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International Portfolio Prospects and Concerns

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Abstract

The recent financial crisis amplifies the need for an updated and more universal investment strategy for both individuals and corporate investors. Diversification satisfies that condition, as it provides access to different economies operating in different countries while, simultaneously, it spreads the risk across different asset allocation[1]. However, to benefit the advantages of a diversified portfolio, a sophisticated decision making process and appeal to re-planning are required. Otherwise, international investors have to face the consequences of political-country risk and currency risk. The goal of this research is to correlate the benefits of diversification with risk undertaking for either individual or corporate investors. The main conclusion is that investors should engage in international diversification, eliminating home country bias where investors prefer to invest in their own domestic environment (Maniam et al, 2005). In addition, the paper finds that the optimal[2] portfolio is not static and its benefits vary across different types of markets included in portfolios.

Keywords: Diversification, Risk, Globalization, Prudent, Investment.

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[1] Asset allocation means decisions on the portion of the portfolio to be exposed to changes in values of certain classes of assets (Greer, 1997).

[2] A portfolio selection model which allocates financial assets by maximizing expected returns (Campbell, Huisman, Koedijk, 2000).

Introduction

The recent economic crisis revealed more than ever that the global mechanism acts interactively. From a bald perspective, the fall of Lehman Brothers had a negative impact[3] to economies in every place of the world. However, globalization has also offered great opportunities too, using technology to facilitate the movement of information from every corner to congregate at every point desirable (Gyarteng, 2013).

The aforementioned fact provided access to more information for the investors, reducing the constraints of dealing internationally. Such portfolio management is the investment diversification, whereas an investor reduces risk of his portfolio and maximizes gain by holding a variety of assets such as stocks, bonds and commodities that have low correlations with each other. The higher the number of securities in a portfolio of investment exists, the lower the risk associated with the portfolio. As Gerke et al (2001) put it diversification achieves both risk reduction and return maximization.

A result of this trend is that many companies' strategies are being influenced by whether they use diversification in their portfolios or not. Faccio, Marchica and Mura (2011) highlight this fact, providing direct evidence that firms controlled by non diversified large shareholders invest more conservatively than firms controlled by well diversified large shareholders. Of course, it is obvious that the benefits of diversification are driven by country factors, broadening therefore the investment horizon from a domestic to a more global perspective (Schindler, 2009, p.23).

Although diversification minimizes risk, it is necessary to recognize obvious dangers such as currency risk (Bartram & Dufey, 2001) and the less obvious ones introduced by large cap companies (Gibson, 2008). Such kind of risks arises from investments of foreign securities in emerging[4] markets, which are vulnerable

[3] It triggered other countries into global rescission by looking at the internal happenings of Lehman within the US (Burkhanov, 2011).

[4] Emerging markets represent potentially some of the most important growth opportunities for companies.

to unstable political regimes. However, these risks can be minimized if firms invest in securities spanning several countries and several denominations and also engaging in hedging (Bartram et al, 2001).

History

The phenomenon of foreign[5] portfolio is not a new concept, as long as there are evidences proving that international investments were happening often even 150 years ago. Appendix 1 illustrates the foreign investments of the main capitalist countries in millions of pounds sterling; based upon information from Emmanuel (1972).

Historically, it was believed that investments made in developed economies used to yield better financial returns to international investors, than the ones made in the emerging markets (Tebogo, 2011). Over the last decades, a major shift in the recipients of the World investment has occurred. Indeed, Appendix 2 illustrates that over the last 20 years, the emerging markets tend to bring good returns for the level of risk undertaken. Thus, it does not seem wise for an investor to ignore the countries responsible for more than 50% of the world's economic output (Prosser, 2012).

The foreign portfolio investment in the United States has been increasing very rapidly since 1990. In that year, the share of foreign equities in the aggregate US portfolio increased from only 2.5 percent to 8 percent (Bohn & Tesar, 1996). The increase in US Holdings8 of foreign stock in the late 1990s can be attributed to the historical performance of foreign stock prior to the late 1990s (Obiri, 2011). Similar to US, the UK and Japan portfolio in international investment have growth over the same period. From the China perspective, there has been an introduction of capitalist[6] market ideas in these decades, but the explosion of international diversification happened mostly after 2005.

