

Box 3: Foreign Investors' Participation in the Colombian Stock Market

Laura Viviana León Díaz

Camilo Andrés Orozco Vanegas

Introduction

In recent years, foreign investors have exhibited a lower appetite for Colombian equities, with their participation decreasing from 16% at the end of 2018 to 11% in June 2024. This decline may be attributed to the reduction in Colombia's participation in international benchmark indexes for emerging markets, as well as a challenging global market environment following the COVID-19 pandemic. Additionally, changes in tax policies may have increased the investment costs for these investors¹⁰⁷.

Despite this, foreign investors have remained crucial players in this market, capturing 37% of the total trading volume in the last five years. Their transactions have been primarily concentrated in the shares of Bancolombia (common and preferred), Ecopetrol, and ISA, which are also among the most representative in the MSCI COLCAP Index¹⁰⁸.

Understanding the dynamics and composition of these investors is important given their significant role in the Colombian stock market and the recent discussions regarding a possible reclassification from emerging to frontier market¹⁰⁹. Colombia is currently classified as an emerging market by MSCI, the world's leading provider of stock indexes, and as such, three Colombian stocks are included in its Emerging Markets Index (MSCI EM), which is the minimum requirement for inclusion in this group¹¹⁰. Given the recent deterioration in market liquidity, and particularly, issues with one of the stocks in the MSCI EM index, there are concerns about a possible reclassification of Colombia from emerging to frontier market¹¹¹. However, in the latest MSCI annual review results published in June, Colombia is not under review for reclassification.

This box provides a brief analysis of the evolution of foreign investors in the local stock market, their characteristics, and the composition of their portfolio at the local level.

¹⁰⁷ In the tax reforms approved at the end of 2018 and the end of 2019, the income tax applied to dividends was increased from 5.0% to 7.5% and from 7.5% to 10%, respectively (Toro *et al.*, 2023).

¹⁰⁸ The MSCI Colcap index is the primary benchmark index of the Colombian stock market. It is composed of the 20 issuers, and 25 most liquid stocks in the market, weighting the stocks by adjusted market capitalization.

¹⁰⁹ In 1994, Colombia was classified as an emerging country by MSCI, considering compliance with the requirements established in the provider's methodology in terms of liquidity, size, stability, and market access facilities. In turn, a country classified as a frontier market is characterized by a small stock market, low liquidity, with barriers to access to foreign investors and political and financial instability. In this regard, being part of a new index as a result of the reclassification could imply a change in the type of investors, less dynamism, and lower investment flows to the stock market.

¹¹⁰ Currently, the MSCI EM index includes the participation of Bancolombia's preferred and common stocks, as well as ISA's stocks. According to the provider's methodology, to be part of the emerging markets group, a country must have at least 3 stocks to be included in this group.

¹¹¹ In the fourth quarter of 2023, discussions began regarding the possibility of MSCI reclassifying the Colombian market from emerging to frontier, considering the deterioration in the market liquidity, particularly of ISA's stock, which, by not complying with the liquidity requirements, could be removed from the index and put at risk Colombia's classification as an emerging market.

Background

Between 2010 and 2013, foreign investors increased their holdings in the country's stock market by more than 180%, while Colombia's participation in the MSCI Emerging Market Index¹¹² (MSCI EM) increased from 0.6% to 1.0% (Graph B3. 1 and Graph B3. 2). Additionally, during this period, the foreign investment regime was modified, simplifying access of these investors to the local financial market¹¹³, the country's credit rating was upgraded, and some initiatives aimed at developing the market were advanced, including the start of the Latin American Integrated Market (MILA in Spanish) and the creation of the first Exchange-Traded Fund (ETF) (Toro et al., 2023).

Subsequently, between 2013 and 2015, foreign investors reduced their balance in the market, in line with Colombia's lower weighting in the MSCI index, which, had dropped to 0.4% by December 2015. Despite this, the participation of these investors in relation to the total market remained stable, even amid significant declines in oil prices that affected local market valuations¹¹⁴. Following this, foreign investor participation remained stable until 2018.

