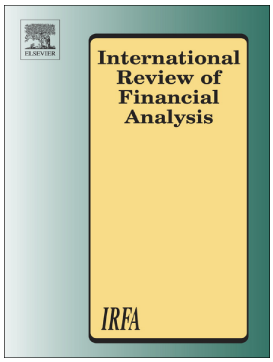


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PII: S1057-5219(23)00078-9

DOI: https://doi.org/10.1016/j.irfa.2023.102562

Reference: FINANA 102562

To appear in: *International Review of Financial Analysis*

Received date: 5 July 2022

Revised date: 27 November 2022

Accepted date: 1 February 2023

Please cite this article as: F. Kwabi, A. Boateng, C. Wonu, et al., Political uncertainty and cross-border equity portfolio allocation decisions: International evidence, *International Review of Financial Analysis* (2023), https://doi.org/10.1016/j.irfa.2023.102562

# Political Uncertainty and Cross-Border Equity Portfolio Allocation Decisions: International Evidence

Frank Kwabi[a*], Agyenim Boateng[a], Chizindu Wonu[a], Charles Kariuki[a], Anna Du[b]

* Corresponding author

[a*]School of Accounting, Finance and Economics, De Montfort University, England, LE1 9BH, Tel: +44 (0) 116 201 3862, Email: frank.kwabi@dmu.ac.uk

[a]School of Accounting, Finance and Economics, De Montfort University, England, LE1 9BH, Tel: +44 (0) 116 366 4575, Email: agyenim.boateng@dmu.ac.uk

[a]School of Accounting, Finance and Economics, De Montfort University, England, LE1 9BH, Email: chizindu.wonu@dmu.ac.uk

[a]School of Accounting, Finance and Economics, De Montfort University, England, LE1 9BH, Email: charles.kariuki@dmu.ac.uk

[b]Department of Accounting and Finance, Edinburgh Napier University, Email: a.du@napier.ac.uk

# Political Uncertainty and Cross-Border Equity Portfolio Allocation Decisions: International Evidence


## Abstract

Political risk models highlight that political uncertainty matters for corporate investment decisions. However, how political uncertainty matters for investment allocation decisions is relatively under-explored. In this study, we examine the impact of political uncertainty associated with national elections on foreign equity portfolio in 48 countries. Our results indicate that political uncertainty reduces international equity allocations to the host country and such reduction appears more pronounced in the election year. Further analysis shows that the interaction between political uncertainty and institutional quality has a positive and significant effect on international equity portfolio flow, suggesting that the value of institutional quality outweighs the negative effects of political uncertainty. Lastly, we find equity home bias to be negative and significant; however, the interaction between political uncertainty and equity home bias appears insignificant.




*Keywords*: Political uncertainty; election uncertainty; foreign equity portfolio flow; institutional quality

*JEL classification D8, F3, H1, H8*

## 1. Introduction

Existing finance literature starting from Grubel (1968) documents the benefits of international equity portfolio diversification[1]. These studies argue that, since the fortunes of different countries do not always move together, investors can improve the risk/reward ratio of a portfolio through international equity portfolio diversification (see Solnik, 1974; Driessen and Laeven, 2007; Lau et al., 2010). The ability of international equity diversification to generate gains for investors and host countries renders international portfolio allocation decisions important not only for academics but also practitioners and policy makers. As a result, there has been extensive literature attempting to shed light on the determinants of international portfolio allocation decisions.

In this study, we contribute to the above debate by analyzing another important source of variation in portfolio investment flows, that is, how political uncertainty impacts international equity portfolio allocation decisions. Recent literature highlights that economic policy and political uncertainties matter for the global economy, asset prices, and corporate investment decisions (Bloom et al., 2018; Julio and Yook, 2012; Pastor and Veronesi, 2013; Francis, Hasan, and Zhu, 2014; An et al., 2016; Bonaime, Gulen and Ion, 2018). However, how political uncertainty affects international investment allocation decisions has been a subject of public speculation by practitioners and the popular press. For example, PricewaterhouseCoopers in 2014 asserted that the stabilization of the US political and economic environment would lead to investment inflows[2]. Similarly, in 2019 the Financial Times claimed that the political uncertainty surrounding Brexit is putting investment inflows into the UK at risk[3]. Moreover, Standard and Poor (a major rating agency) cited political uncertainty as one of the main reasons for its unprecedented decision to downgrade the US

[1] This paper uses 'international' interchangeably with 'cross-border'.
[2] http://www.pwc.com/us/en/deals/publications/assets/pwc-us-technology-deal-insights-2013.pdf.
[3] The Financial Times (2019). Brexit chilling effect on UK inward investment, 21 August, 2019. Available at: http://www.FT.com.

Treasury debt in August 2011 (see, Pastor and Veronesi, 2013). Speculation abounds regarding the effects of political uncertainty on investment flows. Whilst political uncertainty has been the basis of corporate decisions, research appears scant on this important subject (see Julio and Yook, 2012). However, political uncertainty could be an important source of risk to international portfolio investments as it could lead to increased information asymmetry and higher cost of capital and this study attempts to shed light on this. Political uncertainty may heighten not only information asymmetry among investors but may also increase equity risk premia and stock market volatility and consequently impact asset prices (Pastor and Veronesi, 2012, 2013; Boutckova et al., 2011).

The purpose of this study is twofold: (i) to examine the relationship between political uncertainty and international equity portfolio allocation in 48 countries; and (ii) to consider the effects of interaction between political uncertainty and institutional quality on international equity portfolio allocation. We do so by employing national elections as a proxy for political uncertainty in line with the studies of Biakowski et al. (2008), Boutchkova et al. (2011), and Julio and Yook (2012). Although national elections are not a direct measure of political uncertainty, Julio and Yook (2012) and Boutchkova et al. (2011) contend that political uncertainty appears higher on average during election periods. Consistent with Cao et al. (2019), we also use checks and balances to proxy for institutional quality. Further, we use La Porta et al. (1998) revised anti-director rights index (*RADIS*) as alternative measure of institutional quality. Given that there is a growing body of empirical work documenting the role of equity home bias in international finance and a substantial body of work on political uncertainty, it is also important to empirically test the joint effects of these two types of risk on international equity portfolio flow. Consequently, we investigate the interactions of political uncertainty and home bias that may serve as a channel through which political uncertainty may impact cross-border equity portfolio inflows. Consistent with existing

studies (Lau et al. 2010), we also contend that equity home bias will amplify portfolio risk. Thus the domestic stock market may be dominated by corporate insiders, which may increase expropriation risk with implications for international equity investment inflows. Liu and Zhong (2017) find that political uncertainty positively impacts firm-level credit risk in 30 countries.

Our results evince several interesting features. First, we find that political uncertainty reduces international equity portfolio flow and the reduction appears more pronounced in the election year. This challenges the suggestion by the international capital asset pricing model (ICAPM) with regard to the benefits of equity portfolio diversifications. Further analysis indicates that the interaction between political uncertainty and institutional quality has a positive and significant effect on international equity portfolio flow, suggesting that the value of institutional quality outweighs the negative effects of political uncertainty. We also find equity home bias to be negative and significant; however, the interaction between political uncertainty and equity home bias appears insignificant.

Our paper makes two significant contributions to the international finance and political economy literature in the following ways. First, despite a vast number of studies on international equity portfolio diversification (see French and Poterba, 1991; Tesar and Werner, 1995; Karolyi and Stulz, 2003; Dahlquist et al., 2003; Leuz et al., 2009; Giannetti and Koskinen, 2010; Giofre, 2014), no study has provided direct evidence on the impact of political uncertainty on international equity portfolio diversification. Our study suggests that political uncertainty deters foreign investors from constructing internationally diversified portfolios. Thus, our results highlight that political uncertainty exacerbates investment risk and erects informational barriers against international equity portfolio flows across the globe. Our study therefore complements and extends the existing literature on determinants of international portfolio flows (Chan et al., 2005; Portes and Rey, 2005; Coval and Moskowitz,

1999; Kho et al., 2009; and Leuz et al., 2009). Second, we provide evidence on how institutional quality might moderate the political uncertainty-international equity portfolio inflow nexus. The results of this study highlight the importance of interplay between the institutional quality and political uncertainty and their joint effect on international equity portfolio inflow. Thus, we demonstrate that the negative influence of political uncertainty on international equity portfolio inflow is predicated on the institutional quality of the country in question.

The remainder of the paper is organized as follows. Section 2 reviews related literature and provides the hypotheses development. Section 3 presents the data and research methodology. Section 4 shows the empirical results. Section 5 provides the conclusion.

## 2. Related literature review

Prior literature in international finance documents that the financial liberalization in the last four decades has led to greater diversification of international equity portfolios by investors to reduce risk and also to participate in growth opportunities in other countries (Kwabi, Boateng, and Adegbite, 2019). However, scholars contend that risk in the recipient country may deter foreign investors from allocating equity investments into those countries. Political uncertainty associated with national elections in the destination country may reduce that country's attractiveness to foreign investors. Several authors have recognized that political uncertainty exacerbates information asymmetry and causes firms to reduce investment expenditure (Liu, 2010). Thus foreign investors may reduce the amount they invest in those countries due to the perceived risk and lower returns. Political uncertainty associated with elections increases a firm's investment risk and may distort the optimal equity portfolio diversification. Uncertainty around national election outcomes may also impact stock prices due to uncertainties about future government policies. Particularly, when

the opposition party is advocating alternative policies, information quality about stock prices becomes noisy and impaired, thereby increasing the level of information asymmetry and deterring foreign investors from investing in the domestic stock market.

Research evidence shows that election uncertainty affects corporate investment decisions. For example, Çolak et al. (2017) document that political uncertainty reduces initial public offering (IPO) activities as a result of gubernatorial elections. Another strand of the finance literature suggests that political uncertainty impacts stock market return volatility (see Boutchkova et al., 2012; Fishman, 2001; Claessens et al., 2008), and stock market performance (Kim et al., 2012). Recent theoretical and empirical works document the effects of political uncertainty on investment inflows and stock prices. For instance, Pastor and Veronesi (2012, 2013) contend that political uncertainty reduces stock prices and increases equity risk premiums. Durnev (2013) finds that corporate investments tend to be less efficient when political uncertainty appears high. A study by Rodrick (1991) shows that firms substantially reduce their investments even when political uncertainty is at a moderate level. Recent studies by Julio and Yook (2012) and Jens (2017) find that political uncertainty is negatively associated with corporate investment. Other studies document the impacts of political uncertainty and macroeconomics on corporate investment decisions (see Leahy and Whited, 1996; Bloom et al., 2007; Bloom, 2009). We argue that international investors will be skeptical of constructing internationally diversified equity portfolios due to the negative effects of political uncertainty on corporate investment opportunities, macroeconomic fundamentals, and asymmetric information.

The literature on uncertainty (see Bernanke, 1983) and policy uncertainty (see Stokey, 2016) documents that investment decisions are delayed when there is a higher level of political uncertainty. Even though foreign equity investors seek to diversify their investment to reduce portfolio risk and also to participate in growth opportunities in other countries,

however, perceived political uncertainty may reduce the location attractiveness of a country. Lane and Milesi-Ferretti (2007) show that foreign capital flow is an important source of finance particularly in emerging countries. We present time series evidence on how the political process impacts international equity portfolio diversification.