[5] Foreign investors overweight shares of large firms, firms with good accounting performance, firms with low unsystematic risk, and firms with low leverage (Kang & Stulz, 1997).

[6] Capitalism is a system of largely private ownership that is open to new ideas, new firms and new owners.

Current state

Due to the great correlation between economies all over the world, a positive or negative change in one's country regime usually reflects almost immediately on a global scale. As it was expected, the recent financial crisis[7] was a daunting factor for either the individual or corporate investors. The crisis impact to investments was integral as the cross border transactions decreased by 60% due to uncertainty within the global economy (Gyarteng, 2013). Great skepticism about capitalist economies still exists in the minds of investors as long as at the beginning of the crisis (2008-2009) the U.S investors held their dollars in foreign securities coming mostly by "developed" countries, while today the facts show that a diversified portfolio of US and international stocks is relatively less volatile than a portfolio of US stocks alone (Philips et al. 2010). Indeed, the Global Investment Trends Monitor No.13 (UNCTAD 2013) stated that the Global foreign direct investment[8] (FDI) inflows increased in developing and transition economies as driven by acquisitions in Central America and the Caribbean as well as record inflows into the Russian Federation. Regarding the Islamic regions, the FDI is concentrated only in a limited number of countries of the Organization of the Islamic Cooperation (OIC) region, while Egypt is the largest recipient (UNCTAD 2013, report No. 14).

Although investing in emerging markets is considered to be beneficial, since they present investors with high returns, there are instances where governments view it with skepticism and prefer protectionism, in order to promote domestic companies (Tebogo, 2011). This phenomenon has been witnessed, lately, in North Greece where, as a result of the desire to react on crisis and to improve financial returns for companies, a number of firms in Greece shifted their manufacturing to neighbor countries, such as Skopia, Albania and Bulgaria. Given the relatively lower purchase cost of raw material, as well as the lower labor

[7] The global economy is facing the worst economic and financial crisis since the Second World War (Global Fin Crisis, 2010).

[8] Foreign direct investment (FDI) are the net inflows of investment to acquire a lasting management interest in an enterprise operating in an economy other than that of the investor.

costs in those countries, investors have benefited through improved financial returns. This has, however, come at a greater social cost to the larger Greek population, as many people lost their jobs.

Environmental statement

Ethical and socially responsible investing of money is increasingly of mainstream concern in doing business. However, the accounting scandals at Enron[9], WorldCom[10], later at Lehman and other corporations have helped to fuel a massive loss of confidence in the integrity of American business (Carson, 2003). These events have brought ethical questions about business to be answered. The main question, then, is:

"Does the ethical investor can succeed in his ethical goals through buying or selling stock and securities? "

An ethical investor wants his investment to yield a market return while simultaneously he desires not to profit from bad corporate actions and to punish bad firms (Hudson, 2005). Since there is no difference between returns on portfolio which are picked ethically and non-ethical ones (Guerard, 1997), then both corporate and individual investors should select to act ethical.

Discussion of the facts and issues

Diversification - Long term view

International investing requires a more globally outlook when it comes to decision making rather than dealing with domestic markets. Additionally, diversification provides investors with higher returns when investing in a longer duration assets rather in one-year duration ones (Person et al, 2002). Prior studies have shown that entrepreneurs are willing to adjust their strategy and to take risks in the pursuit of profitable opportunities, thus contributing in a long-term economic growth.

[9] The Enron scandal, revealed in October 2001, led to the bankruptcy of the Enron Corporation (Li, 2010).

[10] On July 21, 2002, WorldCom filed for Chapter 11 Bankruptcy Protection.

Individual investors

History has shown that there were cases where the individual investors would have benefit more than they finally did, if they had exploited the advantages of diversification. For example, the research made by Burtless (2006) has shown that the fulltime US workers could substantially have increased their expected pensions if they had included foreign equities in their pension portfolios.

The worldwide trend to shift the burden of investing to individual investors, has created the need to explore whether they are financially sophisticated enough for such a task. The behavior of individual investors is being influenced mostly by their educational level rather than by their financial background or by other criteria. The sophisticated investors are more likely to hold foreign equities than investors from a common sample of stockholders (Kyrychenko & Shum, 2009). Grinblatt and Keloharju (2001) as well as Karlsson and Norden (2007), report that this is the case with Finnish and Swedish investors. They also found that larger and diversified portfolios are positively correlated to more active trading behaviors.