Finally, since 2018, there has been a sustained decrease in foreign investor participation in the market, coinciding with Colombia's reduced participation in the MSCI EM index (0.1% as of Dec-2023) and discussions about a potential reclassification from an emerging market to a frontier market¹¹⁵. The country's lower weighting has been associated with the inclusion of Chinese yuan-denominated stocks, known as "A-Shares," in the MSCI EM index, along with the classification of Saudi Arabia, Argentina¹¹⁶, and Kuwait as emerging markets (Toro et al., 2023). Additionally, other events may have influenced foreign investor behavior in this market, such as the COVID-19 pandemic, sovereign credit rating downgrades, and multiple reforms impacting market costs for issuers and participants¹¹⁷.

¹¹² In 1994, MSCI, the world's leading stock index, classified Colombia as an emerging country. This is based on compliance with the requirements established in the provider's methodology of liquidity, size, stability and market access facilities. According to this classification, Colombian shares are included in the emerging markets index calculated by the provider.

¹¹³ On December 29, 2010, the *General Regime of Foreign Capital Investments in Colombia and Colombian Capital Abroad* (Decree 4800 of 2010) was modified in such a way that, among other determinations, the requirement for foreign investors to constitute a *Foreign Capital Investment Fund* to advance their investments in the local financial market was eliminated, allowing them to be made from that moment on through local administrators.

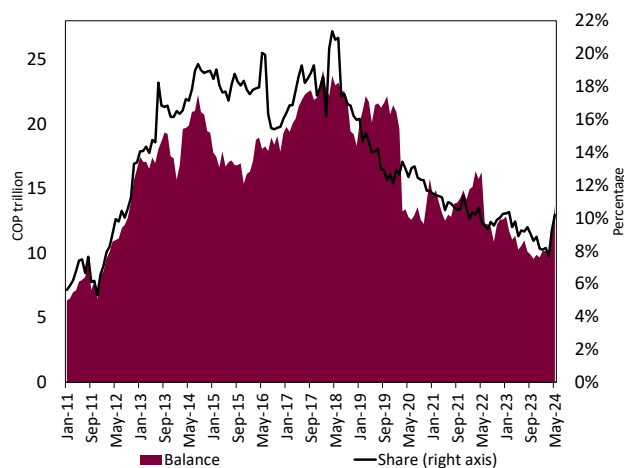
¹¹⁴ Between June 2014 and January 2016, oil prices fell nearly 70%, and the Brent oil benchmark reached a low of USD 27.88 per barrel on January 20, 2016. The MSCI Colcap index showed a 31% drop in the same period.

¹¹⁵ A market classified as frontier is characterized by a small stock market, low liquidity, barriers to access for foreign investors, and political and financial instability.

¹¹⁶ Argentina was classified as emerging in 2019 but lost that classification in 2021.

¹¹⁷ In the tax reforms approved at the end of 2018 and end of 2019, the income tax applied to dividends was increased from 5.0% to 7.5% and from 7.5% to 10%, respectively (Toro et al., 2023). In 2021, Colombia lost its investment grade rating from two of the credit rating agencies, Standard & Poor's and Fitch Ratings.

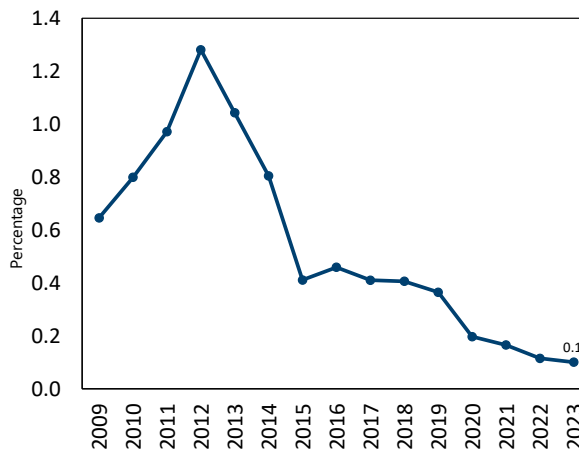
Graph B3. 1. Foreign Investors' Participation in the Colombian Stock Market (float-adjusted).



