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Country selection of emerging equity markets: benefits from country attribute diversification

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Abstract

We propose a multivariate scoring model based on four classes of variables to predict future returns of 23 emerging equity markets. For the periods 1986–1995 and 1996–2003, our long–short portfolio (11 top/bottom ranked countries) posts a quarterly significant average raw return and a quarterly significant average market risk-adjusted return. The all-classes model dominates the one-class-models. Results from this strategy are robust regardless of whether we concentrate on the 6 top/bottom countries, reduce the emerging market universe to the largest countries, eliminate the most rewarding country during the period, use different scores, or account for realistic implementation costs.

JEL classification: G11; G15

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1. Introduction

During the 1990s, capital flows to emerging markets increased dramatically. This increase was due mainly to the structural changes and economic liberalization that

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took place in many of these markets. These changes were beneficial and had a significant impact on the local markets. During the first half of the 1990s, emerging markets offered high rates of returns, high risk, and low correlations with developed markets. Over the last half of the 1990s, the performance characteristics of emerging markets changed because of financial crises and the financial and economic integration of emerging markets with the developed markets (Bekaert et al., 1997; Bruner et al., 2003).

These changes raise several questions for international investors about the benefits of investing in emerging markets and how to select performing emerging markets. However, despite these questions, the potential return of these markets remain higher than those of their developed market counterparts. Bruner et al. (2003) note that at the end of December 2002, emerging markets represent 10.5% of the world market capitalization while they account for 20% of the world GDP.

Another source of concern related to emerging markets is whether investors should focus mainly on country, or industry selection. Bekaert et al. (1997) document an increasing integration between emerging markets and developed markets. Bilson et al. (2001) and Bruner et al. (2003) find evidence that emerging markets remain at least partially segmented and that country factors dominate industry factors in explaining cross-sectional variations among individual stocks. Country diversification is therefore more important than industry diversification for institutional investors.

The risk of investing in emerging markets depends mainly on local factors, and active management should focus on country selection. Serra (2000) also concludes that emerging markets returns are driven mainly by country factors. Van Der Hart et al. (2003) examine a global bottom-up multivariate trading strategy based on the 15% of top ranked stocks. They find that this global strategy is potentially more rewarding, but riskier than a country-neutral strategy. Using a normative approach and a bootstrap method, Estrada et al. (2004) corroborate this general conclusion, but underline that while the conclusion may hold for Asia, it is not as conclusive for Latin America, and Europe, Middle East, and Africa (EMEA).

Previous studies have attempted to identify the most important factors for country selection among emerging markets. Bekaert et al. (1997) examine a comprehensive set of country-specific risk attributes over the January 1985–August 1996 period. They find that long–short portfolios based on country risk, trade-to-GDP or earnings-to-price measures post-significant returns. Kargin (2002) examines a long-only strategy based on the book-to-market ratio, the return on equity, plus a persistence variable. An equally weighted portfolio including the eight countries having the highest regression-forecast returns outperforms the equally and value-weighted emerging markets indexes over the period going from August 1991 to August 2001.

In this paper, we investigate a country selection model for emerging equity markets. We use an ex ante approach and propose an investable strategy based on seven predictive variables. We focus on four classes of predictive variables of emerging market returns: fundamental, macroeconomic, technical, and country risk.

In the same vein as Van Der Hart et al. (2003) who document that multivariate strategies outperform univariate strategies, we examine the diversification benefits that