Corporate investors

Diversification is the logical "next step" of a continuously developed company as it stems from dynamic strategies that maximize value. According to a research made by Gomes and Livdan (2002) diversification allows a firm to explore new productive opportunities while taking advantage of synergies. Statman (1987) posits that a well diversified portfolio must include at least forty stocks, while to succeed an optimal corporate diversification, the breakeven point[11] is when the marginal benefits are the same to its marginal costs.

There is no place like home

There are many studies, as the one made by Driessen and Laven (2007), which show that the benefits of international diversification are reducing. While investing globally adds diversification to a portfolio and the potential for higher returns, investing at home makes investors feel more comfortable. In fact, it also

[11] The market price that a stock must reach for option buyers to avoid a loss if they exercise.

depicts into statistics too, as the domestic capital returns are more positively correlated with domestic securities rather than with foreign stocks (Fieldsten and Horioka, 1980). Last, a lot of investors find it easier to research domestic companies because the press releases are written in their native language.

Analysis of the facts and issues

As mentioned before, the motivation behind the decision to invest internationally encloses two goals: to maximize the expected return of the investment and to minimize the risk. Bartram et al (2001) set some requirements to achieve this objective. Specifically, they stated that the portfolio should provide the highest potential return for a stated amount of risk as well as to be optimal[12] in terms of matching risk to return. Since these two criteria are successfully correlated, then the portfolio is said to be profitable.

International portfolio: pros and cons

Investment diversification has advantages and disadvantages, which need to be assessed in a diverse way. There are several advantages of having an internationally diversified portfolio, such as economies of scale, portfolio hedging and portfolio re-allocation.

Economies of scale

Economies of scale[13] lead to various advantages, such as greater bargaining power for corporate investors, lower R&D and marketing expenses, and more efficient corporate management (Yamamoto, 2010). Economies of scale will become possible if total assets increase through investing and diversifying internationally.

Portfolio hedging

The strategy of diversification via allocating money to different investments provides an easy path for an investor to protect his portfolio. Due to the fact that investing in a variety of assets results in a low asset

[12] An optimal portfolio offers the highest expected return for a defined level of risk or the lowest risk for a given level of expected return.

[13] An economy of Scale is realized when there is an increase in production units which then reduce per unit cost.

correlation portfolio, the risk is considerably reduced. In that way, the investors would not have to worry about a future Lehman Brothers or Enron crushing, as the impact of these stocks to the whole portfolio would be low (Riddix, 2011).

Portfolio re-allocation

The third of the advantages is that diversification enables more flexibility to the portfolio, as long as the investor can decide if his investment goal has changed at any time during the evaluation process. If so, he may allocate assets to minimize portfolio impairment. As Figueiredo et al. (2011) state, a well diversified asset allocation program would prevent a 20-30% annual decline in an investor's portfolio value.

International diversification however has disadvantages such as:

Currency and Country risk

Unexpected fluctuations[14] in foreign currency can reduce the return on the foreign investment. However, currency risks can be minimized by choosing securities in many different currency denominations (Gyarteng, 2013). Moreover, investing international encrypts political, economic and social risk. Events such as wars, revolutions, terror attacks or major economic policy changes in a country can weaken the diversified portfolio.

Both pros and cons are likely to be related to the firm's growth opportunities, its corporate governance and the liquidity of the financial markets (Hartzell, Sun, Titman, 2009).

Conclusions

International diversification has provided access to opportunities in foreign markets to both the individual and corporate investors. Unlike a diversified portfolio, an exclusive domestic one is limiting and seriously prone to losses due to correlations between domestic assets (Obiri, 2011). In addition both corporate and individual investors can benefit from the effects of diversification, as to re-allocate their

[14] Unexpected fluctuations in foreign exchange rates are an important concern to firms with international business operations since future cash flows, and therefore the value of firms are affected (Chiang and Lin, 2005).

portfolio according to updated information, to assemble a large portfolio across a large number of countries (mostly for corporate investors) and to hedge their consumption basket against exchange rate risk (Bartram et al, 2001).