Source: Banrep's IPEXT format, Bloomberg. Data as of May 2024.

Note: Participation is calculated as the balance of foreign investors in the equity market in USD, reported in the IPEXT format at the average monthly exchange rate, relative to the market capitalization in USD extracted from the World Federation of Exchanges and float-adjusted. The float refers to the percentage of the market available for trading, i.e., the share not held by controlling investors.

Graph B3. 2. Colombia's Weighting in the MSCI Index of Emerging Countries



Source: Bloomberg.

Foreign Inverstors' Participation

Foreign Investors' Flows

Since 2010, the participation of foreign investors in total market trading has increased¹¹⁸. In the last five years, they have become the most important agents (37%¹¹⁹) (Graph B3. 3). However, this has occurred in a context of a significant reduction in market liquidity¹²⁰. In turn, in the last five years, individual investors have traded 14% and Pension Funds 16%¹²¹. Additionally, Stock Brokerage Firms (SBFs), which act as intermediaries in this market, have had a share of 18% of the amounts traded.

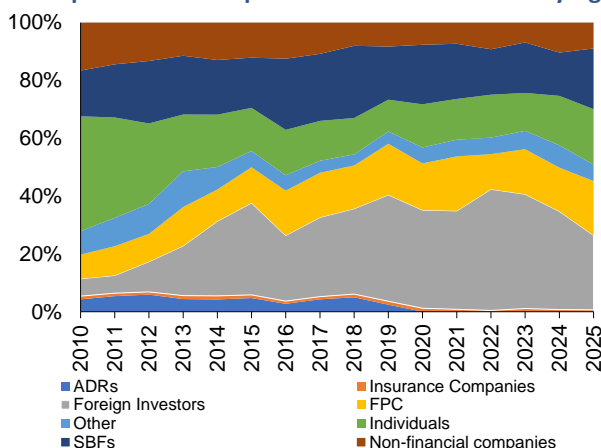
¹¹⁸ Foreigners' share in total market negotiations increased from 6.0% in June 2010 to 37% in June 2024.

¹¹⁹ With information from January 2019 to June 2024.

¹²⁰ Amounts traded in the market decreased from COP 92.5 trillion (t) in 2012 to COP 27 trillion in 2023.

¹²¹ Percentages are calculated as the share of purchases and sales made by each type of agent from January 2019 to June 30, 2024.

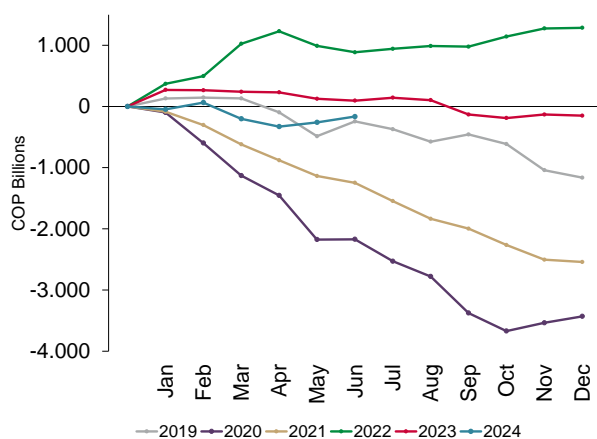
Graph B3. 3. Participation in Amounts Traded by Agent



Source: BVC data. Calculations: Banrep.

