IS INTERNATIONAL DIVERSIFICATION PRUDENT TO EITHER THE INDIVIDUAL OR THE CORPORATE INVESTOR?

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ABSTRACT

All investments are subject to risk. What diversification does is to spread the risk across different assets and in the case of international diversification, across different economies operating in different countries. It does not guarantee profit or a perfect protection against the possibility of a loss and inherent risk. Aside the risks faced by domestic investors, international investors have to contend with the possibility or risk of foreign exchange uncertainties and political uncertainty.

These uncertainties and inherent risk have led to many investors shying away from engaging in international investment diversification. In 1997, U.S investors invested 91% of their stock domestically even though U.S stocks represented only 49% of global market portfolio. However the benefits of international investment diversification are real.

This paper investigates the benefits against the risk for corporate and individual investors. Investors are gradually increasing their international portfolios. There is the benefit of a substantial reduction in risk if investors diversified internationally since correlation is very low.

The paper finds that international diversification is prudent for both individual and corporate investors due to its ability to maximize returns and lower risk. The fact that international diversification may lead to economies of scale especially for the corporate investor is buttressed by this paper. The paper concludes that investors should engage in international diversification but should also have an eye on the risks it presents and engage in the practice but with prudence.

KeyWords: DIVERSIFICATION , PRUDENT , RISK, Globalization, FDI
INTRODUCTION

The world as we know now is a Global Village. Globalization\(^1\) has become a reality as technology has facilitated the movement of information from every corner to congregate at every point desirable. Access to information has facilitated and reduced the constraints of investing internationally.

National economies in all parts of the world have become closely linked by way of growing volume of cross border transactions not only in terms of goods and services but even more so with respect to financial claims of all kinds (Bartram et al, 2001).

“Diversification is the process of investing a portfolio across different asset classes in varying proportions depending on an investor’s time horizon, risk tolerance and goals” (Thornburg Investment Management, Para 1). Time horizon brings about compounding interest. Time also stabilizes short term market fluctuations. International diversification deepens the act of diversifying portfolios as it involves picking securities across different countries. It is a variation of domestic diversification only that it extends to cover a larger base in different markets.

Constructing international stock portfolios have been concluded by many studies to have benefits. Solnik (1974) posits that one half of the total portfolio risk can be eliminated for US investors if they diversified internationally. As Gerke et al (2001) put it diversification achieves both risk reduction and return maximization. Markowitz (1952) discovered that the best portfolio consist of securities which are inversely correlated. Economies of different nations are controlled by different political authorities and hence they pursue different policies. Even though globalization is on the rise, investors can take advantage of the inverse correlation of different economies.

International investment diversification is not without its risk. There is political risk especially in emerging markets, exchange rate risk\(^2\) and the risk of nationalization of assets among others. According to Bartram et al (2001) foreign assets are denominated in foreign currency and therefore an investment of foreign securities can be exposed to exchange rate shocks. Currency risk can however be minimized by investing in securities spanning several countries and several denominations and also engaging in hedging (Bartram et al, 2001).

Political risk can be categorized into transfer risk, operational risk and risk of expropriation (Bartram et al, 2001). Investors should assess the benefits of international investment against the risks before making a push for it.

History

Huberman and Kandel (1987); Lessard (1974); Levy and Sarnat (1970) all confirm benefits of international diversification. However recent studies, as advanced by Chiou et al (2009); Driessen and Laeven (2007) and others show a decrease in the benefits of international diversification. Tesar and Werner (1998) nevertheless show that U.S investors increased their presence in foreign markets in the 1990’s although the practice was not widespread.

\(^1\) Recognition of the entire world as a whole. (Robertson, 1992)

\(^2\) Work done by Anderton (2003) strongly suggest that Exchange Rate changes impact Inflation and Economic Activity and therefore presents risk to International Investors
U.S. investors held 2, 5834 billion dollars in foreign securities in 1999.

This was an increment by 530.5 billion compared to 1998. (Bartram et.al, 2001). From the UK perspective, international investment have grown over the years. The same can be said of Japan where Ruban et al (2009) show that the proportion of exports to total sales grew over the years.

Olma et al (2004) indicates that from 1969 international equities as depicted by the MSCI EAFE INDEX\(^3\) performed much better than domestic U.S equities for more than twenty years.

From the China perspective, there has been an introduction of capitalist market ideas in the past decades. Securitization rate of the Chinese economy increased from 42% in 2008 to 72.36% in 2009 (Jiang et al 2010). According to Jiang et.al (2010), this has resulted in Chinese investors diversifying internationally.

Flandreau and Holfrerich (2003) conclude that the integration of the global economy is a function of the phenomenon whereby information moved freely across boundaries. From the foregoing and from the various perspectives herein, it is evident that international investment diversification increased at the time when stock exchange information flowed freely among nations.

