BACHELOR of ECONOMICS
International Program

Thammasat University | Thailand

FN 312 Investments

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Global investing

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Outline

- The project
- General evidence on global investing
- Risk investing internationally

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Project: numerical analysis

- Estimate variance/covariance and average returns from monthly returns (convert from index levels)
- Generate the efficient frontier
- Choose the risk free rate and obtain global optimum portfolio
- Depending on the risk free rate, you will get different global optimum portfolio

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Project: numerical analysis

- Choose the US risk free rate such as T-bills, T-notes, or T-bonds rates available today for investing at a specific future investment horizon
- Answer why US risk-free rate in the project write up

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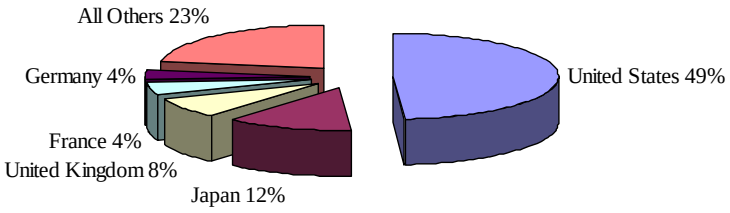
Global Portfolio Shares

Based on USD Value of Country Equity Markets



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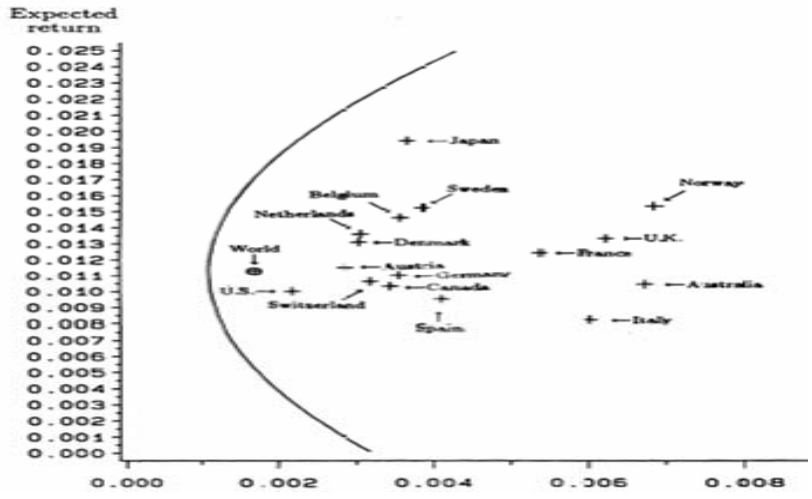
Global Efficient Frontier

Source: The World Price of Covariance Risk Harvey (1991) *Journal of Finance*



Domestic ownership shares

TABLE 1—EQUITY PORTFOLIO WEIGHTS: BRITISH, JAPANESE, U.S. INVESTORS

	Portfolio Weight			Adj. Market Value
	U.S.	Japan	U.K.	
U.S.	.938	.0131	.059	$2941.3
Japan	.031	.9811	.048	1632.9
U.K.	.011	.0019	.820	849.8
France	.005	.0013	.032	265.4
Germany	.005	.0013	.035	235.8
Canada	.010	.0012	.006	233.5

- International share ownership has increased over the years but investors still invest too little internationally based on a simple portfolio theory model.

Issues investing globally

- What are the risks involved in investment in foreign securities?
- How do you measure benchmark returns on foreign investments?
- Are there benefits to diversification in foreign securities?

Why not?

1. Information asymmetry: Lack of knowledge/information relative to local investors
   - Coverage in local media
   - Ability to talk to employees, managers, suppliers, customers
   - Personal ties/knowledge of top managers
   - Evidence of “home bias at home” (Journal of finance)

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Home Bias at Home: Local Equity Preference in Domestic Portfolios

- Asymmetric information between local and nonlocal investors has a significant impact on the preference for local stocks

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Why not?