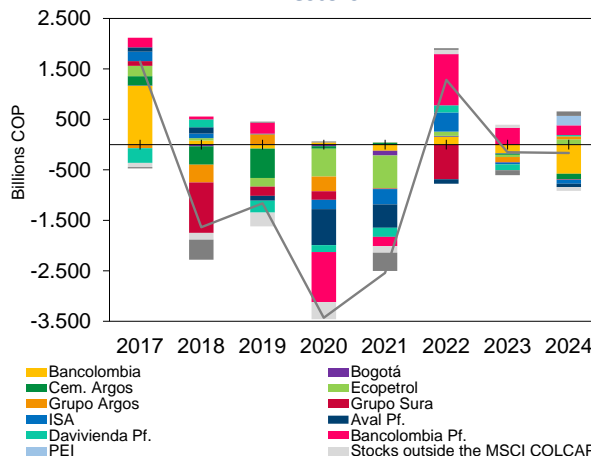
The flows of these agents have reversed. Between 2010 and 2017, they mainly showed net purchases, whereas in the following years, they have accumulated sales, except in 2022 (Graph B3. 4). This may reflect the lower appetite of these agents for Colombian stocks in the recent period. In addition, their trading is concentrated in shares of Bancolombia (preferred and ordinary), Ecopetrol, and ISA (Graph B3. 5).

Graph B3. 4. Cumulative Net Purchases by Foreign Investors



Source: BVC. Calculations: Banrep.

Graph B3. 5. Net Purchase Flow per Share by Foreign Investors



Source: BVC. Calculations: Banrep.

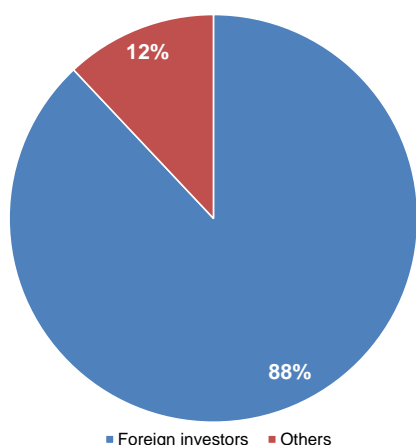
Foreign Investors' Balance

Although foreign investors have been reducing their holdings in the stock market, they still hold 12% of the total outstanding shares¹²² (Graph B3. 6). Since 2019, the balance of foreign investors has decreased by 62.3%. This decline was explained by the withdrawal of mutual funds, whose balance decreased from COP 11.6 trillion (t) in June 2015 to COP 5.10 trillion in July 2024 (Graph B3. 7). As of July 2024, this group of investors remains the most important within the composition of foreign investors with 55%, followed by international pension funds representing 15% of the

¹²² The balance information used in this subsection includes information from foreign portfolio investors with known identity and/or non-controlling. Within the classification of foreigners, 7.9% belong to controlling foreigners, and the remaining 4.1% belong to other types of foreigners.

group, foreign banks with 13%, and monetary authorities with 10%. This is similar to the composition of foreign investors in the public debt market (see *Recuadro 3: Caracterización de inversionistas extranjeros en el mercado de contado de TES* in the Financial Markets Report for the third quarter of 2023).

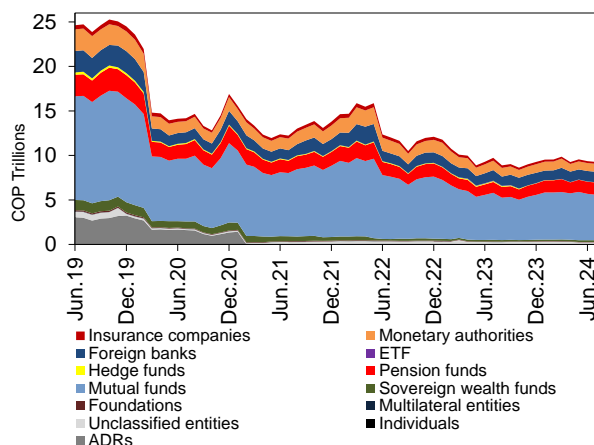
Graph B3. 6. Participation of Foreign Investors in the Stock Market



Source: Deceval. Calculations: Banrep.