### *2.1 Hypotheses development*

#### *2.1.1 Political uncertainty and foreign equity portfolio flow*

The literature offers a link between political uncertainty and foreign equity portfolio flow. Therefore, we draw on theoretical arguments and empirical studies from political science, economics, and finance to develop our hypotheses about how political uncertainty impacts international equity portfolio diversification. Political uncertainty relates to the likely changes in national leadership or government policies. At the macro level, aggregate investment and corporate decisions are affected by national election uncertainty through these channels: (1) uncertainty about the possible winner of the national election; (2) uncertainty concerning the policies (government contracts, taxes) the new government will pursue, particularly when the opposition party is advocating different policies.

Over time, an extensive amount of literature has been developed on determinants of foreign equity portfolio flow (see Hellmanzik and Schmitz, 2017; Lau et al., 2010; Chan et al., 2005). However, a critical examination of the literature on international capital flow reveals several gaps. It is well acknowledged that risk reduces portfolio returns; another interesting line of research is whether political uncertainty impacts cross-border equity portfolio diversification. This is consistent with the fact that several authors have recognized that political uncertainty in general increases portfolio and investment risk. For instance, Pastor and Veronesi (2012, 2013) theoretically predict that political uncertainty reduces asset prices. They show that IPOs decline with political uncertainty. Boutchkova et al. (2012)

postulate that the period leading to an election is characterized by elevated uncertainty and cost. Earlier work by Gemmill (1992) indicates that implied volatility of the FTSE 100 index increased in the two weeks leading to the 1987 UK parliamentary election. Kelly et al. (2016) and Brogaard and Detzel (2015) find that investors price political uncertainty in the equity option.

Concerning the financial effects of national election uncertainty, Li and Born (2006) find abnormal stock returns in the two weeks leading to national elections. This supports an earlier study by Pantzalis et al. (2000). More recently, Gao and Qi (2013) show that municipal bond yields increase around US gubernatorial elections. Bialkowski et al. (2008) document that stock market returns become more volatile around the period of national elections, whilst Boutchkova et al. (2012) show that industries that are exposed to political sensitivity tend to have significant volatile returns around national elections. Goodell and Vahamaa (2013) document that the outcome of the US presidential elections is associated with an implied volatility of the S&P 500 index. To sum up, studies have emphasized that political uncertainties impact on equity investment decisions of foreign investors. However, given the difficulty in reversing firms' investment decisions, companies may delay their investment decisions in the presence of election uncertainty (see Guiso and Parigi, 19991; Jens, 2017). Earlier work by McDonald and Siegel (1986) shows that uncertainty reduces corporate investment. Yook (2012) finds that uncertainty about new policies affects corporate decisions at the micro level and firms subsequently cut capital expenditure when there is electoral uncertainty.

In light of uncertainty about the election outcome, it is conceivable that the level of investment risk will increase. Some authors have found that political uncertainty is associated with risk premium (see Erb et al., 2016; Brogaard and Detzel, 2015). Other studies find a positive relationship between stock market volatility and political uncertainty (see

Bittlingmayer, 1998; Voth, 2002). Further, the expected returns demanded by an investor will increase due to corporations adopting a wait-and-see attitude towards an election outcome before making important corporate investment decisions.

To answer our first research question which investigates whether political uncertainty impacts foreign equity portfolio inflows, we regress our dependent variable, i.e., foreign equity portfolio flow, on political uncertainty and country-level variables. We test the research question using Equation (1).

$$PORTFDIV_{jt} = \alpha + \beta_1.PolU_{jt} + \beta_2.Ctls_{jt} + \beta_3.TFE_t + \beta_4.CFE_j + \epsilon_{jt} \quad (1)$$

$PORTFDIV_{jt}$ represents foreign equity portfolio diversification, *PolU* represents political uncertainty (i.e. $NalElec_{t-1}$, $NalElec_{t-2}$, $NalElec_t$, and $NalElec_{t+1}$,) of country $j$ at time $t$ regressed one at a time. $Ctls_{jt}$ is a vector of the control variables of country $j$ at time $t$. *TFE* and *CFE* are time (year) and country-fixed effects respectively. We hypothesize that foreign investors will delay their equity portfolio investment in those recipient countries.

*$H_1$:* Political uncertainty is negatively associated with international equity portfolio flow.

*2.1.2 Political uncertainty and checks and balances*

Our second research question examines whether the institutional quality and political uncertainty are complements, substitutes, or independent from the perspective of foreign investors[4]. Institutions play an important role in supporting or hindering the effective functioning of market mechanisms (North, 1990; Globerman and Shapiro, 1999; Peng et al., 2008). Strong institutions tend to reduce information asymmetries (Meyer et al., 2009), and may influence foreign investment decisions by moderating the costs and risks of doing business in the host country (Stevens et al., 2016). Several studies (e.g., Blonigen, 2005) have

[4] We use checks and balances to proxy for institutional quality.

found the quality of institutions as a determinant of foreign direct investment inflows. In contrast, weak institutions in the host country may serve as a tax and increase the cost and risk of doing business in the host country (Du and Boateng, 2015). Alfaro et al. (2005) find that low institutional quality explains why foreign capital does not flow from rich to poor countries. Similarly, Bhattacharya et al. (2007) highlight that courts in recipient countries could be biased towards local investors and firms when there are disputes. We expect that the quality of institutions proxied as checks and balances in the host country may compensate for the negative effects of political uncertainty put forward in our first hypothesis.

We, therefore, test the interaction between political uncertainty and checks and balances using the following specification:

$$PORTFDIV_{jt} = \alpha + \beta_1 PolU_{jt} + \beta_2 CHBAL_{jt} + \beta_3 PolU_{jt} \times CHBAL_{jt} + \beta_4 Ctls_{jt} + TFE_t + CFE_t + \epsilon_{jt} \quad (2$$

where $PORTFDIV_{jt}$ represents foreign equity portfolio diversification, *PolU* represents political uncertainty (i.e *NalElec*$_{t-1}$, *NalElec*$_{t-2}$, *NalElec*$_t$, and *NalElec*$_{t+1}$,) of country $j$ at time $t$ regressed one at a time. $CHBAL_{jt}$ are checks and balances, $PolU_{jt} \times CHBAL_{jt}$ represents the interaction between political uncertainty and checks and balances. $Ctls_{jt}$ is a vector of the control variables of country $j$ at time $t$. *TFE* and *CFE* are time (year) and country-fixed effects respectively.

A positive (negative) $\beta_3$ in Equation (2) suggests political uncertainty substitutes for (complements) checks and balances. Therefore, a marginal increase in political uncertainty will cause a greater (smaller) reduction in foreign equity in countries with checks and balances. An insignificant $\beta_3$ indicates the effects of political uncertainty and checks and balances are independent. Isolating political uncertainty could be difficult as it may coincide with economic policy and macroeconomic uncertainty. Nonetheless, in this study, we exploit variations in countries' checks and balances to isolate political uncertainty. Drawing from

theoretical literature that links the impact of political uncertainty and institutional quality on investment, we argue that investors will be less concerned about uncertainties associated with national elections if there are better institutions to provide checks and balances and provide reasonable assurance about the safety of their investments. Thus, we hypothesize that:

*$H_2$:* Institutional quality alleviates the negative effects of political uncertainty associated with foreign equity portfolio flow.

## 3. Data and methodology

In this section, we describe the variables we employ in our analysis. We restrict our sample period to 2001 and 2020 due to data unavailability for key variables used in our analysis. Our country-level sample consists of data mainly sourced from the Coordinated Portfolio Investment Survey (CPIS) of the International Monetary Fund (IMF), the Database of Political Institutions (DPI) of the World Bank, and World Development Indicators (WDI).

### *3.1 Foreign equity portfolio diversification*

We construct foreign equity portfolio flow using data provided by the Coordinated Portfolio Investment Survey (CPIS) of the International Monetary Fund (IMF). The survey provides information on the amount of portfolio investment residents of a source country, $i$, allocate into a destination country, $j$, at the end of the year. The CPIS was developed by the IMF in 2001 to enhance the understanding and quality of portfolio investment fund shares and equity, whereby the participating countries delineate their cross-border portfolio holdings (such as mutual funds, banks, pension funds, long- and short-term debt securities, etc.). The CPIS data are generated from two main sources: (i) international exchange reserves and (ii) securities held by foreign organizations (Josyula, 2018).

Despite some limitations[5], the CPIS data have been widely used in the finance literature (see Kwabi et al., 2019; Hellmanzik and Schmitz, 2017; Poshakwale and Thapa, 2011). Hau and Rey (2009) document that, consistent with data provided at the mutual-fund level, the portfolio investment data provided by CPIS reflect the internal level. Even though the CPIS provides data for more countries and years, our sample period is restricted by the unavailability of political uncertainty data by the World Bank's Database of Political Institutions.

We model cross-border equity portfolio diversification as our dependent variable following Cooper and Kaplanis (1986) and Poshakwale and Thapa (2011). The endogenous variable is computed as the weight of the logarithm value of cross-border equity portfolio diversification from nation $i$ into country $j$, and is represented as:

$$w_{ijt} = log\left(\frac{FPI_{ijt}}{\sum_{j=1}^{48} FPI_{ijt}}\right) \quad (3$$

Where $w_{ijt}$ is the weight of cross-border equity portfolio diversification from country $i$ into country $j$ for the year $t$, and $FPI_{ijt}$ is foreign investors' actual portfolio allocation in USD millions.

*3.2 Political uncertainty*

We proxy political uncertainty using electoral results for 48 countries over the period from 2001 to 2020. In line with Cao et al. (2019), national elections are mainly pre-determined by the country's laws concerning timing; nonetheless, they are often random in terms of election outcomes and ensuing policy changes. This offers us an exogenous model to investigate the impact of political uncertainty on international equity capital allocations. Another reason that national elections make a good setting is that different countries have

[5] For limitations of the CPIS data, please see Lane and Milesi-Ferretti (2008).

different election times, which offers us profuse variation in political uncertainty over time and across countries.

The World Bank's Database of Political Institutions (DPI) provides data on electoral results for 180 countries since 1975. Researchers have widely used the data in the political economy and comparative political institutions studies (see Cao et al., 2019; Julio and Yook, 2012). A national election that relates to the likelihood of change in a country's leader is a salient channel through which political uncertainty could impact foreign equity portfolio inflows. This is consistent with the notion that political uncertainty increases portfolio investment inflows. For instance, Alesina and Perotti (1996) show that political instability negatively relates to aggregate investments, whilst Julio and Yook (2012) find that electoral uncertainty reduces firms' capital expenditure.

The World Bank Database of Political Institutions (DPI) provides national election information that directly or indirectly determines the leadership of a country. These data have been used in previous studies to proxy for political uncertainty (see Cao et al., 2019; Julio and Yook, 2012; Bialkowski et al., 2008; Boutchkova et al., 2012). Several countries in our sample have had a minimum of three elections and they are mainly held one every four years.

The data consist of presidential, parliamentary, legislative, and hybrid elections. In the presidential system, the national leader is referred to as the president while, in the parliamentary form of government, the leader is called a prime minister. In the case of the countries that practice the hybrid (presidential-parliamentary) system (such as France and Finland), we collect election data based on the leader who has the most powerful influence on the executive decisions. We use the dummy of 1 to denote the election year in a country and 0 if otherwise. Out of the 48 countries employed in our study, the political uncertainty dataset consists of 31 countries with a parliamentary system in place while 17 countries practice the presidential form of government.