**Current State**

According to the Global Investment Trends Monitor No.10 (UNCTAD 2012), global foreign direct investment inflows declined by 8% in 2012 compared with the same period in 2011. According to the same report, cross border transactions decreased by 60% within the same period and developing countries absorbed half of the global FDI inflows. The 8% fall in the reasoning of the report was due to uncertainty within the global economy and a slowdown of growth within emerging market economies. The recent crisis in Greece highlights the economic risk the international investor may face. There was a surge in new investment restrictions and regulations between November 2012-February 2013 in many countries (Investment Policy Monitor, UNCTAD 2013). It highlighted, inter alia,

- Benin prohibiting land ownership by foreign countries;
- Canada introducing stricter criteria for the screening of inward FDI\(^4\) by state owned enterprises;
- Sri Lanka and Hungary prohibiting foreigners from owning land;
- Philips et.al (2010) hold the view that there is a growing trend of US investors diversifying internationally and that their international interest is really in emerging markets stocks. A diversified portfolio of US and international stocks is relatively less volatile than a portfolio of US stocks alone (Philips et al. 2010).

Investing internationally is risky and even more so with emerging markets\(^5\). There is the possibility of various risks including expropriation. In recent years Venezuela expropriated many

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\(^3\) The MSCI EAFE Index measures International Equity Performance

\(^4\) Foreign Direct Investment is defined by the International Monetary Fund as Investment that is resident in a foreign economy

\(^5\) Emerging Markets exhibit high expected returns but high volatility as well (Harvey 1995)
oil and gas companies owned by foreigners. According to Duff and Phelps (2010) these kinds of actions decrease the attractiveness of Venezuela and other emerging market to foreigners. However emerging markets present investors with high returns. In 2007, Brazilian equities had 50% returns whereas return for South African equities in 2009 was 26% (Duff and Phelps 2010). Investors are getting alerted to the high return potential of emerging market securities.

According to (Philips et.al 2010) allocations to emerging markets have increased rapidly since 2000 and it accounts for 20% of the US international equity investments.

Environmental Statement

In this age of globalization of information, issues of ethical investing are of mainstream concern. The not too distant corporate scandals of Enron$^6$ and WorldCom$^7$ correlated with a heightened awareness of ethical and other environmental issues.

Some financial theorists following Markowitz (1952) argue that ethical investing can be a negative enterprise and may have a negative impact on net return. However, Guerard (1997) argue that there is no difference between returns on portfolio which were picked ethically and non-ethical ones. Furthermore, Statman (2000) confirmed no difference in returns between ethical and non-ethical portfolios in the US and UK.

Ethical investing therefore has no significant disadvantages and investors, be it corporate or individual should embrace.

DUSCUSSION OF THE FACTS AND ISSUES

How Much Diversification Is Optimal?

Campbell, Lettau, Malkiel and Xu (2001) who studied U.S stocks observe that the benefit of portfolio diversification increase over time. Campbell et al (2000) carve a rule of thumb that a portfolio of twenty stocks attain the benefits of diversification. This assertion is supported by Bloomfield et al (1997).

Statman (1987) posits that a well diversified portfolio must include at least forty stocks. For optimal diversification, diversification should be increased as long as its marginal benefits exceed its marginal costs. As concluded by Markowitz (1952), the benefits of diversification are in the reduction of risk.

Domestic Portfolio As Against International Diversification

Solnik (1974) observe that international diversification is a strategy to reduce market volatility. In spite of this well know fact, investors be it corporate or individual; hesitate to engage in the practice. Cooper and Kaplanis (1994) indicate that investors from UK invest 78.5% of their portfolio domestically. This is against the backdrop that the UK domestic market is just 10.3% of the global equity market capitalization (Ruban et.al 2009).

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$^6$ Enron company lied about its profits and concealed debts so it did not have to show in their books

$^7$ Presently known as MCI, it was caught in a major accounting scandal leading to the company filing bankruptcy in 2002
Recent studies such as Driessen and Laven (2007) show that the benefits of international diversification are reducing. This is because as You and Dagler (2010) argue correlations among global markets tend to exhibit a positive trend over time. This position could lead investors to minimize their already small international portfolio in favor of domestic investment.

Even though US investors have increased their foreign equity participation it still remains at very low levels (Tesar and Werner 1998). Fieldsten and Horioka (1980) argue that domestic investment is correlated with domestic savings which could mean investors prefer to invest domestically.


Without eliminating the home country bias, Cai and Warnock (2006) report that U.S institutional investors prefer domestic multinationals over wholly domestic firms. Abreu et al (2009) categorize investors and their foreign investment pattern in three fold. They find that investors who trade more often in the domestic stock market don’t take too much time before they start investing internationally. Married and female investors and older investors take a longer period of time before they start to invest in foreign securities. Educated and rich investors invest internationally earlier.

As a result of Odean (2000, 2002), Abreu et al (2009) conjecture that active domestic investors become confident and are able to venture into foreign markets earlier.

**Investment Strategy**

With international capital markets, the riskiness of securities is measured by International Capital Asset Pricing Model\(^9\) (Bartram et al 2001). It helps to determine investors return at a given risk including foreign exchange risk. International investors realize that market portfolio is not the only source of risk. Investors therefore take a position out of an analysis of domestic assets and global portfolio while hedging against currency risk (Bartram et al 2001)

Fund managers believe they can add value by actively picking securities. However, Blake et al (1999) advice that diversified funds would generate more favorable returns by following a passive asset allocation policy\(^10\).