However, moving into foreign markets underlies political as well as country risk, even if many nations[15] have already embraced democracy and their economies are growing at a very fast rate. Thus, international investing can be prudent for either individual or corporate investors only when it is being implemented under a strategic plan with sound and wise guidance.

Recommendations

The paper recommends that both corporate and individual investors should carefully research the stocks and markets (Wiersema et al, 2008) that they wish to invest in or consult an investment management company[16]. However, because of the fact that individual investors usually do not have such required knowledge or they cannot afford the cost of the consultants, they should consider investing in international mutual funds, preferably those that are linked to a world capital market index. In that way, they could adopt a more risk-averse strategy into their portfolio. On the other hand, corporate investors stand in a better position, as they can pool resources together and enjoy economies of scale (Gyartneg, 2013).

Additionally, it is necessary to consider that the optimal portfolio is not static and its benefits vary across different types of markets included in portfolios. For example, including developed markets in the portfolio is more effective to reduce portfolio risk than including emerging markets, while diversifying over Euro-American markets is more effective than diversifying over Asian-Pacific markets (Jiang, et al., 2010, p.18).

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[15] Eastern European countries and nations in East Asia (Gyarteng, 2013).

[16] A company that sells and manages a portfolio of securities.

Consequently, there are many available strategies for investors to maximize returns and to minimize risk. When that decision making process is combined with a sophisticated portfolio, then international investment diversification becomes prudent to both the individual investor and the corporate investor.

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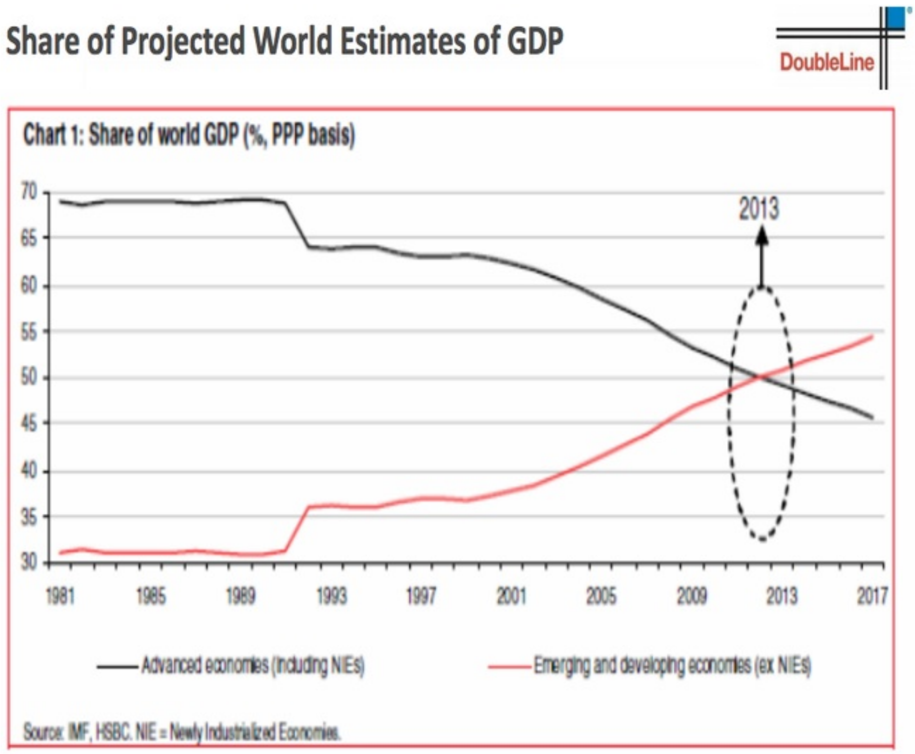
Appendices

Appendix 1[17] - Foreign investments of the main capitalist countries in millions of pounds sterling

YEAR	UNITED KINGDOM	FRANCE	GERMANY	UNITED STATES
1870	1,006	513	negligible	negligible
1885	1,602	678	390	negligible
1900	2,485	1,068	986	103
1914	4,004	1,766	1,376	513

Appendix 2[18] – Share of Projected World Estimates of GDP



[17] Source: (Emmanuel, 1972)

[18] Source: IMF, results reflect current/nominal values of Investment