### *3.3. Checks and balances*

Checks and balances (*CHBAL*) relate to the extent of veto players in a country's political system. Studies show that presidential systems of the election have a higher degree of checks and balances (Julio and Yook, 2012) and therefore restrict government decisions (Cao et al. 2019), and reflect the institutional quality. We, therefore, interact checks and balances with political uncertainty to determine whether they have a combined effect on foreign equity portfolio inflows across the globe. Thus it is expected that lower policy swings as a result of checks and balances are less likely to deter foreign equity investors from increasing their equity portfolio allocation into the host countries. Further, the prevalence of strong checks and balances will not only ensure good regulations but may also strengthen property rights. For instance, Forteza and Pereyra (2019) contend that checks and balances safeguard investors from government abuse of power. In contrast, an earlier study by Keefer (2002) shows that the absence of checks and balances deters international equity portfolio diversifications and therefore puts financial liberalization at risk. Checks and balances also ensure an efficient judicial system that prevents courts from being biased toward domestic investors when there are disputes. We sourced checks and balances from the World Bank's Database of Political Institutions. We construct checks and balances using a dummy variable of 1 if the veto players outweigh the median of the entire country, and 0 if otherwise.

### *3.4. Control variables*

To isolate the effects of political uncertainty on international equity portfolio inflow, we draw from existing literature regarding variables shown to have an impact on international equity inflows. First, following Stulz and Williams (2003), who show the role of cultural similarities in foreign equity investment, we use religion (*RELIG*) to control the effects of

cultural similarity on cross-border equity portfolio diversification. We obtained data from the World religion.

Empirical studies by La Porta et al. (1997) argue that legal origin (*LEGORIG*) impacts foreign equity portfolio flow. This supports the view that common law countries provide better protection for investors and are therefore able to attract foreign equity investment. Following La Porta et al. (1998), we use a dummy variable to proxy for legal origin which takes a value of 1 if a common law country and 0 if otherwise.

Following existing studies (see Busse and Hefeker, 2007; Erel et al., 2012), we use an investment profile (*INVESTPRO*) to capture the effects of government behaviour towards foreign investors. Adverse government behaviour could exacerbate foreign equity investment risk and will deter foreign equity portfolio flow. We obtained investment profile data from International Country Risk Guide (ICRG). The investment profile ranges from 0 (higher risk) to 12 (lower risk).

Next, we control the effects of stock market integration (*SMI*) on foreign equity portfolio flow. Chan et al. (2005) show that openness increases financial integration and therefore enhances international equity diversification. We measure trade openness as the ratio of imports and exports scaled by GDP. We obtained data from World Development Indicators.

Countries that are internationally exposed to investors will be able to attract foreign equity investors. We control the effects of financial development using domestic credit to the private sector scaled by GDP (*DCPS*). This is in line with the view that the development of the domestic financial sector will expose the country to international investors. We sourced data from World Bank's World Development Indicators.

We also control for the the effects of economic environment using inflation (*INFL*). Rising levels of inflation will reduce portfolio returns and will therefore deter investors from

constructing internationally diversified equity portfolios (see Kwabi et al., 2020). We expect inflation to have a negative effect on foreign equity portfolio flow. We obtained inflation data from World Bank's World Development Indicators (WDI).

Additionally, we control for net interest margin (*NETIMARGIN*) as a market structure measure to account for how financial institutions efficiently transmit money from savers to foreign investors. Beck et al. (2000) document that *NETIMARGIN* is the accounting value of a bank's interest revenue as a proportion of its overall assets. Countries with high *NETIMARGIN* are likely to experience lower investment and flow of credits, and thus have a negative influence on cross-border equity portfolio allocation. We sourced data from the IBCA's Bankscope Database.

Studies show that foreign equity investors are attracted to stable countries. However, Barro, (1991) and Pindyck and Solimano (1993) document that political instability reduces investment inflows. We, therefore, use government stability (*GOVTSAB*) to control the effects of stable governments, which are also linked to investor protection. This is consistent with the assertion that stable countries are associated with better institutions. We obtained data from the International Country Risk Guide (ICRG) of the Political Risk Services. The government stability index ranges from 0 (least stable government) to 12 (most stable government) and captures the ability of a government to successfully execute its set objectives and remain in power.

Next, we control the effects of financial and stock market development on international equity portfolio flow. Foreign investors will be attracted to countries that have well-developed financial markets. Following Seven and Yetkiner (2016), we control financial development using deposit money bank assets to GDP (*DBAGDP*). We sourced *DBAGDP* from the IMF's International Financial Statistics. Additionally, we use GDP growth (*GDPG*) to control the effects of economic growth. Existing studies show that the economic

environment of the host country helps attract foreign equity investors (Chan et al., 2005). We sourced data from WDI.

Finally, we controlled for democracy (*DEMOC*) and the general government's final consumption expenditure of GDP (*GOVTSIZE)*. Intuitively, investors prefer stable democratic countries as destination countries for their foreign equity portfolio allocation. We expect *DEMOC* to positively relate to foreign equity portfolio flow. We sourced data from Polity IV.

## 4. Empirical Analysis

In this section, we report our results on whether political uncertainty has varying effects on international equity portfolio diversification and the moderating role of institutional quality. We first begin our empirical analysis with univariate analysis. Then we proceed to analyse the impact of political uncertainty on foreign equity portfolio diversification. We also investigate the role of institutional quality. Lastly, we perform several tests to ensure that our baseline results are not spurious. More specifically, we check the robustness of our results: (1) to generalized method of moments (GMM) regression, (2) to one year before a national election, (3) to political uncertainty interaction with equity home bias.



### *4.1. Summary statistics*

Panel A of Table 1 presents the summary statistics of the dependent variable and the key independent variables of interest (political uncertainty and revised anti-director right) for developed countries. Panel B of Table 1 reports the summary statistics for emerging countries. We further provide the summary statistics for all the control variables used in our analysis in Table 2. Table 1 shows that the mean score for portfolio diversification for

developed countries is -1.66, but in contrast, the mean for emerging countries is -3.44, suggesting that developed countries are more diversified in terms of their portfolios relative to emerging countries. In terms of political uncertainty, developed countries appear to have lower levels of political uncertainty with an average of 0.06 compared with an average of 0.13 for emerging countries.

**[Insert Tables 1 & 2 Here]**

*4.2. Correlation matrix*

Table 3 reports the cross-correlation matrix among the variables employed in our empirical analysis. Consistent with theoretical predictions, political uncertainty is negatively related to cross-country equity portfolio diversification. Interestingly, the four measures of political uncertainty are negatively correlated with each other. The results show that the correlation coefficients among most of the variables are relatively low, suggesting that multicollinearity is not an issue in this study.

*4.3 Multivariate regression analysis*

*4.3.1. Political uncertainty and international equity portfolio flow*

In this section, we examine whether political uncertainty has a varying impact on equity portfolio inflows. We run our regressions using Equation (1). *PolU* represents political uncertainty (i.e. $NalElec_{t-1}$, $NalElec_t$, and $NalElec_{t+1}$) of country *j* at time *t* regressed one at a time. Table 4 presents the results of OLS regression. The estimated coefficients of the four political uncertainty measures are all significantly negative. Model 1 shows that political uncertainty has a negative impact on international equity portfolio inflows. The coefficient on $NalElec_t$ is -0.082 (t-statistics=-3.20), suggesting that political uncertainty is sensitive to international capital one year before a national election. This indicates that political uncertainty is significantly higher and deters foreign investors from allocating equity investment into the host country.

Model 2 of Table 4 reports the results of the impact of political uncertainty during the year of a national election. The coefficient is -0.055 (t-statistics=-2.12). The result further indicates that, as political uncertainty increases in the election year, it deters foreign investors from diversifying into the host country. The magnitude of the impact is economically significant relative to one year before a national election. The estimated coefficient in Model 3 is -0.074 (t-statistics=-3.08). The results support our hypothesis that political uncertainty proxied by national elections reduces the attractiveness of the recipient country to foreign investors. The findings support the conclusion drawn by Julio and Yook (2016), which shows a negative impact of policy uncertainty on international capital flow. Our findings may be explained by information asymmetry. Thus, political uncertainty heightens not only information asymmetry among investors but may also increase equity risk premia, equity market volatility, and impact asset prices (Boutchkova et al., 2012; Pástor and Veronesi, 2012; 2013). As a result, if a risk-averse investor anticipates that political uncertainty may lead to an unfavourable outcome, the option value of waiting to invest increases, and investors tend to reduce the level of investments or postpone investments until political uncertainty is reduced or resolved (Bloom, Bond, and Van Reenen, 2007). In other words, thus the inability of corporate investors to predict the policies to be pursued by the new government and ultimately passed into law hurts investment decisions and international capital flows.

**[Insert Table 4 Here]**

*4.3.2. The moderating role of institutional quality*

This section investigates whether institutional quality can mitigate the impact of political uncertainty on international equity portfolio diversification. We proxy institutional quality using checks and balances (*CHBAL*). Countries that have better institutions may have checks and balances that promote an efficient legal system to reduce investment risk. We estimate our results using Equation (2).

Model 1 of Table 5 reports the results of the interaction effects of institutional quality and political uncertainty on international equity portfolio inflows using OLS regression. We find the interaction between the $NalElec_t \times CHBAL$ reverses the negative and significant effect of political uncertainty into a positive and significant effect (coefficient = 0.048; t-statistics=2.44). This finding indicates that the combined effect of political uncertainty and checks and balances increases the level of international equity portfolio inflows. Thus, the negative effect of political uncertainty on equity portfolio inflows is completely canceled out by the interaction between the quality of institutions and political uncertainty. Hypothesis 2 is therefore supported. This finding suggests that two major considerations, the quality of institutions and political uncertainty, explain the level of international equity portfolio inflows. The results imply that, under high-quality institutions, political uncertainty tends to be less important for investments to occur.

In Model 2 of Table 5, we use Newey-West regression to address the concern of autocorrelation and heteroscedasticity to provide robustness to our analyses. The magnitude of the coefficient increases in Model 2 of Table 5. The coefficient of the interactive in model 2 is also positive and statistically significant at the 10% level (coefficient=0.046; t-statistics=1.70). The results show that institutional quality interacts with political uncertainty to attract foreign equity portfolio flow. Overall, the results reported in Table 5 confirm our earlier findings in Table 4 that, checks and balances play a decisive role in alleviating the negative impact of political uncertainty on international equity portfolio inflows. The results suggest that the presence of elections on portfolio investment when there are checks and balances is even beneficial.

**[Insert Table 5 Here]**

*4.3.3. Control variables*

Several control variables have expected and consistent signs throughout the regressions. *GOVTSTAB, DCPS,* and *DEMOC* have positive effects on foreign equity

portfolio flow. The coefficient on *INFL* is negative and statistically significant at the 1% level. This indicates that investors are reluctant to allocate equity to countries that have high levels of inflation. *NETIMARGIN* and *LEGORIG*. None of *GOVTSIZE*, *DBAGDP*, *INVESTPRO*, and *RELIG* variables affect the relation between political uncertainty and foreign equity portfolio flow.

### *4.4. Robustness tests*

In this section, we perform several analyses to provide robustness to our baseline results concerning the sensitivity of international capital flow to political uncertainty. First, we perform analysis using the generalized method of moments (GMM). Second, we examine the interactive effect between checks and balances one year before the national elections of the host country. Third, we investigate whether political uncertainty and equity home bias have an independent effect on foreign equity portfolio flow.