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\(^8\) Human capital represents the wealth of a nation (Baxter, 1997)

\(^9\) CAPM is a tool that can be used to determine prices of Securities (Bartram et al 2006). International Capital Asset Pricing Model extends the model to cover International Markets.

\(^10\) For aggregate fund performance, fund managers should employ both active and passive asset allocation strategies (Benson 2007)
ANALYSIS OF THE FACTS AND ISSUES

Investors generally spread their assets to guard against short term volatility. According to Bartram et al (2001) there are several advantages of having an internationally diversified portfolio.

They include:

Participation of the Growth of Foreign Markets

Economies of Scale

Lower Risk Portfolio

Participation of the Growth of Foreign Markets

Different economies in different countries grow at varying rates. By investing internationally, an investor albeit corporate or individual, is able to share in the benefits of faster growth of other countries.

According to Malkiel and Mei (1998) the rate of growth in the economy of emerging nations will exceed growth in developed nations for a long time. This indicates that stock returns in emerging markets will be higher than returns of securities in developed countries. The annualized return in the MSCI emerging markets index between 1999 to 2009 was 10.2%. On the other hand the return for the MSCI USA index was -1.2% (Davis et al 2010)

Although industrialized nations may not grow as much as emerging markets they provide a potentially much politically stable environment.

Economies of Scale

Many mutual fund expenses are fixed cost (Latzko 1998). Asset growth through investing and diversifying internationally will make economies of scale\(^ {11}\) possible. Even though individual investors may benefit from economies of scale when they diversify internationally, corporate investors have a higher buying power and they are able to pool greater resources to invest across a wider range of securities.

Lower Risk Portfolio

A benefit for international diversification is that investors get to select securities that have very low correlation. Bartram et al (2001) suggests that there is a strong tendency for fiscal policies in the same country to be the same since they emanate from the same political authority. It is therefore possible for returns to be affected by domestic happenings. A portfolio of domestic securities only can lead to high correlation and therefore higher risk and vice versa for a portfolio which is internationally diversified.

International diversification however has downsides such as:

\(^{11}\) Administrative fee component of Mutual Fund operating expenses is subject to Economies of Scale (Latzko 1998)
Currency Risk

International investors may be exposed to unexpected fluctuations in foreign currency. Exchange rate risks can be minimized by choosing securities in many different currency denominations. Bartram et al (2001) suggests that foreign exchange risk may be compensated for by diversification benefits. Besides, the real forex rates between developed countries remain unchanged over a long time span (Froot, 1993).

Political Risk

Foreign investors are exposed to inter alia political risk, ownership control risks, foreign tax laws and restrictions on capital outflows. There is also the risk of corruption. Mauro (1995) concluded that corruption can result in diminished economic growth. Getz and Volkema (2001) extended the argument when they list corruption as having a disincentive effect on investment. Nationalization of foreign assets is presently not a frequent phenomenon but it is still a possibility (Jensen 2003). According to Biglaiser et.al (2006) countries can attract more investments if they put in place strong property rights and policies that can stem expropriation.

CONCLUSION

Economic interdependence and cross social integration have aided international investment diversification. Eastern European countries and nations in East Asia have all embraced democracy. Political risk therefore has minimized. Moreover there is a growing number of emerging countries whose economies are growing at a very fast rate. International investing can therefore be beneficial to both individual and corporate investors. Corporate investors especially can enjoy economies of scale when they diversify internationally because they have the buying power to assemble a large portfolio across a large number of countries. Moreover, they can withstand and respond much better (than individual investors) to foreign exchange risk and other associated risk.

In sum, international investing can be prudent to individual investors but even so to corporate investors.

12 Political risk as opined by Brink (2004) is predicated on social and governmental stability and the extent to which the government intervenes in the economy.

13 Kobrin (1980) explains that nationalization is a symptom of expropriation whereby the host government takes control of capital stock of foreign owned corporations.
RECOMMENDATION

Diversification has a recognized benefit for both individual and corporate investors. With international diversification, there is even a much bigger potential to derive benefits as there are low correlations between different economies. Recent financial crisis amplifies the need for investors to diversify internationally.

The reality though is that, a large number of investors have a home country bias. Some investors also hold the view that international diversification is losing its relevance because of increased globalization which can increase correlation between securities. According to Lewellen (1971) potential benefits of diversification include lower risk, greater debt capacity and lower taxes. Stultz (1990) on the other hand argues that diversification results in over investment in low or non-performing securities.

As stated by Santis and Sarno (2008), overall, gains in international diversification exist but they can be limited due to risks it presents. All investors (corporate and individual) may take advantage of diversifying internationally but only if they take cognizance of the risks inherent. Corporate investors can pool resources together and enjoy economies of scale. They also stand in a better position of resuscitating in the event of a loss as a result of investing in international securities.

Based on the arguments above-for and against-this paper posits that it is prudent for both the individual investor and even more so, the corporate investor to engage in international investment diversification.
REFERENCES


