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# The role of country and industry factors during volatile times



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### ABSTRACT

Global stock market investment has highlighted the debate about whether country effects are typically more relevant than sector/industry effects in international stock returns. This paper studies the roles of country and industry effect on several major European financial markets. We find clear evidence that diversification over industries yields fundamental relevance for obtaining more efficient portfolios, and that ignoring the industrial mix leads to an important loss of diversification benefits. In addition we examine the behavior of country and industry effects during high (low) volatility periods. Alluring investors to diversify across industries requires a country to industry effect ratio to be substantially lower during high than low volatility periods. The fact that countries tend to move together during volatile periods posits that industry diversification may provide relatively more protection in crisis. For the entire time span we find that industries provide better protection in times of high volatility relative to countries. However, countries do perform better in absolute terms. Finally, we conclude that investors seeking global representation in their investment portfolios should continue to consider diversifying broadly across both countries and industries. Our findings have important implications for international portfolio diversification.

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## 1. Introduction

Investing globally is an increasing reality. Academic research in recent decades has supported the belief that professionals should not restrict investments to domestic markets because foreign financial markets would bring benefits in terms of decreased risk (through diversification) as well as the ability to increase profitability since a broader investment base would be available.

Nevertheless, the conviction that the globalization course leads to a major international integration of world financial markets presents a new question: should the process of global investments continue to be based on a geographic diversification approach? Or should it be made globally without considering the national dimensions? Based on the hypothesis that considers that the dominance of the country factor has been reduced, the industry factor is certainly the factor of choice.

The traditional selection of country diversification strategies has come into question. The movement toward the Europe unification and market integration affected the typical dominance of country factors and, therefore, revitalized the debate concerning the benefits of international diversification, as well as the question of the relative benefits of diversifying across countries or industries. Even though the evidence on this issue is vast and contradictory, there seems to be a consensus that industry effects have over time grown in importance relative to country effects.

Freiman (1998) reports a dramatic growth in correlations across European countries, and argues that portfolio managers acting in European markets should reconsider country diversification and focus on industry diversification instead. Subsequent studies by Baca et al. (2000), Cavaglia et al. (2000), among others, reinforce and generalize this recommendation by reporting a clear ascending trend in the importance of industry effects relative to country effects.

This vision seems to be accepted by the main market participants. A survey by Goldman Sachs reports that 70% of portfolio managers interviewed had reconsidered their method of asset allocation, and 64% were willing to change to an industry allocation strategy (Brookes, 1999).

Logically, the number of assets traded in different markets implies the need to synthesize information in a narrower set of relevant statistics, grouping the companies involved. One possibility is to build a geographical segregation, considering each national market as a separate entity. Thus, based on the traditional top-down approach, the process begins with the selection of markets (countries) and then the selection of assets within each of the previously selected countries.

If portfolio managers believe that countries' domestic market factors are more important than industry factors in explaining market returns, then the appropriate investment strategy should focus on country allocation and not on industry allocation. On the other hand, if they believe that global economic integration is reducing the distinctions between countries, then an investment process based on industries may be more appropriate.

Regarding country and industry diversification strategies, geographic analysis can be criticized. Countries currently compete in a global environment. For many companies, both their incomes and production activities are truly international, so it is extremely difficult to assign a nationality to a multinational company. However, an analysis by industry/sector is not exempt from criticism. Firstly, there has been over the years a steady rise in cross-industry mergers and acquisitions. Secondly, the possible existence of subjectivity involved in the industry classification process does not always permit a consideration of homogeneous settings.

We believe that the re-examination of this matter continues to be legitimized. From a financial markets perspective, there are a number of changes in the investment environment, and the global integration of financial markets, that demand further investigation. For example, since January 1999, with the introduction of the Euro (where a group of countries formed the Economic and Monetary Union (EMU)), member countries achieve increased stability in exchange rates and convergence of bond yields and interest rates. In theory this might have increased the correlations between national equity markets as the determinants of a company's profits and risk move more closely.

In fact, before integration, countries implemented their own monetary and fiscal policies which differed across the countries given differences in their legal and regulatory frameworks along with cultural differences. However, now that there is greater mobility among European citizens and, given that individual countries' central banks have delegated several important economic policy matters to the European Central Bank, we would expect industry factors to be more

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