#### *4.4.1. System generalized method of moments*

In this section, we provide robustness to the baseline regression by addressing potential endogeneity concerns as a result of reverse causality. Foreign investors may influence political uncertainty through institutional quality. Studies show that foreign investors play an important role in enhancing institutional quality in the host country (see Ferreira and Matos, 2008). Therefore, countries that attract less foreign equity portfolio investment will have high political uncertainty due to weak institutions. Following Arellano and Bond (1991), we use lagged levels of *PORTFDIV* as the instrument. The system GMM estimation is appropriate when cross-section observation is large and the period is smaller. We estimate our results using Equation (4).

$$PORTFDIV_{jt} = a + \beta_2 PORTFDIV_{jt-1} + \beta_2 PolU_{jt} + \beta_3 Ctls_{jt} + \beta_3 . TFE_t + \beta_4 . CFE_j + \epsilon_{jt} \quad (4$$

Where $PORTFDIV_{jt}$ represents foreign equity portfolio diversification, $PORTFDIV_{jt-1}$ represents the lagged foreign equity portfolio diversification, *PolU* represents political uncertainty, (i.e. $NalElec_{t-1}$, $NalElec_{t-2}$, $NalElec_t$, and $NalElec_{t+1}$) of country *j* at time *t* regressed one at a time. $Ctls_{jt}$ is a vector of the control variables of country $j$ at time $t$. *TFE* and *CFE* are time (year) and country-fixed effects respectively.

Table 6 presents the results of the system GMM which we employ to address the concern of endogeneity. The coefficients on $NalElec_{t-1}$ and $NalElec_{t-2}$ in models 1 and 2 are significant and statistically significant at the 5% level and the 10% level respectively, whilst the coefficients on $NalElec_t$ and $NalElec_{t+1}$ in models 3 and 4 are also negative and statistically significant at least at the 5% level. Except for Model 2, in which the magnitude of the coefficient is statistically smaller relative to the results reported in Table 4, the rest of the results are consistent with our baseline regression. The results suggest that our main results are robust to endogeneity.

**[Insert Table 6 Here]**

*4.4.2. One year before a national election*

Table 7 presents the interactive effect between one year before the national election and checks and balances. In Model 1, we use OLS to examine whether political uncertainty one year before the national election interacts with checks and balances to influence international equity portfolio investments. The coefficient of the interactive variable $NalElec_{t-1} \times CHBAL$ is positive and statistically, significant at the 10% level. To provide robustness to the result, in Model 2 of Table 7, we use the Newey-West model to address autocorrelation and heteroscedasticity. The coefficient on the interactive variable $NalElec_{t-1} \times CHBAL$ increases and it is significant at the 5% level. The results suggest that,

even though national elections are associated with the risk of future policy swing by a future government, investors are more willingly to allocate more equity investment to the host country if there are strong institutions to ensure checks and balances and the safety of their investments.

**[Insert Table 7 Here]**

*4.4.3. Political uncertainty effects on equity home bias*

In this section, we examine whether political uncertainty impacts the attractiveness of the host country when there is a high prevalence of equity home bias[6]. Lau et al. (2010) show that equity home bias increases portfolio risk due to lower risk sharing between domestic and foreign investors. Further, the domestic stock market may be dominated by corporate insiders, which increases expropriation risk. We, therefore, examine whether political uncertainty and equity home bias have a combined effect to reduce the attractiveness of a country to foreign investors or if they have independent effects. We run the following specification using Equation (5).

$$PORTFDIV_{jt} = \alpha + \beta_1 PolU_{jt} + \beta_2 HBIAS_{jt} + \beta_3 PolU_{jt} \times HBIAS_{jt} + \beta_4 Ctls_{jt} + TFE_t + CFE_t + \epsilon_{jt} \quad (5$$

where $PORTFDIV_{jt}$ represents international equity portfolio diversification, *PolU* represents political uncertainty, (i.e. $NalElec_{t-1}$, $NalElec_{t-2}$, $NalElec_t$, and $NalElec_{t+1}$,) of country *j* at time *t* regressed one at a time. $HBIAS_{jt}$ is equity home bias, $PolU_{jt} \times HBIAS_{jt}$ represents the interaction between political uncertainty and equity home bias. $Ctls_{jt}$ is a vector of the control variables of country $j$ at time $t$. *TFE* and *CFE* are time (year) and country-fixed effects, respectively.

Table 8 reports the results. To save space, we report the coefficients of political uncertainty, equity home bias, and interaction terms. In models 1 to 4, the coefficients on

[6] Equity home bias is the overinvestment in the local stock market by domestic equity investors relative to the benchmark weight suggested by the international capital asset pricing model (ICAPM).

*HBIAS* are negative and statistically significant at least at the 1% level. This supports the results reported by earlier studies (see Sorensen et al., 2007). However, the results for the interaction term between political uncertainty and equity home bias are insignificant. This suggests that the sensitivity of risk around national elections in reducing the attractiveness of a country to foreign investors is independent of risk due to equity home bias.

**[Insert Table 8 Here]**

*4.4.4. Alternative measure of institutional quality*

We use La Porta et al. (1998) revised anti-director rights index (*RADIS*) as an alternative measure of institutional quality. This is consistent with the view that foreign investors may be more concern about minority rights protection. We provide the results in Table 9.

The results show that anti-director rights interact with political uncertainty to have a combined effect to enhance equity portfolio flow. The coefficient on $NalElec_t$ x *RADIS* in models 1 and 2 are positive and statistically significant at the 1% level. This suggests that investors consider minority rights protection and therefore allocate more equity portfolios to those countries during a period of political uncertainty.

**[Insert Table 9 Here]**

*4.4.5. The role of the information environment*

We check the role the information environment of the host country plays in influencing cross-border equity portfolio allocation during a period of political uncertainty. Intuitively, the negative impact of political uncertainty on international equity portfolio flow will be more pronounced for countries with weak information environments. We, therefore, partition the host countries into weak and strong information environments using La Porta et al. (2006) disclosure quality index. We report the results in Table 10. The coefficients for the interactive term $NalElec_t$ x *DISCLO* are positive and statistically significant in model 2 but insignificant in model 3. This suggests that countries with a strong informational environment can attract foreign equity portfolio investment during a period of political uncertainty.

**[Insert Table 10 Here]**

## 5. Conclusion

We investigate the varying effects of political uncertainty on cross-border equity portfolio allocation decisions. We find that political uncertainty around national elections reduces cross-border equity portfolio flows in the election year. We also find that the interaction between political uncertainty and institutional quality increases international equity portfolio flows. The findings suggest that the negative effect of political uncertainty on international equity portfolio inflows is nullified by the quality of host country institutions. However, the interaction of equity home bias and political uncertainty appears not to affect international equity portfolio inflows.

Our study contributes to the political economy and the international finance literature. Although there are many studies on determinants of international equity portfolio flow (see Dahlquist et al., 2003; Giofre, 2014), as far as we are aware, no previous research has examined the effects of political uncertainty on cross-border equity portfolio flow. The research on institutional quality interaction with political uncertainty effects on cross-border equity portfolio flow remains limited. We show how the interplay between institutional quality and political uncertainty effect on cross-border equity portfolio flows. Further analysis indicates that the information environment of the host country plays a key role in cross-border equity portfolio flow. Host countries with stronger information environments can mitigate the negative impact of political uncertainty on international equity portfolio flow.

The study has implications for the country-level cost of capital and cost of doing business in host countries in that as political uncertainty increases due to national elections, corporate investments by foreign equity investors reduce. The results that political uncertainty and institutional quality interact to increase international equity portfolio inflows appear interesting and imply that institutional quality compensates for the negative effects of

political uncertainty, increasing international portfolio inflows. This finding is particularly important for policy makers because it shows that the extent to which political uncertainty affects international equity portfolio investment inflows is predicated on institutional quality, particularly, the information environment of the host country. Therefore, policy makers should strengthen domestic institutions to mitigate the negative impact of political uncertainty on international equity portfolio inflows

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**Table 1:**
Descriptive statistics by country.
The table reports the means for the key variables employed in our regressions. All variables are defined in Appendix A1.

**Panel A: Developed Economies**

| Country | *PORTFDIV* | *NalElec$_{t-1}$* | *NalElec$_{t-2}$* | *NalElec$_t$* | *NalElec$_{t+1}$* | *RADIS* | *CHBAL* |
|---|---|---|---|---|---|---|---|
| Australia | -1.85 | 0.00 | 0.00 | 0.00 | 0.00 | 4.00 | 4.90 |
| Austria | -1.96 | 0.11 | 0.11 | 0.10 | 0.11 | 2.50 | 4.05 |
| Belgium | -1.63 | 0.00 | 0.00 | 0.00 | 0.00 | 3.00 | 4.60 |
| Canada | -1.54 | 0.00 | 0.00 | 0.00 | 0.00 | 4.00 | 4.35 |
| Denmark | -1.97 | 0.00 | 0.00 | 0.00 | 0.00 | 4.00 | 5.55 |
| Finland | -2.07 | 0.11 | 0.11 | 0.10 | 0.11 | 3.50 | 4.15 |
| France | -1.08 | 0.32 | 0.28 | 0.35 | 0.37 | 3.50 | 4.10 |
| Germany | -1.07 | 0.00 | 0.00 | 0.00 | 0.00 | 3.50 | 4.95 |
| Greece | -2.49 | 0.05 | 0.06 | 0.05 | 0.05 | 2.00 | 3.30 |
| Ireland | -1.18 | 0.00 | 0.00 | 0.00 | 0.00 | 5.00 | 5.90 |
| Israel | -2.70 | 0.05 | 0.06 | 0.05 | 0.00 | 4.00 | 4.00 |
| Italy | -1.38 | 0.00 | 0.00 | 0.00 | 0.00 | 2.00 | 3.85 |
| Japan | -0.98 | 0.00 | 0.00 | 0.00 | 0.00 | 4.50 | 3.00 |
| Netherland | -1.28 | 0.00 | 0.00 | 0.00 | 0.00 | 2.50 | 5.85 |
| New Zealand | -2.77 | 0.00 | 0.00 | 0.00 | 0.00 | 4.00 | 3.10 |
| Norway | -1.66 | 0.00 | 0.00 | 0.00 | 0.00 | 3.50 | 4.80 |
| Portugal | -2.29 | 0.21 | 0.22 | 0.20 | 0.16 | 2.50 | 4.00 |
| Singapore | -1.69 | 0.11 | 0.11 | 0.10 | 0.11 | 5.00 | 2.00 |
| Spain | -1.71 | 0.00 | 0.00 | 0.00 | 0.00 | 5.00 | 4.00 |
| Sweden | -1.82 | 0.00 | 0.00 | 0.00 | 0.00 | 3.50 | 4.60 |
| Switzerland | -1.42 | 0.00 | 0.00 | 0.00 | 0.00 | 3.00 | 3.05 |
| United Kingdom | -0.97 | 0.21 | 0.17 | 0.20 | 0.21 | 5.00 | 3.35 |
| United States | -0.61 | 0.21 | 0.22 | 0.25 | 0.26 | 3.00 | 4.40 |
| **Mean** | -1.66 | 0.06 | 0.06 | 0.06 | 0.06 | 3.59 | 4.17 |