2. Different corporate governance
   - In many foreign markets, companies are controlled by founding families
   - Laxer reporting standards
   - Greater possibility of managers extracting private benefits at the expense of other shareholders
3. Different accounting standards
4. Country risk such as political risk

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Measuring country risk

- Political Risk Services Group Ratings
  - Rank countries with respect to political risk, financial risk and economic risk
  - Political Risk Variables
    - Government stability, corruption etc
  - Financial Risk Variables
    - Foreign debt (%GDP), Exchange rate stability
  - Economic Risk Variables
    - GDP per capita, annual inflation etc

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Country Specific Risk

Political Risk Services Group Ratings

Rank countries with respect to political risk, financial risk and economic risk

Assign composite rating from very high risk to very low risk based on the above elements of risk

Table 25.4 Composite Risk Ratings for October 2004 and November 2003

TABLE 25.4

Composite risk ratings for October 2004 and November 2003

Rank in 10/04	Country	Composite Risk Rating 10/04	10/04 minus 11/03	Rank in 11/03
	Very low risk			
1	Norway	92.3	1.75	2
14	Japan	84.5	−1.75	9
15	United Kingdom	84.0	0	17
	Low risk			
42	United States	77.5	1.75	48
44	China, People's Republic	76.8	−0.5	40
55	Mexico	74.8	4.25	65
67	India	71.8	2.75	72
	Moderate risk			
86	Argentina	67.5	3.5	92
109	Indonesia	62.5	1.75	108
	High risk			
119	Lebanon	59.0	3.5	124
125	Sierra Leone	58.3	7.5	133
	Very high risk			
139	Iraq	38.0	−3.5	138
140	Zimbabwe	36.3	2	140

Source: *International Country Risk Guide*. October 2004, Table 1. © The PRS Group, Inc., E. Syracuse, NY. Used by permission.

Table 25.5 The Three Ratings that Comprise ICRG's Composite Risk Rating

Political Risk Variables	Financial Risk Variables	Economic Risk Variables
Government stability	Foreign debt (% of GDP)	GDP per capita
Socioeconomic conditions	Foreign debt service (% of GDP)	Real annual GDP growth
Investment profile	Current account (% of exports)	Annual inflation rate
Internal conflicts	Net liquidity in months of imports	Budget balance (% of GDP)
External conflicts	Exchange rate stability	Current account balance (% GDP)
Corruption		
Military in politics		
Religious tensions		
Law and order		
Ethnic tensions		
Democratic accountability		
Bureaucracy quality		

TABLE 25.5

The three ratings that comprise ICRG's composite risk rating

Table 25.6 Current Risk Ratings and Composite Risk Forecasts

Country	Composite Ratings: Year Ago Nov. 4	Composite Ratings: Current Oct. 4	Current Ratings: Political Risk Oct. 4	Current Ratings: Financial Risk Oct. 4	Current Ratings: Economic Risk Oct. 4
Japan	86.3	**84.5**	82	46.5	40.5
United States	75.8	**77.5**	82	33.5	39.5
China, People's Rep.	77.3	**76.8**	70.5	44.5	38.5
India	69	**71.8**	63.5	44.5	35.5
Indonesia	60.8	**62.5**	50.5	37.5	37

Source: *International Country Risk Guide*, October 2004, Table 2B. © The PRS Group, Inc., E. Syracuse, NY. Used by permission.

TABLE 25.6

Current risk ratings and composite risk forecasts

Table 25.7 Composite and Political Risk Forecasts

A. Composite risk forecasts

Country	Current Rating, Oct. 2004	1 Year Ahead: Worst Case	1 Year Ahead: Best Case	1 Year Ahead: Risk Stability	5 Years Ahead: Worst Case	5 Years Ahead: Best Case	5 Years Ahead: Risk Stability
Japan	**84.5**	81.8	86.5	4.8	76.5	90.0	13.5
United States	**77.5**	73.3	79.8	6.5	72.8	83.5	10.8
China	**76.8**	74.0	78.0	4.0	62.8	81.8	19.0
India	**71.8**	69.3	74.3	5.0	63.8	77.3	13.5
Indonesia	**62.5**	60.5	65.3	4.8	55.0	72.0	17.0

B. Political risk forecasts

Country	Current Rating Oct. 2004	1 Year Ahead: Worst Case	1 Year Ahead: Best Case	1 Year Ahead: Risk Stability	5 Years Ahead: Worst Case	5 Years Ahead: Best Case	5 Years Ahead: Risk Stability
Japan	**82.0**	80.5	84.0	12.0	76.0	94.0	18.0
United States	**82.0**	80.5	84.0	15.0	80.0	88.0	8.0
China	**70.5**	69.0	72.5	7.0	60.0	74.0	14.0
India	**63.5**	62.0	65.5	13.0	58.0	67.0	9.0
Indonesia	**50.5**	40.0	52.5	10.0	40.0	64.0	24.0

TABLE 25.7

Composite and political risk forecasts

Sources: *panel A, International Country Risk Guide*, October 2004, Table 2C; *Panel B, International Country Risk Guide*, October 2004, Table 3C. © The PRS Group, Inc., E. Syracuse, NY. Used by permission.

