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An investigation of the benefits of portfolio investment in Central and Eastern European stock markets

C.A.J. Middleton [a], S.G.M. Fifield [b,*], D.M. Power [b]

[a] *University of St. Andrews, School of Management, St. Andrews KY16 9SS, United Kingdom*
[b] *University of Dundee, School of Accounting & Finance, Perth Road, Dundee DD1 4HN, United Kingdom*

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Abstract

This paper: (i) examines the potential benefits from diversifying into eight stock markets of Central and Eastern Europe (CEE); and (ii) quantifies the importance of country, industry and time factors in CEE equity returns. The findings suggest that substantial benefits exist from investing in CEE stock markets and that they accrue more from the geographical spread than from the industrial mix of the equities included in the portfolio. However, the returns earned by CEE equities vary dramatically over time. This variability may hamper the efforts of investors attempting to exploit the diversification "free lunch".
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1. Introduction

Recent years have seen a tremendous increase in the volume of foreign portfolio flows to emerging stock markets (ESMs). These increased investment flows appear to have been stimulated by the reported opportunity for higher returns and reduced portfolio risk (Divecha et al., 1992; Eaker et al., 2000). As a result, financial institutions have begun to offer numerous global emerging market investment funds in addition to specialised Asian and Latin American

* Corresponding author. Tel.: +44 1382 345 148.
E-mail address: s.g.m.fifield@dundee.ac.uk (S.G.M. Fifield).

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investment vehicles which focus on a specific region.[1] However, more recently, a number of specialised European emerging market funds have been established; these funds have recorded exceptional results. For example, in 2003, eight of the top ten performing emerging market funds had a European focus (Financial Times, 2003). Furthermore, the top ranking fund, Pictet Fund Eastern Europe, earned a total return over the three-year period, 2001–2003, of 70.6 percent.[2]

Most of the previous research which has investigated the performance of emerging markets has adopted either a global focus or employed a regional perspective by considering the emerging markets of Asia and Latin America. By contrast, this paper examines the emerging markets of Central and Eastern Europe (CEE)—a group that to date has not been analysed to any great extent in academic studies. The objectives of this paper are to: (i) investigate the theoretical benefits available from investing in emerging markets by examining the historical returns earned by equities from a number of countries located in the CEE region over the recent period 1998–2003; and (ii) quantify the role of country, industry and time effects in driving the returns of individual CEE emerging market shares. The results of this analysis have important implications for the management of CEE investment portfolios. Specifically, they determine the size and nature of the gains from diversifying into the CEE region and indicate how the research function of institutions engaged in CEE equity investment should be managed.

This research has a number of novel features. First, while most studies which examine the performance of ESMs focus on aggregate national indices, this study employs disaggregated data. Thus, a measure of realism is injected into the analysis by allowing portfolios of equities of individual companies from different markets to be constructed. Second, the study analyses a mix of different markets from the CEE region which vary in terms of size, industrial composition, spread of securities traded and technological sophistication; previous research has tended to concentrate on the larger markets in this region. Third, the study examines the gains from diversifying into the CEE region for a recent time period, January 1998 to December 2003.[3] Finally, to date, no study has investigated the nature of the gains from diversifying into CEE equity markets. This study attempts to fill this gap.

In order to establish a background for the analysis, Section 2 presents a brief review of the literature on ESM investment. Section 3 introduces the dataset and presents some descriptive statistics. The case for investing in CEE markets is examined in Section 4 and the nature of the possible gains from CEE equity investment is explored in Section 5. The final section offers a number of concluding observations.

[1] As interest in ESM investment has increased, the flow of funds to these emerging economies has risen at an astonishing rate (Claessens, 1995). In addition to increased portfolio flows, Tesar and Werner (1995) highlight that developing economies as a whole have increased their financing through new equity issues, from almost zero in 1985 to US$ 5 billion in 1991. As a result, the proportion of the world's equity market capitalisation attributable to emerging markets has increased dramatically since the early 1990s.

[2] The performance of Central and Eastern European emerging markets is also of interest because the countries in this region: (i) are moving from centrally controlled to market economies; (ii) have obtained, or are seeking, European Union (EU) membership; and (iii) are currently enjoying increasing net private portfolio investment flows; private portfolio flows reached an estimated net inflow of US$ 7.6 billion in 2004 (Institute of International Finance, 2005). For a discussion of the impact of EU membership on CEE countries, the reader is referred to Mockaitis (2005).

[3] This recent period has seen a great transformation in the CEE financial systems (Schobert, 2006) and a huge increase in the volume of foreign direct investment flows as these countries have moved to join the EU (Kalotay, 2004).

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