**Panel B: Emerging Economies**

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Argentina | -3.13 | 0.26 | 0.22 | 0.25 | 0.26 | 2.00 | 4.25 |
| Brazil | -3.19 | 0.26 | 0.28 | 0.25 | 0.26 | 5.00 | 4.70 |
| Bulgaria | -3.96 | 0.16 | 0.17 | 0.15 | 0.11 | 3.00 | 2.95 |
| Chile | -2.60 | 0.37 | 0.33 | 0.40 | 0.42 | 4.00 | 3.00 |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| China | -1.93 | 0.00 | 0.00 | 0.00 | 0.00 | 1.00 | 1.00 |
| Colombia | -3.34 | 0.26 | 0.28 | 0.25 | 0.26 | 3.00 | 4.10 |
| Czech Republic | -3.07 | 0.00 | 0.00 | 0.00 | 0.00 | 4.00 | 5.53 |
| Egypt | -4.13 | 0.21 | 0.22 | 0.20 | 0.21 | 3.00 | 1.75 |
| Hungary | -3.66 | 0.16 | 0.17 | 0.15 | 0.16 | 2.00 | 3.30 |
| India | -4.39 | 0.00 | 0.00 | 0.00 | 0.00 | 5.00 | 7.45 |
| Indonesia | -3.69 | 0.21 | 0.17 | 0.20 | 0.21 | 4.00 | 3.30 |
| Korea | -2.38 | 0.21 | 0.22 | 0.20 | 0.21 | 4.50 | 2.85 |
| Malaysia | -3.09 | 0.00 | 0.00 | 0.00 | 0.00 | 5.00 | 4.30 |
| Mexico | -2.92 | 0.16 | 0.17 | 0.15 | 0.16 | 3.00 | 4.75 |
| Pakistan | -5.08 | 0.00 | 0.00 | 0.00 | 0.00 | 4.00 | 2.80 |
| Peru | -3.14 | 0.21 | 0.22 | 0.20 | 0.16 | 3.50 | 4.00 |
| Philippines | -3.59 | 0.16 | 0.17 | 0.15 | 0.16 | 4.00 | 4.15 |
| Poland | -3.30 | 0.16 | 0.17 | 0.20 | 0.21 | 2.00 | 3.55 |
| Romania | -4.39 | 0.16 | 0.11 | 0.15 | 0.16 | 5.00 | 4.30 |
| Russia | -3.01 | 0.21 | 0.17 | 0.20 | 0.21 | 4.00 | 2.75 |
| Slovenia | -3.29 | 0.00 | 0.00 | 0.00 | 0.00 | 3.00 | 5.75 |
| South Africa | -2.45 | 0.00 | 0.00 | 0.00 | 0.00 | 5.00 | 2.00 |
| Thailand | -3.27 | 0.00 | 0.00 | 0.00 | 0.00 | 4.00 | 2.90 |
| Turkey | -4.29 | 0.05 | 0.06 | 0.05 | 0.05 | 3.00 | 2.50 |
| Ukraine | -5.48 | 0.00 | 0.00 | 0.00 | 0.00 | 3.00 | 3.45 |
| **Mean** | -3.47 | 0.13 | 0.12 | 0.13 | 0.13 | 3.56 | 3.66 |
| **Overall Summary** | | | | | | | |
| No. of Observations | 904 | 912 | 864 | 960 | 912 | 960 | 958 |
| Mean | -2.55 | 0.10 | 0.09 | 0.09 | 0.10 | 3.57 | 3.90 |
| Median | -2.45 | 0.00 | 0.00 | 0.00 | 0.00 | 3.50 | 4.00 |
| Std. Dev. | 1.14 | 0.29 | 0.29 | 0.29 | 0.29 | 1.00 | 1.66 |
| Minimum | -6.10 | 0.00 | 0.00 | 0.00 | 0.00 | 1.00 | 1.00 |
| Maximum | -0.55 | 1.00 | 1.00 | 1.00 | 1.00 | 5.00 | 17.00 |

**Table 2:**

Descriptive statistics by country.

The table reports the means for all control variables used in our regressions. All variables are defined in Appendix A1.

**Panel A: Developed Economies**

| Country | *GOVTSTAB* | *SMI* | INFL | DCPS | *DBAGDP* | DEMOC | *GDPG* | *NETIMARGIN* | GOVTSIZE | *INVESTPRO* | *RELIG* | *LEGORIG* |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Australia | 0.97 | 42.06 | 1.87 | 21.47 | 123.92 | 0.93 | 2.72 | 1.93 | 18.25 | 1.75 | 8.00 | 1.00 |
| Austria | 1.12 | 98.74 | 1.88 | 0.73 | 105.63 | 0.91 | 1.12 | 1.48 | 19.59 | 1.50 | 3.00 | 2.00 |
| Belgium | 0.75 | 152.12 | 6.17 | 2.91 | 86.04 | 0.93 | 1.25 | 1.30 | 23.10 | 1.29 | 3.00 | 1.00 |
| Canada | 1.07 | 66.25 | 3.12 | 1.41 | 133.14 | 0.88 | 2.20 | 2.10 | 20.47 | 1.66 | 3.00 | 1.00 |
| Denmark | 1.06 | 97.17 | 1.15 | 1.68.31 | 181.89 | 0.95 | 1.13 | 1.18 | 25.2[illegible] | 1.75 | 8.00 | 3.00 |
| Finland | 1.35 | 75.39 | 1.36 | 8.2.21 | 88.27 | 0.92 | 1.24 | 0.72 | 22.[illegible]7 | 1.78 | 8.00 | 3.00 |
| France | 0.42 | 57.57 | 1.41 | 9.2.66 | 109.40 | 0.93 | 0.85 | 0.[illegible]9 | 23.42 | 1.18 | 3.00 | 2.00 |
| Germany | 0.83 | 78.47 | 1.70 | 9.1.79 | 112.21 | 0.94 | 0.99 | 0.95 | 19.44 | 1.60 | 8.00 | 3.00 |
| Greece | 0.18 | 60.34 | 3.98 | 8.9.83 | 107.40 | 0.92 | -0.30 | 2.66 | 20.66 | 0.64 | 7.00 | 2.00 |
| Ireland | 1.11 | 186.60 | 1.45 | 9.5.06 | 103.20 | 0.93 | 4.81 | 0.96 | 15.73 | 1.67 | 3.00 | 1.00 |
| Israel | -1.16 | 67.31 | 1.59 | 6.9.85 | 86.04 | 0.80 | 3.31 | 2.37 | 23.42 | 1.13 | 5.00 | 1.00 |
| Italy | 0.48 | 53.39 | 0.14 | 8.0.13 | 108.56 | 0.90 | -0.23 | 1.69 | 19.41 | 0.84 | 3.00 | 2.00 |
| Japan | 1.03 | 30.03 | 2.33 | [illegible]67.41 | [illegible]60.12 | 0.89 | 0.48 | 1.02 | 18.95 | 1.14 | 2.00 | 3.00 |
| Netherland | 1.02 | 136.90 | 2.08 | 1.11.57 | 123.27 | 0.92 | 1.16 | 1.11 | 24.26 | 1.81 | 8.00 | 2.00 |
| New Zealand | 1.37 | 57.21 | 2.01 | 1.54.03 | 140.70 | 0.93 | 2.63 | 2.06 | 18.52 | 1.82 | 8.00 | 1.00 |
| Norway | 1.27 | 69.68 | 8.03 | 1.24.69 | 114.13 | 0.94 | 1.45 | 1.69 | 21.66 | 1.51 | 8.00 | 3.00 |
| Portugal | 0.98 | 72.78 | 7.43 | 1.27.38 | 141.48 | 0.93 | 0.30 | 1.48 | 19.15 | 0.96 | 3.00 | 2.00 |
| Singapore | 1.28 | 363.50 | 2.62 | 1.08.56 | 134.83 | 0.43 | 4.52 | 1.64 | 10.23 | 1.96 | 7.00 | 1.00 |
| Spain | 0.08 | 59.00 | 1.28 | 1.31.88 | 153.88 | 0.92 | 1.05 | 1.70 | 18.81 | 1.08 | 3.00 | 2.00 |
| Sweden | 1.16 | 84.05 | 0.38 | 1.16.90 | 126.39 | 0.95 | 1.95 | 1.29 | 25.49 | 1.70 | 8.00 | 3.00 |

| | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Switzerland | 1.32 | 11.41 | 1.90 | 51.94 | 161.87 | 0.94 | 1.68 | 0.85 | 11.20 | 1.68 | 3.00 | 3.00 |
| United Kingdom | 0.43 | 6.84 | 2.06 | 47.87 | 147.49 | 0.92 | 1.18 | 1.75 | 19.74 | 1.72 | 8.00 | 1.00 |
| United States | 0.39 | 6.74 | 3.49 | 8.94 | 61.67 | 0.77 | 1.71 | 3.46 | 17.30 | 1.47 | 8.00 | 1.00 |
| **Mean** | 0.80 | 91.46 | 2.97 | 112.76 | 122.24 | 0.89 | 1.62 | 1.57 | 19.86 | 1.46 | 5.57 | 1.91 |
| **Panel B: Emerging Economies** | | | | | | | | | | | | |
| Argentina | -0.07 | 32.81 | 2.46 | 13.68 | 25.53 | 0.85 | 1.53 | 6.35 | 14.86 | -0.21 | 3.00 | 1.00 |
| Brazil | -0.20 | 26.39 | 3.77 | 50.10 | 90.29 | 0.89 | 2.01 | 5.70 | 19.35 | 0.[illegible] | 3.00 | 2.00 |
| Bulgaria | 0.29 | 11.39 | 1.83 | 50.05 | 57.33 | 0.75 | 3.06 | 4.25 | 17.24 | 0.60 | 7.00 | 2.00 |
| Chile | 0.50 | 65.56 | 2.33 | 98.23 | 75.78 | 0.92 | 3.24 | 4.04 | 1[illegible].84 | 1.37 | 3.00 | 2.00 |
| China | -0.45 | 47.91 | 4.67 | 132.40 | 147.83 | 0.10 | 8.70 | 2.58 | 15.63 | -0.29 | 1.00 | 2.00 |
| Colombia | -1.47 | 37.06 | 2.21 | 35.74 | 44.48 | 0.68 | 3.31 | 5.1[illegible] | 14.70 | 0.20 | 3.00 | 2.00 |
| Czech Republic | 0.95 | 130.60 | 1.54 | 42.56 | 58.34 | 0.92 | 2.46 | 2.74 | 19.91 | 1.12 | 1.00 | 3.00 |
| Egypt | -0.99 | 47.98 | 1.36 | 37.57 | 76.80 | 0.22 | 4.25 | 2.76 | 11.11 | -0.50 | 6.00 | 2.00 |
| Hungary | 0.82 | 151.16 | 6.29 | 43.36 | 61.58 | 0.79 | 2.21 | 3.71 | 20.91 | 0.93 | 3.00 | 3.00 |
| India | -1.10 | 43.11 | 6.51 | 45.97 | 67.67 | 0.[illegible]2 | 5.93 | 3.14 | 10.76 | -0.33 | 4.00 | 1.00 |
| Indonesia | -0.98 | 49.44 | 1.56 | 35.28 | [illegible]7.[illegible]5 | 0.74 | 4.91 | 5.75 | 8.79 | -0.28 | 6.00 | 2.00 |
| Korea | 0.38 | 79.62 | 2.03 | 129.43 | 114.01 | 0.86 | 3.63 | 2.04 | 14.34 | -2.30 | 2.00 | 3.00 |
| Malaysia | 0.21 | 162.42 | 4.28 | 115.47 | 128.50 | 0.36 | 4.34 | 2.50 | 12.53 | 0.56 | 6.00 | 1.00 |
| Mexico | -0.61 | 62.87 | 1.82 | 25.03 | 35.12 | 0.72 | 1.42 | 5.40 | 11.35 | 0.26 | 3.00 | 2.00 |
| Pakistan | -2.21 | 30.40 | 2.63 | 20.05 | 39.72 | 0.43 | 4.01 | 3.92 | 9.89 | -0.68 | 6.00 | 1.00 |
| Peru | -0.72 | 47.29 | 3.76 | 32.80 | 32.92 | 0.85 | 4.09 | 6.36 | 11.89 | 0.32 | 3.00 | 2.00 |
| Philippines | -1.28 | 77.97 | 2.23 | 35.51 | 49.09 | 0.57 | 4.78 | 4.06 | 10.54 | -0.05 | 3.00 | 2.00 |
| Poland | 0.67 | 85.36 | 1.74 | 41.70 | 60.17 | 0.88 | 3.48 | 3.31 | 18.38 | 0.87 | 3.00 | 3.00 |
| Romania | 0.19 | 7 | 9 | 2 | 35.4 | 0.7 | 3 | 5.23 | 15.61 | 0.42 | 7 | 2.00 |

| | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | 5.46 | .54 | 7.19 | 9 | 3 | .74 | | | | .00 | |
| Russia | -0.92 | 5 1.22 | 1 .49 | 4 0.89 | 45.5 9 | 0.3 4 | 3 .12 | 4.73 | 18.04 | -0.36 | 7 .00 | 2.00 |
| Slovenia | 0.98 | 1 33.62 | 5 .19 | 5 7.63 | 69.6 2 | 0.8 9 | 2 .07 | 2.54 | 19.09 | 0.76 | 3 .00 | 3.00 |
| South Africa | -0.12 | 5 8.87 | 1 .91 | 1 21.94 | 71.3 3 | 0.8 2 | 2 .13 | 3.21 | 18.03 | 0.42 | 8 .00 | 1.00 |
| Thailand | -0.82 | 1 25.81 | 1 4.17 | 1 34.27 | 115. 52 | 0.3 9 | 3 .44 | 2.94 | 15.31 | 0.16 | 2 .00 | 1.00 |
| Turkey | -1.08 | 5 1.68 | 1 1.59 | 5 8.00 | 61.4 6 | 0.5 6 | 4 .68 | 5.40 | 13.85 | 0.22 | 6 .00 | 2.00 |
| Ukraine | -0.75 | 9 7.56 | 1 .99 | 5 8.77 | 50.8 3 | 0.5 2 | 1 .95 | 6.69 | 18.56 | -0.46 | 7 .00 | 2.00 |
| **Mean** | -0.35 | 7 5.34 | 3 .96 | 5 9.35 | 66.0 9 | 0.6 6 | 3 .54 | 4.18 | 14.94 | 0.10 | 4 .24 | 1.96 |
| **Overall Summary** | | | | | | | | | | | | |
| Observations | 960 | 9 60 | 9 40 | 8 97 | 939 | 96 0 | 9 60 | 909 | 960 | 960 | 9 60 | 960 |
| Mean | 0.20 | 8 3.06 | 3 .49 | 8 6.24 | 92.3 0 | 0.7 7 | 2 .62 | 2.9[illegible] | 17.25 | 0.75 | 4 .88 | 1.94 |
| Median | 0.42 | 6 6.25 | 2 .43 | 8 4.26 | 85.3 1 | 0.8 9 | 2 .73 | 2.48 | 18.06 | 0.90 | 3 .50 | 2.00 |
| Std. Dev. | 0.96 | 5 7.30 | 4 .49 | 4 7.74 | 43.7 9 | 0.2 2 | 3 .82 | 1.95 | 4.54 | 0.91 | 2 .34 | 0.75 |
| Minimum | -2.81 | 1 9.80 | - 4.48 | 0 .19 | 13.3 1 | 0.0 8 | - 15.14 | 0.15 | 6.89 | -2.53 | 1 .00 | 1.00 |
| Maximum | 1.76 | 4 37.33 | 5 4.40 | 2 16.56 | 219. 08 | 0.9 6 | 2 5.18 | 15.36 | 27.94 | 2.26 | 8 .00 | 3.00 |

**Table 3:**

The table reports the Pearson's pairwise correlation coefficients of all variables used in our regressions. All variables are defined in Appendix A1. Coefficients in bold are significant at the 5% level.

| Variables | *(1)* | *(2)* | *(3)* | *(4)* | *(5)* | *(6)* | *(7)* | *(8)* | *(9)* | *(10)* | *(11)* | *(12)* | *(13)* | *(14)* | *(15)* | *(16)* | *(17)* | *(18)* | *(19)* |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| *PORTFDIV (1)* | 1 | | | | | | | | | | | | | | | | | | |
| *$NalElec_{t-1}$ (2)* | -0.05 | 1 | | | | | | | | | | | | | | | | | |
| *$NalElec_{t-2}$ (3)* | -0.05 | -0.04 | 1 | | | | | | | | | | | | | | | | |
| *$NalElec_{t}$ (4)* | -0.04 | -0.02 | -0.02 | 1 | | | | | | | | | | | | | | | |
| *$NalElec_{t+1}$ (5)* | -0.04 | -0.02 | -0.06 | -0.02 | 1 | | | | | | | | | | | | | | |
| *RADIS (6)* | 0.02 | -0.02 | -0.03 | -0.03 | -0.02 | 1 | | | | | | | | | | | | | |
| *GOVTSTAB (7)* | **0.64** | **-0.09** | **-0.08** | **-0.08** | **-0.09** | 0.04 | 1 | | | | | | | | | | | | |
| *SMI (8)* | **0.10** | **-0.11** | **-0.10** | **-0.11** | **-0.12** | .05 | **-0.41** | 1 | | | | | | | | | | | |
| *INFL (9)* | **-0.53** | 0.05 | 0.05 | 0.02 | 0.04 | 0.02 | **0.44** | **0.17** | 1 | | | | | | | | | | |
| *DCPS (10)* | **0.70** | **-0.09** | **-0.09** | **-0.08** | **-0.08** | **-0.14** | **-0.48** | **-0.09** | **-0.39** | 1 | | | | | | | | | |
| *DBAGDP (11)* | **0.62** | **-0.13** | **-0.12** | **-0.13** | **-0.12** | **-0.10** | **-0.51** | **-0.23** | **-0.42** | **-0.82** | 1 | | | | | | | | |
| *DEMOC (12)* | **0.53** | 0.01 | 0.01 | 0.01 | 0.01 | 0.04 | **-0.58** | 0.02 | **-0.32** | **-0.23** | **-0.18** | 1 | | | | | | | |
| *GDPG (13)* | **0.26** | 0.05 | 0.02 | 0.03 | 0.01 | **-0.07** | **-0.20** | 0.05 | **-0.10** | **-0.22** | **-0.26** | **-0.30** | 1 | | | | | | |
| *NETIMARGIN (14)* | **0.68** | **-0.13** | **-0.12** | **-0.11** | **-0.10** | 0.03 | **-0.58** | **-0.32** | **-0.45** | **-0.54** | **-0.70** | **-0.34** | **-0.19** | 1 | | | | | |
| *GOVTSIZE (15)* | **0.44** | **-0.08** | **-0.08** | **-0.08** | **-0.08** | **-0.17** | **-0.48** | **-0.12** | **-0.26** | **-0.31** | **-0.43** | **-0.48** | **-0.39** | **-0.43** | 1 | | | | |
| *INVESTPRO (16)* | **0.63** | **-0.11** | **-0.10** | **-0.10** | **-0.10** | .04 | **-0.69** | **-0.33** | **-0.40** | **-0.43** | **-0.47** | **-0.52** | **-0.19** | **-0.60** | **-0.48** | 1 | | | |
| *RELIG (17)* | .06 | -0.06 | **-0.07** | -0.06 | -0.06 | **-0.19** | **-0.11** | -0.01 | **-0.13** | **-0.20** | **-0.07** | -0.04 | **-0.08** | **-0.07** | **-0.19** | **-0.29** | 1 | | |
| *LEGORIG (18)* | .05 | -0.01 | -0.02 | -0.01 | -0.01 | **-0.29** | **-0.30** | **-0.11** | **-0.08** | -0.01 | **-0.08** | **-0.24** | **-0.12** | **-0.20** | **-0.27** | -0.03 | **-0.12** | 1 | |
| *CHBAL (19)* | **0.08** | -0.03 | -0.04 | -0.04 | -0.05 | **-0.12** | **-0.15** | **-0.08** | **-0.07** | **-0.07** | -0.03 | **-0.40** | **-0.12** | **-0.12** | **-0.21** | **-0.20** | -0.01 | -0.04 | 1 |

**Table 4:**

Effects of political uncertainty on cross-border equity portfolio diversification

The table shows regression estimates of foreign equity portfolio diversification on political uncertainty and country controls (Equation 1 in the text). All variables are as defined in Appendix A1. The specifications are estimated with OLS. The *t*-statistics, reported in parentheses, are based on standard errors double clustered at the country and year levels. For tractable interpretation, all the coefficients are reported as elasticity, and the statistical significance is reported against 10% (*), 5% (**), and 1% (***) significance levels respectively.

| Variable | Model (1) *PORTFDIV* | Model (2) *PORTFDIV* | Model (3) *PORTFDIV* | Model (4) *PORTFDIV* |
|---|---|---|---|---|
| $NalELEC_{t-2}$ | -0.082*** (-3.20) | | | |
| $NalELEC_{t-1}$ | | -0.055** (-2.12) | | |
| $NalELEC_{t}$ | | | -0.074*** (-3.08) | |
| $NalELEC_{t+1}$ | | | | -0.022 (-0.7[illegible]) |
| *GOVTSTAB* | 0.240* | 0.226 | 0.228 | 0.239* |
| | (1.69) | (1.60) | (1.66) | (1.76) |
| *SMI* | -0.326** | -0.322* | -0.334** | -0.3[illegible]** |
| | (-2.04) | (-2.00) | (-2.12) | (-2.22) |
| *INFL* | -0.045*** | -0.045*** | -0.044*** | -0.042*** |
| | (-3.90) | (-3.64) | (-3.54) | (-3.33) |
| *DCPS* | 0.010*** | 0.010*** | 0.010*** | 0.010*** |
| | (3.80) | (3.72) | (3.76) | (3.65) |
| *DBAGDP* | -0.443 | -0.391 | -0.372 | -0.381 |
| | (-1.45) | (-1.30) | (-1.28) | (-1.28) |
| *DEMOC* | 0.234** | 0.2[illegible]8** | 0.194* | 0.204* |
| | (2.41) | (2.[illegible]1) | (1.82) | (1.91) |
| *GDPG* | -0.031 | -0.032 | -0.029 | -0.028 |
| | (-1.57) | (-1.59) | (-1.49) | (-1.37) |
| *NETIMARGIN* | -0.597*** | -0.573*** | -0.572*** | -0.579*** |
| | (-3.79) | (-3.83) | (-3.96) | (-4.01) |
| *GOVTSIZE* | 0.011 | 0.011 | 0.011 | 0.011 |
| | (0.48) | (0.47) | (0.49) | (0.48) |
| *INVESTPRO* | 0.266 | 0.280 | 0.277 | 0.294 |
| | (1.38) | (1.43) | (1.45) | (1.46) |
| *RELIG* | -0.050 | -0.049 | -0.048 | -0.050 |
| | (-1.45) | (-1.42) | (-1.41) | (-1.48) |
| *LEGORIG* | -0.212* | -0.207* | -0.207* | -0.214* |
| | (-1.87) | (-1.83) | (-1.86) | (-1.92) |
| Constant | 0.738 | 0.401 | 0.369 | 0.504 |
| | (0.41) | (0.22) | (0.21) | (0.29) |
| No of Observations | 727 | 759 | 791 | 749 |
| Adj. R-Square | 0.755 | 0.755 | 0.757 | 0.757 |
| Country effects | Yes | Yes | Yes | Yes |

| | | | | |
|---|---|---|---|---|
| Year fixed effects | Yes | Yes | Yes | Yes |

**Table 5:**

Political uncertainty and checks and balances

The table shows regression estimates of foreign equity portfolio diversification on political uncertainty and country controls (Equation 2 in the text). $NalElec_t$ x *CHBAL* is the interaction between political uncertainty and checks and balances. All variables are defined in Appendix A1. The specifications are estimated with OLS in Model 1 and Newey-West in Model 2. The *t*-statistics, reported in parentheses, are based on standard errors double clustered at the country and year levels. For tractable interpretation, all the coefficients are reported as elasticity, and the statistical significance is reported against 10% (*), 5% (**), and 1% (***) significance levels respectively.

