

# What are the risks when investing in thin emerging equity markets: Evidence from the Arab world

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## Abstract

This study attempts to identify the risks involved when investing in five emerging Arab capital markets. We first find that a constant beta is not a good proxy for risk in these thinly traded emerging markets. However, firms' fundamentals and country risk rating factors prove significant in explaining the cross-sections of stock returns. The paper provides three important contributions to the literature on asset pricing in emerging capital markets: (i) we show how country risk ratings can be aggregated into a country risk factor; (ii) we add to a growing literature suggesting that, in markets other than the US, it is possible to find large and growth stocks to be riskier than small and value stocks; (iii) we determine that despite economic, financial and political reforms, issues related to financial transparency and political instability are still powerful obstacles to investments in these nascent emerging markets.

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## 1. Introduction

Equity risk premiums are central components of every risk and return model in finance and are fundamental and critical components in portfolio management. While the return generating process of individual stock is more established for developed markets, risk components that determine risk premiums are difficult to evaluate in thin emerging markets, where the historical

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data tend to be limited. Our paper attempts to identify risks affecting long-run stock returns in an Arab block comprised of five thin emerging Arab markets.

Many Arab countries have embarked on a process of privatization and stock market liberalization with the goal of deepening their markets and improving corporate governance for a nascent private sector. As a result, it is worthwhile to study the region on its own, and to see what impact these reforms have had on the relationship between risk and return. In other words, do stock returns reflect the ongoing infrastructure improvement in the Arab stock markets? What risks are involved when investing in these markets?

Our paper addresses a research area previously ignored in finance literature. We examine the relationship between risk and stock returns in thinly traded emerging markets using not only fundamental risk measures but also country risk scores. A previous study has investigated the relationship between volatility and returns in Arab equity indices (Girard et al., 2003a). Several papers have investigated the relationship between stock returns and fundamental risk attributes in emerging markets (Claessens et al., 1998; Lyn and Zychowicz, 2004; Ramcharan, 2004). Numerous papers have investigated the relationship between country index returns and composite risks—i.e., a weighted average of the 22 risk scores used in our study (Erb et al., 1995, 1996a,b, 1998; Beakaert and Harvey, 2002, 2003; Harvey et al., 2002). Finally, several papers have specifically investigated the relationship between country index returns and demographics or only one type of composite risk—i.e., political risk alone which is a weighted average of twelve risk scores used in this study (Diamonte et al., 1996; Erb et al., 1997).

We first consider the conventional approach to estimating risk premiums, which uses the Capital Asset Pricing Model (CAPM) developed by Sharpe and Lintner, and we evaluate its weaknesses. In essence, we follow Omran (2005) by testing for the null hypothesis of no cross-sectional abnormal returns for a sample of more than 100 firms over 5 years. Second, we investigate a multifactor extension to the CAPM by showing how the cross-sections of 4 fundamental firm-specific and 22 country-specific risk scores can be linearly related to risk premiums in five emerging Arab capital markets. The firm-specific risk scores include beta, market-to-book value, size and industry type while the country-specific risk scores comprise 12 political, 5 economic and 5 financial risk scores. In conducting the investigation, we employ a principal component analysis methodology (Chen et al., 1986; Groenewold and Fraser, 1997) to reduce the factor loading, and identify the significance of each risk factor's effects on long-term stock risk premiums. Finally, as in Chen (1983) we test the information content of our multifactor expression as compared to three nested models.

In our study: (i) we support, with strong evidence, an argument that stock returns in all Arab countries do not follow the unconditional CAPM, but we reject a constant beta as a good proxy for risk in determining stock returns and (ii) we find that fundamental attributes and country risk scores are both significant in explaining the return generating process of individual firms within our Arab block universe. In fact, we show that a model with both fundamentals and risk scores is a significantly better explanatory tool than either the CAPM, or a model which only includes a firm's fundamentals, or a model based on country composite risk ratings alone.

The remainder of the paper is organized as follows. Section 2 briefly discusses the relevant literature. Data selection, research methodology and empirical models are described in Section 3. Section 4 provides analysis and interpretations of the empirical findings and Section 5 concludes the paper.

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