

Lectures 04.04.01, 04.09.01 & 04.11.01: International Asset Portfolios

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Plan

- Levich, Chapters 14 and 15

- ◆ Bond portfolio

Risks: hedge or not to hedge?

- ◆ Equity portfolio

- ◆ major types of equity portfolios

- ◆ cross-country differences

- ◆ Home country bias

[over-investment in domestic assets]

common for both types of international portfolios

Bond portfolio I

- Two components of associated risk: [for unhedged foreign bond]
 - ◆ 1. Variability in foreign bond prices
[country interest rate risk]
 - ◆ 2. Variability in foreign exchange rate
[central bank risk]
 - ◆ and the covariance between them
[Levich, pp. 525 – 526 and Table 14.2]
 - ◆ + exposure to changes in
credit risk, exchange controls & the risk of default
- Empirics [Facts]
 - ◆ International bond returns are weakly correlated
 - ◆ Three heavily concentrated markets:
US, EU countries, Japan

Bond portfolio II

- Terms [Jargon]:
 - ◆ Non-hedged portfolios under-perform
 - ◆ Passively hedged portfolios
 - ◆ Passively hedged portfolios under-perform
 - ◆ Actively hedged portfolios
 - ✦ [tactical (based on technical rules) or
 - ✦ Overlay (always hedge currency risk)]
 - ◆ Brady Bonds (1989)
[to resolve emerging market debt issues]
<http://www.brady.net.com>

Equity portfolio: I

- Associated risks [similar to bond portfolios]
Levich, p. 573 [compare to p. 539]
- Institutional aspects
Market size & concentration, trading volume
Transaction taxes & costs, clearing & settlement
- Main types of Funds [p. 566]
 - ◆ Close-End and Open-End Funds
 - ◆ Country Baskets (CBs)
 - ◆ World Equity Benchmark Shares (WEBS)!
 - ◆ Regional Funds
 - ◆ Industry Funds

Equity portfolio: II

- Pricing, Levich, pp. 577-579
 - ◆ Generalized capital asset pricing model (CAPM) [p. 578]
 - Unrealistic assumptions:
 - (no transaction costs & taxes,
 - returns are in nominal terms
 - existence of a risk-free asset
 - investor utility depends only on expected return and risk)
 - ◆ Arbitrage pricing theory (APT) [p. 579]
 - (a set of `factors` drive equity returns)
- Importance of financial variables as factors*

Home country bias: Possible explanations

- ◆ Barriers to international investment
- ◆ Regulatory and tax reasons [& uncertainty]
- ◆ High share of non-tradables in consumption
- ◆ Substitution of investment in foreign assets by investment in multinational corporations (MNC)
- ◆ Informational imperfections
- ◆ Endogenous currency exchange risk
[increasing in the volume of foreign exchange market]

Summary of the Material

- ◆ Bonds and Equity international portfolio
 - ◆ Common features:
 - Exposure to exchange rate risk
 - Cross country regulatory & tax differences
 - Robust home country bias
 - ◆ Current trends
 - Increased correlation of returns between mature markets
 - Increased market volatility & its correlation with high correlation of returns
 - ➔ Lower gains from diversification
 - Low correlation with emerging markets
 - ➔ Emerging markets are good for diversification

What is next:

- Summary of what we have learned