year (source: FactSet/LionShares database)
Non-U.S. Institutional Ownership	The sum of holdings of Non-U.S. institutions in a firm's stock (including ordinary shares, preferred shares, American Depositary Receipts (ADRs), Global Depositary Receipts (GDRs), and shares of dual listed stocks) divided by the total number of adjusted outstanding shares at the end of each calendar year (source: FactSet/LionShares database)
Foreign Policy Disagreement I	Absolute distance in ideal points between a country and the United States. We use the ideal point developed and estimated by Bailey, Strezhnev and Voeten (2017). The ideal points have a mean of 0 and a standard deviation of 1 (source: Harvard Dataverse).
Foreign Policy Disagreement II	The number of non-important votes cast by a country at the UNGA that are not identical to the U.S. vote minus identical votes scaled by the total number of votes (source: U.S. Department of State).
U.S. Operating Income	1 if a firm has the U.S. operating income during the year and 0 otherwise (source: WorldScope)
Politically Connected	1 if a firm is politically connected and zero otherwise. A company is identified as being connected with a politician if at least one of its large shareholders (anyone controlling at least 10 percent of voting shares) or one of its top officers (CEO, president, vice-president, chairman, or secretary) is a member of parliament, a minister, or is closely related to a top politician or party. Identification of politicians is based on the first half of 2001 (source: OpenICPSR)
Tobin's Q	The book value of total assets plus the market value of equity minus the book value of equity divided by total assets
Firm Size	The logarithm of market capitalization in U.S. dollars
Book-to-Market Ratio	Book-to-market equity ratio
ROE	Net income divided by book equity
Debt/Assets	The ratio of total debt to total assets
Dividend Yield	Dividend per share divided by share price
Cash Holdings	Cash and short-term investments divided by total assets
Inside Ownership	Number of shares held by insiders divided by the number of shares outstanding
Sales Growth	Annual growth in net sales or revenues

ADR	A dummy variable that takes a value of 1 if a firm issued an American depository receipt (ADR) and 0 otherwise (including Level I ADRs)
Governance	Worldwide Governance Indicators (WGI) by Kaufmann, Kraay, and Mastruzzi (2007). The indicators measure six dimensions of governance: Voice and Accountability, Political Stability and Absence of Violence/Terrorism, Government Effectiveness, Regulatory Quality, Rule of Law, and Control of Corruption.
GDP Growth	The annual growth rate of gross domestic product, in percentage (source: World Bank WDI)
GDP per capita	The logarithm of per capita gross domestic product in U.S. dollars (source: World Bank WDI)
Trade Share	Measures economic trade volume between a country and the United States. It is the country's total trade volume (imports plus exports) with the United States divided by the entire trade volume (imports plus exports) of the United States. (source: U.N. Comtrade Database)
Investment Share	Defined as the difference between 'annual gross sales of foreign stocks by foreigners to U.S. residents' and 'annual gross purchases of foreign stocks by foreigners from U.S. residents' divided by the sum of 'annual gross sales and annual purchases of foreign stocks by foreigners to/from U.S. residents.' (source: Treasury International Capital)