Note: The category of foreigners includes agents classified as such by Deceval, excluding those whose identities are unknown, which are included in the “Others” share. Within the classification of foreigners, 7.9% belong to controlling foreigners, and the remaining 4.1% to other types of foreigners.

Graph B3. 7. Balances of Types of Foreign Investors in the Stock Market

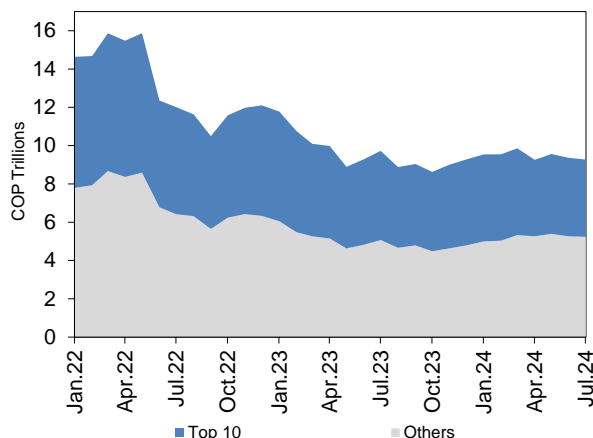


Source: Deceval. Calculations: Banrep.

On the other hand, although the ten largest foreign shareholders account for 43.5% of the total foreign agents’ balance as of June 2024, there is no significant concentration in this market (*Graph B3. 8*). When analyzing concentration using the Herfindahl Hirschman Index (HHI), it is evident that there is not a high concentration in the total foreign investor base or the most important groups, such as mutual funds (*Graph B3. 9*). However, the only case of high concentration is observed in the monetary authorities. This group, composed of a few agents, presents an average HHI of 52% since 2019.

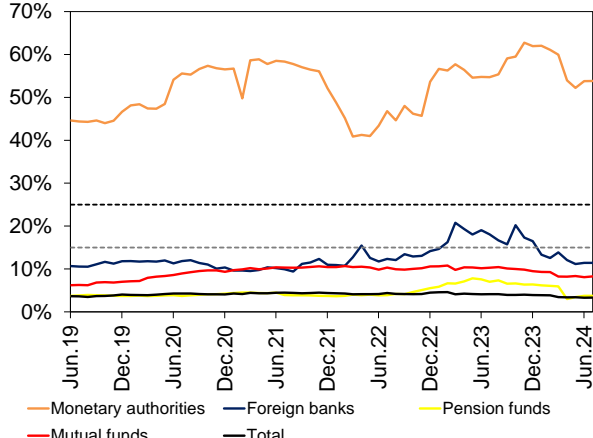
In line with the flows observed in section *Foreign Investors’ Flows* of this box, although foreign investors’ holdings in the stock market are focused on the shares of Bancolombia, ISA, and Ecopetrol, the participation of these investors in this group of shares is diversified and does not present a high concentration. However, the reduction in the appetite of these agents for Ecopetrol shares is highlighted, which could be associated with its exit from the MSCI EM index in December 2022. Consequently, their portfolio has lost diversification in the last five years and they have tended to concentrate their participation in the issuer Bancolombia, which represents 56.4% of their portfolio in local stocks (*Graph B3. 10*). Despite this, after calculating the HHI for stocks with the largest foreign holdings, there is no evidence of high concentration for Bancolombia issues, however, in line with Ecopetrol’s exit from the MSCI EM index, since 2022 a lower diversity of agents with this shares is seen (*Graph B3. 11*).

