

Chapter 22 Managing an International Investment Portfolio

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Overcoming capital flow barriers

> Domestic-based MNCs

- **Advantage**
Domestically-based MNCs are familiar and accessible to domestic investors
- **Disadvantage**
MNC share prices move more closely with the domestic stock market than with international markets

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Overcoming capital flow barriers

- > Domestic-based MNCs
- > **Individual foreign securities**
 - Direct purchase in the foreign market
 - Direct purchase in the domestic market
 - **Foreign shares**
(American shares in the US)
 - **Depository receipts**
(ADRs in the US)

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Overcoming capital flow barriers

- > Domestic-based MNCs
- > Individual foreign securities
- > **Mutual funds of foreign assets**
 - **Mutual funds** (open-end or closed-end)
 - Many mutual funds are exchange-listed
 - **Closed-end country funds (CECFs)**
 - CECFs trading on the NYSE include Brazil, Germany, Italy, India, Korea, Mexico, Malaysia, S. Africa, Spain, Switzerland, Taiwan, Thailand, UK

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Overcoming capital flow barriers

- > Domestic-based MNCs
- > Individual foreign securities
- > Mutual funds of foreign assets
- > **Hedge funds**
 - **Private investment partnerships**
 - In the U.S., hedge funds have a **general manager**, fewer than 100 **limited partners**, and are **not regulated** by the SEC

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Hedge fund strategies

- > A wide variety...
 - Emerging markets
 - Market-neutral
 - Opportunistic
 - Short-selling
 - Small-cap
 - Special situations
 - Value
 - Arbitrage
 - e.g., yield-curve arbitrage

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Overcoming capital flow barriers

- Domestic-based MNCs
- Individual foreign securities
- Mutual funds of foreign assets
- Hedge funds
- **Other international investment vehicles**
 - Equity-linked bonds
 - Index futures, options or swaps

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Share prices in restricted markets

- Governments allow restricted access to their financial markets through
 - **Closed-end country funds** (CECFs) (mutual funds invested in a single country)
 - **Unrestricted shares** sold internationally (only domestic investors can hold restricted shares)
- CECFs and unrestricted shares can trade at substantial premiums to **net asset value** (NAV)

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Explanations for share prices in segmented markets

- **International asset pricing with investment restrictions**
 - A classic portfolio maximization argument
 - Assumes rational investors maximizing the mean-variance efficiency of their portfolios

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Explanations for share prices in segmented markets

- **International asset pricing with investment restrictions**
- **Investor sentiment**
 - Individual investors trade on their (possibly irrational) sentiment regarding future returns and risks
 - Premiums are large when foreign investor demand is high

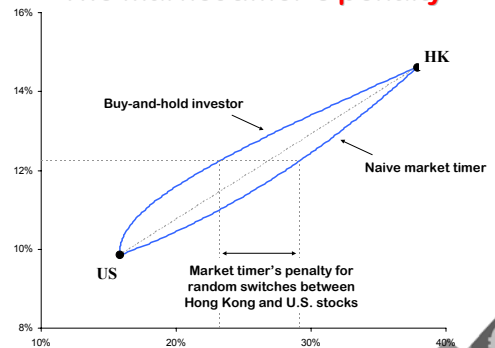
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Portfolio investment styles

- **Asset allocation policy**
 - A fund's target weights on various asset classes
- **Investment philosophy**
 - **Passive fund management**
 - Benchmarked to an index
 - **Active fund management**
 - Active asset allocation
 - Active security selection

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The market timer's penalty



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Financial accounting measurement

> **Cross-country financial statement analysis** is difficult because of **national differences** in the **measurement of accounting income**

- Differences show up in the construction of nearly every financial account
- National accounting differences can result in huge differences in reported income

Financial accounting disclosure

> There are also cross-border differences in **financial disclosure** requirements

- > **Alternatives for providing financial information to investors in another country**
 - Do nothing
 - Prepare **convenience translations**
 - Using **different accounting principles**, such as IAS standards, in preparing the firm's financial statements

Portfolio analysis

> **Inputs to portfolio analysis**

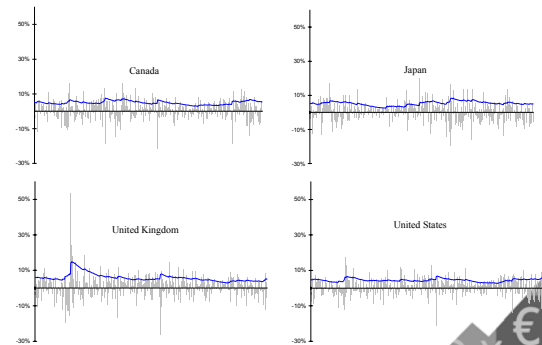
$$E[r_P] = \sum_i X_i E[r_i]$$

$$\sigma_P^2 = \sum_i \sum_j X_i X_j \sigma_{ij}$$

> **The shifting sands of portfolio analysis**

- Time-varying **expected returns & risk premia**
- Time-varying **volatilities**
- Time-varying **correlations**

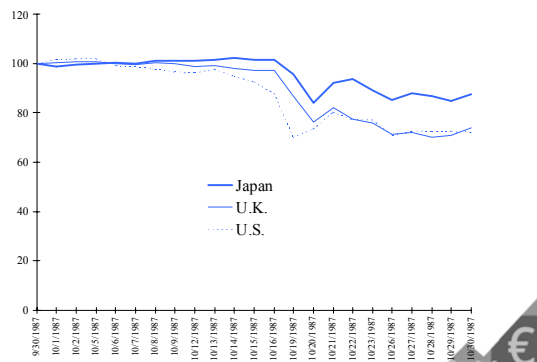
Time-varying volatility, 1970-2002



60-month rolling correlations with the U.S. stock market



Returns during the crash of 1987



When it rains, it pours...

> Fact

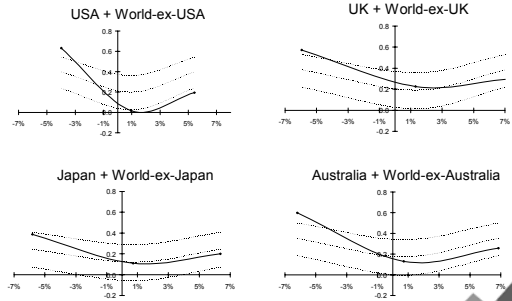
Observed correlations are higher during market downturns than conventional models predict

> Consequence

International diversification may fail to yield its promised gains just when they are most needed

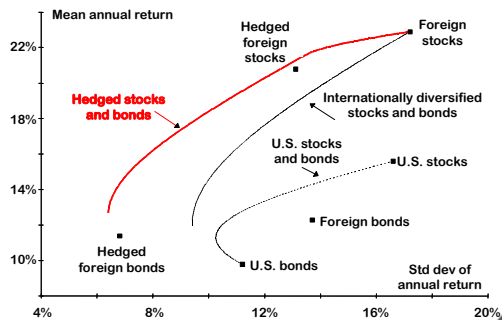
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Stock market correlations in bear, calm, and bull markets



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The benefits of currency risk hedging



Adapted from "Asset Allocation with Hedged and Unhedged Foreign Stocks and Bonds" by Philippe Jorion, *Journal of Portfolio Management*, Summer 1989, p.49-54.

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