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Who benefits more from international diversification?

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Abstract

This paper investigates the relative magnitude of the international diversification benefits for the domestic investors in various countries. The constraints of short-sales, over-weighting investments, and investing region are considered. The empirical results suggest that local investors in the less developed countries, particularly in East Asia and Latin America, comparatively benefit more from both regional and global diversification. This finding holds even though the international market has become more integrated so that the diversification benefits have decreased over the past two decades. The results are useful for asset management professionals to determine target markets to promote the business of national/international funds.

JEL classification: F37; G11; G15

Keywords: Investment constraints; Home-biased investment; International portfolio management

1. Introduction

In past years, the meetings of the World Trade Organization (WTO) have caught substantial attention worldwide for not only their agendas but also the aggressive demonstrations against the removal of free-trade barriers among economies. The allegation of protestors is that the wealthy nations take advantage of the less developed countries via pressuring them to liberalize markets. One may be curious about whether this accusation is true, at least in international investment. This paper aims to answer this question by empirically exploring the comparative benefits of international diversification for domestic investors in different countries.

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The benefits of international diversification have been documented by financial economists over the past four decades. The majority of previous researches investigate strategies and benefits of global diversification from perspective of investors in developed countries, particularly those in the United States.[1] A comparison of international diversification benefits to local investors in various countries was not yet explored. Moreover, to ensure the feasibility of strategies, the impact of disproportional asset allocation on the optimal portfolio needs to be taken into account. The answers to the above issues provide critical insights to financial professionals. The countries in which domestic investors receive comparatively higher benefits from international diversification represent target markets for the asset management industry. The evident enhancement of portfolio performance for investors in less developed countries also implies that liberalizing international investment is a win–win policy that allows both domestic and foreign investors to maximize wealth.

The analyses of global diversification benefits discussed in this paper are different from previous studies in two dimensions. First, this paper evaluates the benefits of diversification from the local perspective in various countries. International investment is critical for investors in newly developed markets with small asset menus. Second, the infeasibility of strategies produced by extreme asset allocation is considered. Previous researches document that the benefits of international diversification are not entirely eroded by short-sale constraints. However, due to the lack of investibility in certain nations,[2] investors may also need to consider the relative magnitudes of market values since they associate to the liquidity of a portfolio. The more constrained optimal portfolios allow international investors to generate more feasible strategies.

Previous empirical evidence has confirmed the improvement of mean-variance efficiency via diversifying internationally. De Roon et al. (2001), Harvey (1995), Li et al. (2003), and Pástor and Stambaugh (2000) showed that domestic investors can enhance investment performance by including foreign assets in a portfolio when short-sales are not allowed. Errunza et al. (1999) find that the benefits of international diversification can be duplicated by utilizing domestically traded American Depositary Receipts (ADRs). Green and Hollifield (1992) and Jagannathan and Ma (2003) demonstrate theoretical models and suggest that extreme portfolio weights cast doubt on the practicability of the optimal asset allocation. This paper explicitly links upper weighting boundaries with sizes of international markets while simultaneously considering non-negative weighting. In addition, since investors often prefer to invest in familiar assets as opposed to unfamiliar securities,[3] the benefits of the "home-biased" international diversification, or regional diversification, for domestic investors also are evaluated in this paper.

There are three reasons that the unattainability of short-sale and extreme weights in international asset allocation need to be taken into account. First, when the portfolio weighting is determined, both the profitability and marketability of investment targets should be taken into account. The centralization of funds in the minor markets recommended by the extreme weights in less-constrained asset allocation strategies may cause illiquidity of the portfolio. Second, the excessive foreign capital in- and out-flows in small markets tend to trigger volatility in asset values. This may generate dramatic alterations in mean-variance efficiencies and correlations in

[1] For a more detailed discussion, please see Bekaert and Urias (1996), Cosset and Suret (1995), De Roon et al. (2001), De Santis and Gerard (1997), Fletcher and Marshall (2005), French and Poterba (1991), Harvey (1995), Li et al. (2003), Novomestky (1997), and Obstfeld (1994).

[2] The investibility of the stock market is decided by the degrees that foreign investors can trade like the local investors in the domestic markets and liquidity of assets. See Bae et al. (2004).

[3] See Grinblatt and Keloharju (2001) and Huberman (2001).