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Diversification Potential of Asian frontier, BRIC emerging and major
developed stock markets: A wavelet-based Value at Risk approach

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Abstract
This study examines the portfolio risk and the co-movements between each of the BRIC emerging and South Asian frontier stock markets and each of the major developed stock markets (U.S., UK and Japan), using the wavelet squared coherence approach as well as the wavelet-based Value at Risk (VaR) method. The results show that the co-movements and diversification benefits between these markets vary over time and across frequencies. Additionally, the co-movements are intensified in the wake of the recent global financial crisis (GFC) and the Eurozone sovereign debt crisis (ESDC). More precisely, the wavelet-based VaR ratio indicates that including a BRIC or a South Asian (particularly Pakistan and Sri Lanka at both the short- and long-term) stock market in a portfolio of the developed stock markets reduces the resulting portfolio’s VaR. Specifically, adding China in the medium term to this portfolio reduces risk in the pre- and during both the GFC and ESDC periods. By assigning optimal weights to the different market assets in the portfolio formulation, the analysis thus has implications for international investors.

Gel Classification: G14; G15.
Keywords: Stock markets; Wavelet analysis, Value at Risk
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