| Variable | OLS | Newey-West |
|---|---|---|
| | Model (1) *PORTFDIV* | Model (2) *PORTFDIV* |
| $NalElec_t$ | -0.271*** | -0.250** |
| | (-3.03) | (-2.13) |
| *CHBAL* | 0.058* | 0.042** |
| | (1.79) | (2.04) |
| $NalElec_t$ x *CHBAL* | 0.048** | 0.046* |
| | (2.44) | (1.72) |
| *GOVTSTAB* | 0.142 | 0.221*** |
| | (1.00) | (2.79) |
| *SMI* | -0.313** | -0.313*** |
| | (-2.01) | (-3.58) |
| *INFL* | -0.042*** | -0.044*** |
| | (-3.30) | (-3.92) |
| *DCPS* | 0.011*** | 0.009*** |
| | (3.54) | (6.24) |
| *DBAGDP* | -0.384 | -0.377** |
| | (-1.17) | (-2.48) |
| *DEMOC* | 0.593 | 0.302 |
| | (0.88) | (0.97) |
| *GDPG* | -0.028 | -0.029** |
| | (-1.46) | (-2.06) |
| *NETIMARGIN* | -0.565*** | -0.587*** |
| | (-3.76) | (-7.12) |
| *GOVTSIZE* | 0.007 | 0.012 |
| | (0.28) | (1.09) |
| *INVESTPRO* | 0.256 | 0.276*** |
| | (1.59) | (2.79) |
| *RELIG* | -0.042 | -0.050*** |
| | (-1.22) | (-3.06) |
| *LEGORIG* | -0.207* | -0.218*** |
| | (-1.83) | (-3.90) |
| Constant | -0.942 | -0.250** |
| | (-0.59) | (-2.13) |

| | | |
|---|---|---|
| No of Observations | 789 | 757 |
| Adj. R-Square | 0.750 | |
| F-Statistics | | 29.596 |
| Country fixed effects | Yes | Yes |
| Year fixed effects | Yes | Yes |

**Table 6:**

System GMM estimation

The table shows GMM estimates of foreign equity portfolio diversification on political uncertainty and country controls (Equation 4 in the text). All variables are as defined in Appendix A1. The reported results are for two years pre-national elections, one-year pre-national elections, the election year, and one year post national elections. The *t*-statistics, reported in parentheses, are based on standard errors double clustered at the country and year levels. For tractable interpretation, all the coefficients are reported as elasticity and the statistical significance is reported against 10% (*), 5% (**) and 1% (***) significance levels respectively.

| Variable | Model (1) | Model (2) | Model (3) | Model (4) |
|---|---|---|---|---|
| | *PORTFDIV* | *PORTFDIV* | *PORTFDIV* | *PORTFDIV* |
| $NalElec_{t-2}$ | -0.157** | | | |
| | (-2.33) | | | |
| $NalElec_{t-1}$ | | -0.067* | | |
| | | (-1.78) | | |
| *NalElec* | | | -0.117*** | |
| | | | (-3.33) | |
| $NalElec_{t+1}$ | | | | -0.134** |
| | | | | (-2.07) |
| *GOVTSTAB* | 0.043** | 0.079* | 0.069** | 0.124** |
| | (2.12) | (1.88) | (1.94) | (2.45) |
| *SMI* | -0.043* | -0.084 | -0.071 | -0.076 |
| | (-1.94) | (-1.47) | (-1.55) | (-1.19) |
| *INFL* | -0.005** | -0.011*** | -0.008*** | 0.012 |
| | (-2.59) | (-3.29) | (-3.11) | (1.32) |
| *DCPS* | 0.001** | 0.003*** | 0.002** | 0.004** |
| | (2.01) | (2.92) | (2.00) | (2.56) |
| *DBAGDP* | -0.048 | -0.095 | -0.050 | -0.176 |
| | (-1.57) | (-1.25) | (-0.58) | (-1.62) |
| *DEMOC* | 0.055 | 0.145 | 0.159 | 0.115 |
| | (0.76) | (0.73) | (0.86) | (0.39) |
| *GDPG* | -0.000 | -0.002 | -0.001 | -0.002 |
| | (-0.02) | (-0.37) | (-0.10) | (-0.33) |
| *NETIMARGIN* | -0.056** | -0.136** | -0.083* | -0.145*** |
| | (-2.34) | (-2.39) | (-1.90) | (-2.93) |
| *GOVTSIZE* | -0.003 | -0.003 | -0.005 | -0.001 |
| | (-0.37) | (-0.22) | (-0.27) | (-0.03) |
| *INVESTPRO* | 0.016 | 0.069 | 0.072 | 0.145 |
| | (0.46) | (0.93) | (1.10) | (1.42) |
| *RELIG* | -0.006 | -0.012 | -0.005 | -0.028 |
| | (-1.11) | (-0.78) | (-0.30) | (-1.59) |
| *LEGORIG* | -0.035** | -0.057 | -0.050 | -0.093* |
| | (-2.17) | (-1.22) | (-1.38) | (-1.92) |
| *Lagged PORTFDIV* | 0.891*** | 0.687*** | 0.740*** | 0.610*** |
| | (28.80) | (10.17) | (10.29) | (7.47) |
| No of observation | 721 | 752 | 752 | 710 |
| AR1 (P-value) | 0.010 | 0.027 | 0.030 | 0.023 |
| AR2 (P-value) | 0.248 | 0.212 | 0.210 | 0.299 |
| Hansen J (P-value) | 0.731 | 0.256 | 0.536 | 0.706 |

| | | | | | |
|---|---|---|---|---|---|
| Hansen J Statistics | | 30 | 42 | 32 | 29 |

Model 1 examines the effects of political uncertainty one before national elections on foreign equity portfolio diversification

Model 2 examines the effects of political uncertainty two years prior to national elections on foreign equity portfolio diversification

Model 3 examines the effects of political uncertainty two years into the national election year on foreign equity portfolio diversification

Model 4 examines the effects of political uncertainty one year post-national election on foreign equity portfolio diversification

**Table 7:**

Political uncertainty and checks and balances

The table shows regression estimates of foreign equity portfolio diversification on political uncertainty and country controls (Equation 2 in the text). $NalElec_{-1} \times CHBAL$ is the interaction between political uncertainty and checks and balances one before a national election. All variables are defined in Appendix A1. The specifications are estimated with OLS in Model 1, and Newey-West in model 2. The *t*-statistics, reported in parentheses, are based on standard errors double clustered at the country and year levels. For tractable interpretation, all the coefficients are reported as elasticity, and the statistical significance is reported against 10% (*), 5% (**), and 1% (***) significance levels respectively.

| Variable | OLS | Newey-West |
|---|---|---|
| | Model (1) | Model (2) |
| | *PORTFDIV* | *PORTFDIV* |
| $NalElec_{t-1}$ | -0.809** | -0.760*** |
| | (-2.47) | (-4.02) |
| *CHBAL* | 0.013 | 0.022 |
| | (0.54) | (0.99) |
| $NalElec_{t-1}$ x *CHBAL* | 0.157* | 0.146** |
| | (1.93) | (2.13) |
| *GOVTSTAB* | 0.132 | 0.219*** |
| | (0.91) | (3.21) |
| *SMI* | -0.001 | -0.313*** |
| | (-0.02) | (-4.21) |
| *INFL* | -0.042*** | -0.044*** |
| | (-3.37) | (-4.23) |
| *DCPS* | 0.011*** | 0.009*** |
| | (3.55) | (7.37) |
| *DBAGDP* | -0.402 | -0.374*** |
| | (-1.21) | (-2.86) |
| *DEMOC* | 0.550 | 0.288 |
| | (0.83) | (1.08) |
| *GDPG* | -0.027 | -0.029** |
| | (-1.37) | (-2.20) |
| *NETIMARGIN* | -0.575*** | -0.585*** |
| | (-3.78) | (-8.25) |
| *GOVTSIZE* | 0.008 | 0.012 |
| | (0.33) | (1.31) |
| *INVESTPRO* | 0.257 | 0.277*** |
| | (1.59) | (3.31) |
| *RELIG* | -0.043 | -0.050*** |
| | (-1.23) | (-3.61) |
| *LEGORIG* | -0.204* | -0.215*** |
| | (-1.77) | (-4.56) |
| Constant | -0.538 | -0.878 |
| | (-0.33) | (-1.25) |
| No of Observations | 757 | 757 |
| Adj. R-Square | 0.748 | |

| | | |
|---|---|---|
| F-Statistics | | 40.645 |
| Country fixed effects | Yes | Yes |
| Year fixed effects | Yes | Yes |

**Table 8:**

Political uncertainty and equity home bias

The table shows regression estimates of the role of home bias on political uncertainty and country controls. *NalElec* × *HBIAS* is the interaction between political and equity home bias. All variables are defined in Appendix A1. The specifications are estimated with OLS in Models 1-4, and Newey-West in Models 5-8. For brevity and to conserve space, we report only the coefficients of the key variables. The *t*-statistics, reported in parentheses, are based on standard errors double clustered at the country and year levels. For tractable interpretation, all the coefficients are reported as elasticity, and the statistical significance is reported against 10% (*), 5% (**) and 1% (***) significance levels respectively.