Graph B3. 8. Balance per Foreigner



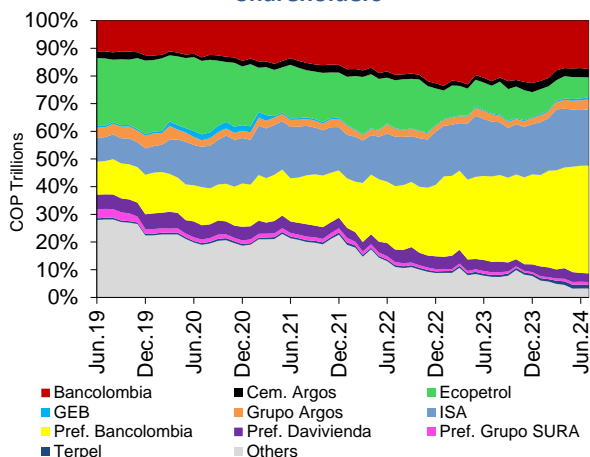
Source: Deceval. Calculations: Banrep.

Graph B3. 9. Foreign Investors' HHI by Type and Total



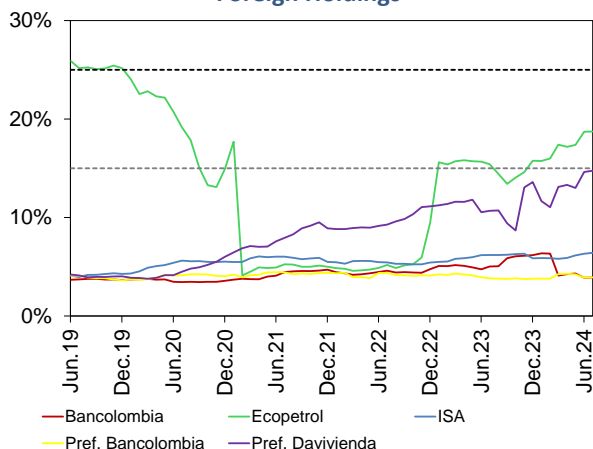
Source: Deceval. Calculations: Banrep. Note: The gray dotted line corresponds to the value of 15% (moderately concentrated), while the black dotted line corresponds to the value of 25% (highly concentrated).

Graph B3. 10. Local Stocks Portfolio of Foreign Shareholders



Source: Deceval. Calculations: Banrep.

Graph B3. 11. HHI of the Shares with the Largest Foreign Holdings



Source: Deceval. Calculations: Banrep. Note: The gray dotted line corresponds to the value of 15% (moderately concentrated), while the black dotted line corresponds to the value of 25% (highly concentrated).

Final Considerations

Despite the decrease in their holdings, foreign investors continue to play a relevant role in the Colombian stock market, positioning themselves as the main players in the total negotiations. The progress of the total balance of these agents in recent years follows the behavior of Colombia's participation in the MSCI EM index. Consequently, their investments have been concentrated in the stocks that are still part of the index, which has caused a loss of diversification in their portfolios. Moreover, as in the public debt market, mutual funds and international pension funds stand out as the most significant foreign agents.

In this context, the public and private sectors have collaborated to promote greater development of the stock market and other securities markets in recent years. This collaboration seeks to strengthen fundamental aspects such as liquidity, accessibility, issuers, and international promotion of these markets. As a result, the National Government has promoted several bills to boost the stock market. The proposed reforms include greater participation of market makers, facilities for short sales and temporary transfer of securities, as well as the promotion of the issuance and placement of securities under more flexible conditions for issuers. Likewise, regulatory provisions have been implemented to increase the participation of Collective Investment Funds, Stock Brokerage Firms, and other stock market agents.

Finally, other initiatives have been launched, such as the regional integration of the Stock Exchanges of Chile, Peru, and Colombia. Once in operation in 2025, this integration is expected to promote greater liquidity and market depth, as well as an increase in the number of participants, making this market one of the most relevant in Latin America.

References

Toro, J. (coordinator); Arango, L.; Gamboa, F.; León, L.; López, M.; Martínez, D.; Melo, L.; Quicazán, C.; Rincón, H.; Rodríguez, N.; Romero, J.; Ruiz, M.; Ruiz, C.; Sánchez, A.; Sarmiento, M.; Villamizar, M. (2023). Flujos de capital de portafolio en Colombia. Ensayos sobre Política Económica (ESPE), issue. 105, July 2023.

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