Table 25.8 Political Risk Points by Component, October 2004

This table lists the total points for each of the following political risk components out of the maximum points indicated. The final columns in the table show the overall political risk rating (the sum of the points awarded to each component) and the change from the preceding month.

A	Government stability	12	G	Military in politics	6
B	Socioeconomic conditions	12	H	Religious tensions	6
C	Investment profile	12	I	Law and order	6
D	Internal conflict	12	J	Ethnic tensions	6
E	External conflict	12	K	Democratic accountability	6
F	Corruption	6	L	Bureaucracy quality	4

Country	A	B	C	D	E	F	G	H	I	J	K	L	Political Risk Rating, Oct. 2004	Change from Sept. 2004
Japan	9.0	8.0	11.5	10.5	9.5	3.5	5.0	5.5	5.0	5.5	5.0	4.0	82.0	–1.5
United States	9.5	8.0	11.5	10.5	8.0	5.0	4.0	5.5	5.0	5.0	6.0	4.0	82.0	–0.5
China, People's Rep.	11.0	7.0	7.5	11.5	11.0	2.0	3.0	5.0	4.5	5.0	1.0	2.0	70.5	0.0
India	8.0	3.5	9.0	8.5	10.0	2.5	4.0	2.5	4.0	2.5	6.0	3.0	63.5	0.0
Indonesia	5.5	3.5	6.5	7.5	11.0	1.0	2.5	1.0	3.0	2.0	5.0	2.0	50.5	–1.0

TABLE 25.8

Political risk points by component, October 2004

Source: *International Country Risk Guide*, October 2004, Table 3B. © The PRS Group, Inc., E. Syracuse, NY. Used by permission.

How to Invest in International Stocks

- Invest directly overseas
  - High transaction costs and hassle factor
- Invest in Country Funds
  - Actively traded mutual Funds
  - International index Funds
  - Exchange Traded Funds such as WEBS
- Invest in ADRs (American Depositary Receipts)
- Invest in ETFs

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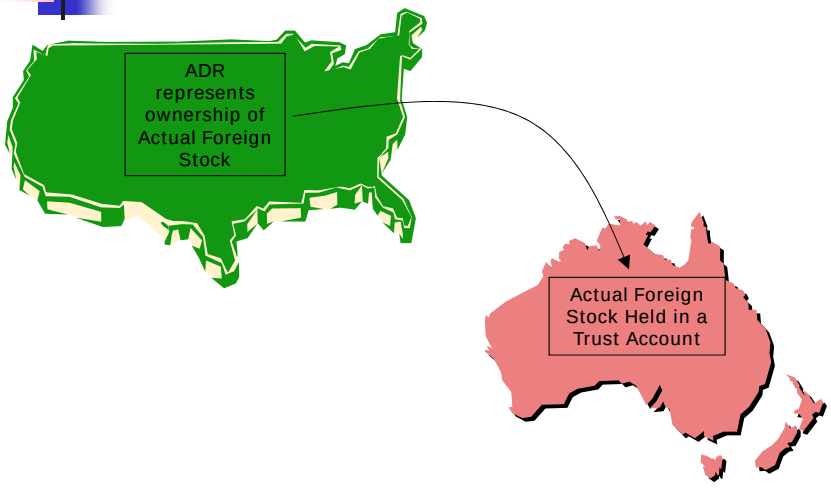
American Depositary Receipt



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ADR details

- 2,000 foreign firms from over 70 countries trade in U.S. via ADRs
- Level I
  - Trade OTC
  - Only partial SEC registration
  - U.S. GAAP not required
- Level II and III
  - Trade on Nasdaq, NYSE, or AMEX
  - Requires full SEC registration and U.S. GAAP
  - Level III for raising capital
- Private placements

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Summary

- Theoretical gains to international diversification
- Measured gains to international diversification depend on measurement window
- Reasons to be cautious

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