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A note on the long-run benefits from international equity diversification for a Taiwan investor diversifying in the US equity market

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Abstract

This note provides evidence that long-run benefits exist for Taiwanese investors diversifying into the US equity market over the period of January 5, 1995 to February 16, 2001. The evidence is based on tests for pairwise cointegration between the Taiwanese national equity index and the equity index for the US. We use five cointegrating tests, namely, the Multivariate Trace statistic, Harris–Inder approach, the Johansen method, the KSS approach, and the partial structural model of Bai and Perron [Bai, J., & Perron, P. (2003). Computation and analysis of multiple structural change models. *Journal of Applied Econometrics*, 18, 1–22]. The results from these five tests are consistent and suggest that the Taiwanese stock market is not pairwise cointegrated with the US stock market. This finding should prove valuable to individual investors and financial institutions holding long-run investment portfolios in these two markets.

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1. Introduction

This purpose of this note is to explore whether there exist long-run benefits from international equity diversification for Taiwanese investors who invest in the US equity

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market. To explore this issue, recent empirical studies have employed cointegration techniques to investigate whether there exist such long-run benefits from international equity diversification (see Arshanapalli & Doukas, 1993; Arshanapalli, Doukas, & Lang, 1995; Chan, Gup, & Pan, 1992; Chowdhury, 1994; Kanas, 1998a, 1998b, 1999; Kasa, 1992; Kwan, Sim, & Cotsomotis, 1995; Masih & Masih, 1997; Roger, 1994; Taylor & Tonks, 1989). According to these studies, asset prices from two different efficient markets cannot be cointegrated. If a pair of stock prices is cointegrated, then one stock price can be forecast from the other stock price. If that is the case, there are no gains from portfolio diversification.

Here, we examine this issue for the US and Taiwanese equity markets. We use five tests for cointegration: the Multivariate Trace statistic, the Harris–Inder approach, the Johansen method, the KSS approach, and the partial structural model of Bai and Perron (2003). The results from all five tests suggest that the Taiwanese market is not pairwise-cointegrated with the US equity market during the period from January 5, 1995 to February 16, 2001. Our finding of no cointegration can be interpreted as evidence that there is no long-run linkage between the Taiwanese and the US markets, and thus, there exist potential gains for Taiwan investors from diversifying in the US equity markets or vice versa. This result should prove valuable to individual investors and financial institutions.

The main reason for us to choose these two markets is that there exists strong international trade-ties between Taiwan and the US. For the year 2002, the share of Taiwan exports to the US was 20.5% and the share of Taiwan imports from the US was 24.2%, respectively (see Table 1). For the year 2002, Taiwan ranks as the eighth largest trading partner for the US.

There are two motivations for this note. First, Taiwan is a rapidly expanding emerging market, and a significant number of Taiwan investors have adopted diversification benefits as the primary criterion in investing outside Taiwan. Second, the rapid growth of the Taiwan economy has attracted the attention of international investors, and both Dow Jones and Morgan Stanley have included Taiwan stocks in their international indices beginning September 1997. This suggests that the issue of international linkages to the Taiwan share market is of practical interest to a number of international investors.

Table 1
International trade between Taiwan and the US, 1995–2002

Year	Share of exports to US (%)	Total exports rest of the world (%)	Share of imports out of US (%)	Total imports rest of the world (%)
1995	23.7	76.3	29.2	70.8
1996	23.2	76.8	26.9	73.1
1997	24.2	75.8	25.4	74.6
1998	26.6	73.4	25.8	74.2
1999	25.4	74.6	27.6	73.4
2000	23.5	76.5	27.5	72.5
2001	22.5	77.5	24.1	75.9
2002	20.5	79.5	24.2	75.8

Source: Taiwan Statistical Data Book (2003).

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