| Variable | OLS | | | | Newey-West | | | |
|---|---|---|---|---|---|---|---|---|
| | Model (1) *PORTFDIV* | Model (2) *PORTFDIV* | Model (3) *PORTFDIV* | Model (4) *PORTFDIV* | Model (5) *PORTFDIV* | Model (6) *PORTFDIV* | Model (7) *PORTFDIV* | Model (8) *PORTFDIV* |
| *HBIAS* | -0.683*** (-7.43) | -0.669*** (-6.91) | -0.654*** (-6.41) | -0.665*** (-6.39) | -0.690*** (-8.86) | -0.674*** (-8.62) | -0.671*** (-8.58) | -0.686*** (-8.78) |
| $NalElec_{t-2}$ | -0.107** (-2.47) | | | | -0.103** (-2.25) | | | |
| $NalElec_{t-2}$ x *HBIAS* | 0.028 (1.02) | | | | 0.0[illegible] (0.9[illegible]) | | | |
| $NalElec_{t-1}$ | | -0.100* (-1.93) | | | | -0.096* (-1.93) | | |
| $NalElec_{t-1}$ x *HBIAS* | | 0.042 (1.26) | | | | 0.040 (1.17) | | |
| $NalElec_{t}$ | | | -0.1[illegible]*** (-3.05) | | | | -0.103** (-2.19) | |
| $NalElec_{t}$ x *HBIAS* | | | 0.04[illegible] (1.55) | | | | 0.031 (0.91) | |
| $NalElec_{t+1}$ | | | | -0.098* (-1.93) | | | | -0.095* (-1.72) |
| $NalElec_{t+1}$ x *HBIAS* | | | | 0.049 (1.40) | | | | 0.039 (0.98) |
| No of Observations | 7[illegible]7 | 759 | 791 | 749 | 727 | 759 | 759 | 717 |
| Adj. R-Square | 0.8[illegible]6 | 0.824 | 0.824 | 0.826 | | | | |
| F-Statistics | | | | | 26.282 | 23.938 | 27.262 | 25.576 |
| Country fixed effects | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes |
| Year fixed effects | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes |

**Table 9:**

Political uncertainty and revised anti-director rights

The table shows regression estimates of the role of anti-director rights on political uncertainty and country controls. *NalElec$_t$* x *RADIS* is the interaction between political and revised anti-director rights. All variables are defined in Appendix A1. The specifications are estimated with OLS in Model 1 and Newey-West in Model 2. The t-statistics, reported in parentheses, are based on standard errors double clustered at the country and year levels. For tractable interpretation, all the coefficients are reported as elasticity, and the statistical significance is reported against 10% (*), 5% (**) and 1% (***) significance levels respectively.

| Variable | OLS | Newey-West |
|---|---|---|
| | Model (1) | Model (2) |
| | *PORTFDIV* | *PORTFDIV* |
| *NalElec$_t$* | -0.678*** | -0.655*** |
| | (-3.25) | (-3.03) |
| *RASDI* | 0.047** | 0.036 |
| | (2.00) | (1.10) |
| *NalElec$_t$* x *RASDI* | 0.238*** | 0.240*** |
| | (4.07) | (4.01) |
| *GOVTSTAB* | 0.145*** | 0.143* |
| | (3.06) | (1.96) |
| *SMI* | -0.001** | -0.001 |
| | (-2.32) | (-1.42) |
| *INFL* | -0.037*** | -0.042*** |
| | (-4.79) | (-4.01) |
| *DCPS* | 0.011*** | 0.011*** |
| | (13.47) | (8.25) |
| *DBAGDP* | -0.362*** | -0.392*** |
| | (-3.76) | (-2.84) |
| *DEMOC* | 0.467** | 0.345 |
| | (2.42) | (1.21) |
| *GDPG* | -0.012 | -0.032** |
| | (-1.56) | (-2.31) |
| *NETIMARGIN* | -0.557*** | -0.562*** |
| | (-10.82) | (-8.11) |
| *GOVTSIZE* | 0.005 | 0.006 |
| | (0.82) | (0.60) |
| *INVESTPRO* | 0.269*** | 0.264*** |
| | (4.96) | (3.44) |
| *RELIG* | -0.043*** | -0.043*** |
| | (-4.57) | (-3.16) |
| *LEGORIG* | -0.202*** | -0.203*** |
| | (-6.02) | (-3.98) |
| Constant | -1.145** | -0.918 |
| | (-2.45) | (-1.40) |

| | | |
|---|---|---|
| No of Observations | 791 | 759 |
| Adj. R-Square | 0.752 | - |
| F-Statistics | - | 38.951 |
| Country fixed effects | Yes | Yes |
| Year fixed effects | Yes | Yes |

**Table 10:**

**The weak and strong information environment**

The table shows regression estimates of the role of disclosure quality on political uncertainty and country controls. *NalElec*$_t$ x *DISCLO* is the interaction between political and disclosure quality. All variables are defined in Appendix A1. The specifications are estimated with Newey-West estimations in Models 1 and 2. The t-statistics, reported in parentheses, are based on standard errors double clustered at the country and year levels. For tractable interpretation, all the coefficients are reported as elasticity, and the statistical significance is reported against 10% (*), 5% (**), and 1% (***) significance levels respectively.

| Variable | Overall informational environment (All countries) | Countries with a strong informational environment | Countries with a weak informational environment |
|---|---|---|---|
| | Model (1) *PORTFDIV* | Model (2) *PORTFDIV* | Model (3) *PORTFDIV* |
| *NalElec*$_t$ | -0.392* | -1.772* | -0.204 |
| | (-1.93) | (-1.89) | (-0.95) |
| *DISCLO* | 1.091** | 3.180** | 0.015 |
| | (2.59) | (2.30) | (0.02) |
| *NalElec*$_t$ x *DISCLO* | 0.762** | 2.207* | 0.536 |
| | (2.45) | (1.94) | (1.07) |
| *GOVTSTAB* | 0.115 | 0.396* | -0.116 |
| | (0.93) | (2.07) | (-0.61) |
| *SMI* | -0.113 | 0.438*** | 0.756*** |
| | (-0.68) | (3.23) | (2.99) |
| *INFL* | -0.051*** | -0.067* | -0.037*** |
| | (-3.87) | (-1.99) | (-3.56) |
| *DCPS* | 0.009** | 0.006** | -0.009** |
| | (2.15) | (2.24) | (-2.37) |
| *DBAGDP* | -0.257 | -0.957** | 0.978** |
| | (-0.64) | (-2.67) | (2.38) |
| *DEMOC* | 0.068 | 1.733** | 2.396*** |
| | (0.10) | (2.32) | (3.43) |
| *GDPG* | -0.024 | -0.036 | -0.036** |
| | (-1.07) | (-1.3[illegible]) | (-2.45) |
| *NETIMARGIN* | -0.552*** | -0.0[illegible] | -0.092 |
| | (-3.43) | (-0.60) | (-0.57) |
| *GOVTSIZE* | 0.019 | 0.10[illegible]** | -0.033 |
| | (0.64) | ([illegible].17) | (-1.15) |
| *INVESTPRO* | 0.199 | 0.28([illegible]*** | 0.310 |
| | (1.12) | ([illegible]6) | (1.48) |
| *RELIG* | -0.042 | -0.018 | -0.022 |
| | (-1.08) | (-0.33) | (-0.23) |
| *LEGORIG* | -0.180 | 0.431** | 0.341* |
| | (-1.38) | (2.55) | (1.75) |
| Constant | -0.467 | -6.492** | -11.199*** |
| | (-0.24) | (-2.36) | (-4.43) |
| No of Observations | 642 | 297 | 347 |
| Adj. R-Square | 0.747 | 0.846 | 0.893 |
| Country fixed effects | Yes | Yes | Yes |
| Year fixed effects | Yes | Yes | Yes |

# Appendix: A1

## Definitions of variables

| Acronym | Variable | Description | Source |
|---|---|---|---|
| *PORTFDIV* | Cross-border equity portfolio diversification | The variable estimates the logarithm of the country-level bilateral cross-border portfolio diversification of country i in country j at year t ($w_{ijt}$) | IMF's, Coordinated Portfolio Investment Survey (CPIS) |
| *NalElec*$_{t-1}$ | pre-election year by one year | The dummy variable that takes the value of 1 just before the country's election is to hold in the next one year 0 otherwise. | World Bank's Database of Political Institutions (DPI) |
| *NalElec*$_{t-2}$ | pre-election year by two years | Dummy variable that takes the value of 1 just one year before the country's election year, and 0 otherwise. | World Bank's Database of Political Institutions (DPI) |
| *NalElec*$_t$ | The election year | Dummy variable that takes the value of 1 if it is the country's election year, and 0 otherwise. | World Bank's Database of Political Institutions (DPI) |
| *NalElec*$_{t+1}$ | Post-election year by one year | Dummy variable that takes the value of 1 just one year after the country's election year, and 0 otherwise. | World Bank's Database of Political Institutions (DPI) |
| *CHBAL* | Checks and balances | This refers to the amount of veto power between the three arms of government in a country. | World Bank's Database of Political Institutions (DPI) |
| *GOVTSTAB* | Government stability | This is the measure of the government's propensity to manage its projects and programs effectively and to remain stable. The higher this index, the more effective and stronger the government will become. | International Country Risk Guide (ICRG) database |
| *SMI* | Stock market integration | This is the summation of trade exports and imports as a percentage of GDP | World Bank's World Development Indicators (WDI) |

| | | | |
|---|---|---|---|
| *INFL* | Inflation rate | This is the consumer price inflation rate for the annual one-year lagged rate. | World Bank's World Development Indicators (WDI) |
| *DCPS* | Domestic credit to the private sector (% of GDP) | This is the financial resources provided to the private sector, such as through purchases of non-equity securities, loans, trade credits, and other accounts receivable that establish a claim for repayment. | World Bank's World Development Indicators (WDI) |
| *DBAGDP* | Deposit money bank assets to GDP (%) | This is a measure of claims made by deposit money banks in the domestic non-financial sector as a percentage of GDP | IMF's International Financial Statistics (IFS) |
| *DEMOC* | Democracy | This is a polity IV democracy score as a measure for political freedom, taken from the Freedom in the World database. This is a measure of the combined polity score (Polity2). | POLITY IV |
| *GDPG* | Gross domestic product growth rate | This is the GDP growth rate per annum in percentage. | World Bank's OECD National Accounts database |
| *NETIMARGIN* | Net interest margin | This index represents the ratio of the bank's net interest revenue to its interest-bearing assets | Bankscope database |
| *GOVTSIZE* | General government final consumption expenditure (% of GDP) | This entails all government current expenditures for purchases of goods and services including most of the national defence and security spending. | World Bank's World Development Indicators (WDI) |
| *INVESTPRO* | Investment profile | This measure outlines the requirement that an investor needs to make investments in offers. It is also a good indicator of knowing what mix and investment types to be considered. | International Country Risk Guide (ICRG) database |
| *RELIG* | Religion | A dummy variable of the religion practiced by a majority of the citizenry of a country. These religions include Atheist, Buddhist, Catholic, Hindu, Indigenous, Judaism, Muslim, Orthodox Christian, and Protestant. | World Religion Database and Stulz and Williamson (2003) |
| *LEGORIG* | Legal origin | A dummy variable depicts the origin of a nation's legal system. The five most common origins include English, French, German, Nordic, and Socialist. | La Porta et al. (1999) |
| *RADIS* | Revised anti-director right | This index aggregates the shareholder rights (anti-director right) and ranges from 0 to 6. | La Porta et al. (1998) |

Political Uncertainty and Cross-Border Equity Portfolio Allocation Decisions: International Evidence



Highlights

- Political uncertainty reduces international equity portfolio flow.
- Political uncertainty interacts with institutional quality to increase international equity portfolio flow
- International equity investors are sensitive to uncertainty around national elections.
- Interaction between equity home bias and political uncertainty has no effect on international equity portfolio diversification.