



Financial integration and the price of world covariance risk: Large- vs. small-cap stocks

Wei Huang*

Shidler College of Business, University of Hawai'i at Manoa, Honolulu, HI 96822, USA

Abstract

We investigate whether recent country-level evidence of global pricing is particular to large-cap stocks. Specifically, we examine cross-country return correlations and conduct asset pricing tests on three size-based stock portfolios for nine developed countries over the period from 1980 to 2004. We find that large-cap stocks realize significant comovements across countries, whereas small-cap stocks realize smaller average correlations (relative to both large-cap stocks and small-cap stocks across countries). More important, asset pricing tests suggest that while large-cap stocks are priced globally, global pricing is rejected for most small-cap stocks. Finally, the evidence indicates that financial integration deepened in recent years primarily for large-cap stocks. Overall, the results suggest that the global pricing pertains chiefly to large-cap stocks.

© 2007 Elsevier Ltd. All rights reserved.

JEL classification: G12; G15

Keywords: Financial integration; International asset pricing; World covariance risk; MSCI indices

1. Introduction

Whether the world's equity markets are integrated and securities are priced globally has important implications for both the determination of the cost of equity capital and international portfolio diversification. Accordingly, a large literature in international finance focuses on determining the extent of global pricing.

* Tel.: +1 808 956 7679; fax: +1 808 956 9887.

E-mail address: weih@hawaii.edu

Early studies present empirical evidence that generally supports the segmentation hypothesis. Using simple beta factor models, Solnik (1974) and Stehle (1977) conducted tests on large-cap stocks from the U.S. and other developed markets and report evidence that is consistent with market segmentation. Building on their work, several studies examine whether the developed markets of Canada (Jorion and Schwartz, 1986; Mittoo, 1992) and Japan (Gultekin et al., 1989; Campbell and Hamao, 1992) are integrated with that of the U.S. market. They find evidence of segmentation prior to the liberalization of the stock markets in the early 1980s, with some evidence of integration afterwards. In early tests of global pricing in a multimarket context, Korajczyk and Viallet (1989) find support for market segmentation. In contrast, the literature since the 1990s, which is generally based on conditional international asset pricing models (IAPM) that capture time-varying risk premia, increasingly tends to present evidence in support of equity market integration. For example, using returns on national or regional stock indices, Harvey (1991), Chan et al. (1992), and De Santis and Gerard (1997) provide strong evidence in support of the global pricing hypothesis.

With very few exceptions, all of the above studies analyze cross-country integration at the national equity market level, that is, these papers primarily use aggregate market indices.¹ Researchers have recently started to ask, however, whether evidence of country-level integration necessarily implies the integration of equity market segments within countries. Fedorov and Sarkissian (2000) make the first attempt to quantify the integration process across different industry sectors and market capitalization groups. Focusing on the Russian equity market, they find that the degree of integration is weaker for portfolios of less diversified industries and for smaller-sized portfolios, but is stronger for stocks that have overseas listings or international sales. The results of their study may not generalize, however, due to the fact that, historically, political intervention has segmented the Russian equity market from the global system. In an extension, Carrieri et al. (2004) explore industry-level global integration for the G-7 industrialized countries and find that integration at the country level does not preclude segmentation at the industry level.

Building on the above research, this paper investigates subcountry-level financial integration in a multicountry framework by examining whether the evidence of global pricing based on market indices is particular to large-cap stocks. This question is motivated first by the well-known fact that national indices such as the S&P 500 index or the Morgan Stanley Capital International (MSCI) indices are constructed mostly from large-cap stocks.² A country's stock market indices are likely to be priced globally to the extent that the country's large-cap stocks have greater international operations and consequently greater exposure to global risk.

Furthermore, because a country's large-cap stocks are more likely to be cross-listed in foreign equity markets, and international portfolio investments tend to be concentrated in large-cap stocks, these stocks thus have greater investor recognition and face less direct or indirect

¹ Korajczyk and Viallet (1989) test global pricing by contrasting domestic and international asset pricing models using stock portfolios from the U.S., Japan, the U.K., and France over the 1969–1983 period. They document that small-sized portfolios generally realize larger mispricing than large-sized portfolios. However, the focus of Korajczyk and Viallet is on the performance of different versions of the asset pricing models.

² According to www.msci.com, for example, the 391 stocks included in the MSCI U.S. Index as of September 1997 represent 65% of the total estimated U.S. domestic market capitalization. This pattern is similar for other developed markets.

متن کامل مقاله

دریافت فوری ←

ISIArticles

مرجع مقالات تخصصی ایران

- ✓ امکان دانلود نسخه تمام متن مقالات انگلیسی
- ✓ امکان دانلود نسخه ترجمه شده مقالات
- ✓ پذیرش سفارش ترجمه تخصصی
- ✓ امکان جستجو در آرشیو جامعی از صدها موضوع و هزاران مقاله
- ✓ امکان دانلود رایگان ۲ صفحه اول هر مقاله
- ✓ امکان پرداخت اینترنتی با کلیه کارت های عضو شتاب
- ✓ دانلود فوری مقاله پس از پرداخت آنلاین
- ✓ پشتیبانی کامل خرید با بهره مندی از سیستم هوشمند رهگیری سفارشات