International Investment And Correlation Breakdown: Evidence From Emerging Stock Markets

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ABSTRACT

The motivation for international investment is to reduce the risk of a portfolio through international diversification. Because diversification allows for the same portfolio return but reduced risk. International diversification refers to diversifying internationally because correlations between country markets are less than 1.0. Therefore, an attractively low correlation between national markets is quite needed when investors construct a global portfolio.

As economies and financial markets are becoming increasingly integrated, the correlation coefficient is expected to increase over time. But, what is really troubling is that correlation seems to increase dramatically in periods of high market volatility, so that the benefits of international diversification disappear when they are most needed. This phenomenon is referred to as "correlation breakdown".

This study aims to examine the correlation between emerging stock market and developed stock market. The purpose is to analyze whether a correlation breakdown occurs in emerging markets and hence lead the benefits of diversification disappear in the worst possible time.

The study is conducted by first test the changes in correlation coefficient during 1995-2006, which is called unconditional correlation estimates. Second, test the correlation coefficient during the period of high market volatility, and this is called conditional correlation estimates.

Throughout the findings of the study, we find that the correlation conditional on large monthly variances is much higher than the overall unconditional correlation. Therefore, we make a conclusion of the correlation breakdown and note that the benefits arising from international diversification are curtailed. At the end give recommendations that may help investors to construct a well-diversified portfolio.

Keyword: international investment, international diversification, market volatility, unconditional correlation, conditional correlation, correlation breakdown.