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# Emerging market benefits, investability and the rule of law

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ABSTRACT

We revisit the Barry, Peavy and Rodriguez (1998) paper and investigate the underlying source of emerging market performance benefits. We classify stocks according to their investability and legal origin. Emerging markets continue to represent the performance benefits they had during the Barry et al. (1998) period by providing not only return enhancement but primarily risk-reduction. More specifically, we find that an investor can achieve greater benefits by focusing on a limited set of emerging markets with a French civil law foundation and that are moderately investable stocks.


> "Capital markets in developing countries have become an important asset class. These emerging markets are commonly associated with high returns, high volatility, and diversification benefits for investors in developed markets"Barry, Peavy and RodriguezFinancial Analysts Journal, 1998.

The beneficial inclusion of emerging market stocks in developed market portfolios is something generally advocated and believed today. Indeed the overwhelming capital flows channeled into these markets over the past decade are testimony to their return enhancement and diversification potential. This capital allocation to emerging markets is in part due to the academic work documenting the benefits of including emerging market

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assets in developed market portfolios. Beginning with the seminal works of Solnik (1974), Errunza (1977), Harvey (1991, 1995), Bekaert and Harvey (1997, 2002a,b, 2003) and continuing to Barry et al. (1998) and beyond, the performance characteristics, both relative and absolute, of emerging market indices and stocks have been widely and thoroughly investigated. The general conclusion, following Barry et al. (1998), is that investors gain higher returns and lower volatility in their overall portfolio over time by including holdings of emerging markets stocks as represented by their country-level indices. What remains in part, as they note in their concluding remarks, is to investigate the underlying source of the performance benefits.

We revisit the Barry et al. (1998) paper to answer three questions:

1) As markets have become more global and integrated, has the benefit from investing in emerging market stocks changed particularly for those stocks that are investable?
2) Has the increased level of holding emerging market stocks changed the level of inclusion at which they should appear in investor portfolios[2]?
3) Are there characteristics logically associated with the legal traditions and families of the differing emerging markets that suggest allocation to individual emerging markets should occur along lines of legal tradition?[3]

Emerging market capitalization has soared in recent years, growing from less than $2 trillion in 1995 to over $12.87 trillion in 2009.[4] Developing markets account for approximately 84% of the world's population in 2009 and 26.8% of the world's GNI.[5] As in 1998, the emerging markets in 2008 exhibited high growth rates (7% GDP growth in emerging markets compared with 2% growth globally[6]) and the potential for continuing such rates into the future. We end our sample in 2006 due to data constraints and uncharacteristically volatile world markets. While investigation of the value of emerging market diversification during the financial crises may prove insightful, such an analysis would be premature until the crisis has ended and the recovery is complete. Recent work by Reinhart and Reinhart (2010) suggests that a return to "normality" could take as much as a decade. In addition, there is continued debate regarding this matter including a failure to declare the recession over by the National Bureau of Economic Research (Tseng, 2010). Given the wide-spread turmoil in global markets in 2007–2009, analysis of this period shows abnormal patterns and would not be representative of the role developing markets play. Prior to the financial crises, the volatility of world market monthly returns, as measured by the standard deviation of the monthly return to the Morgan Stanley Capital International World Index (MXWO), for the 3 years prior to the crises (2004–2006), was 0.023 or 2.3% per month while during the crises (2007–2009) it was 0.062 or 6.2% per month.[7] Finally, Barry et al. (1998) cast doubt on the availability of diversification benefits during such tumultuous periods.

Over the decade prior to the crises, financial markets have responded to the diversification benefits and return enhancement available in emerging markets by channeling (pouring) capital into these markets and even going so far as to create products designed to be attractive to investors interested in particular markets or sets of markets. By far, the most well-known of these are the BRIC funds which represent the high growth economies of Brazil, Russia, India and China. Accordingly, during our analysis, we also analyze

[2] Barry et al. (1998) note in their concluding remarks that the optimal allocation to emerging markets changes from period to period. The answer to this question is effectively an update of their findings with regards to the proportion of the portfolio allocated to emerging markets.

[3] In addition to the emerging markets, the World Bank now recognizes a classification of markets known as frontier markets. In our follow up paper, we explore the role of frontier markets in the portfolio allocation and diversification process.

[4] Source: World Development Indicators (WDI).

[5] Source: World Development Indicators (WDI). The sample markets we use in this paper account for 63% of the world population.

[6] Source: World Development Indicators (WDI).

[7] The variance estimates for these two periods are statistically significantly different at the $p = 0.0001$ level. For robustness, the average monthly standard deviation for the same index over the 7 non-overlapping 3 year periods within our sample is 0.041 or 4.1% per month. The difference between the average variance of monthly returns across the non-overlapping 3 year periods prior to the crises is different from the crises period monthly variance at the $p = 0.0002$ level.