



you run
with the ball



Economist.com

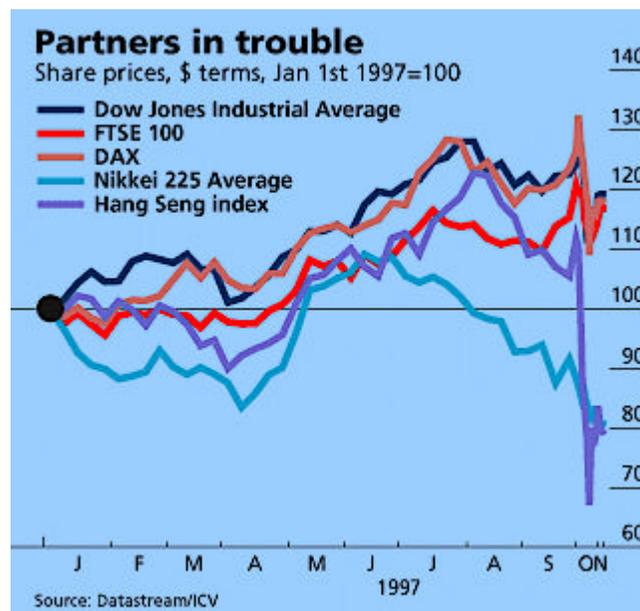
FINANCE & ECONOMICS

All fall down

Nov 6th 1997

From The Economist print edition

Last week investors who had bought shares in different countries lost money everywhere. That does not alter the case for diversification



THE near-crash in stockmarkets last week was truly a global event. Although Hong Kong and Wall Street led the descent, hardly a single stockmarket did not experience a sharp fall in prices. Those investors not shaken by their losses were left with something more fundamental to worry about: does the fact that so many markets moved so sharply in the same direction at the same time undermine their entire investment strategy?

During the past decade or so, investors everywhere have rushed to buy foreign shares. That is exactly what economic theory counsels. Efficient portfolio theory, developed since the 1970s, formalises the old saw, "don't put all your eggs in one basket". The theory assumes that investors want as high a return as possible for the amount of risk they are willing to bear—or to get the return they want by taking as little risk as possible. If stockmarkets in different countries tend to rise and fall at different times, the theory implies, investors can reduce their risk—meaning the amount by which their returns vary from one year to the next—by including foreign shares in their portfolios.

Events such as last week's market tumbles call this strategy into question. If an investor has put money into foreign markets which are highly correlated with his home market, then all of the investor's eggs are still, in effect, in the same basket. In that case, buying foreign shares will not reduce the variability of the investor's returns. But last week's global crash should not sound the death knell for international diversification. Although the world's stockmarkets mostly fell, the degree of correlation should not be overstated. Some markets dropped much further than others. And some rebounded quickly while others did not.

Where's the news?

In theory, share prices should change only if there is fresh news affecting valuations. For all the world's stockmarkets to move in the same direction at once, there ought to be some piece of news significant enough to affect valuations everywhere in the same way. The fact that some markets, including Wall Street's, recovered quickly suggests that the fall was based on short-lived copy-cat behaviour by traders worried by steep share-price drops in Hong Kong, rather than by important new information about the value of American shares.

Moreover, much like the October 1987 crash, last week's global tumble was the exception that proves the rule. The occasional crash aside, there has been no great increase in correlation between stockmarkets in different countries for several decades, according to Bruno Solnik, an economist at the Haute Ecole de Commerce in Paris. Among nine big economies, stockmarket correlations have averaged around 0.5 since the 1960s. In other words, for every 1% rise (or fall) in, say, American share prices, share prices in the other markets will typically rise (fall) by 0.5%. One reason for this may be that at least one of the big economies has always been out of line with the rest since the 1960s, its shares tending to fall while others are rising or vice versa.

But, as a sign of what may lie ahead, Mr Solnik has spotted an increase in the correlation of stockmarkets within regions, notably Asia and continental Europe, since the 1960s. This, he says, reflects greater regional economic integration. And as emerging countries have opened to international trade and foreign investment, their stockmarkets have rapidly become more correlated with those of developed countries.

There is other evidence that correlations between particular markets are not particularly stable over time. During 1985-90, for example, the correlation between Italy's stockmarket and America's was 0.42; during 1991-97, it was only 0.18. Steve Strongin, an economist at Goldman Sachs, an investment bank, argues that markets become more correlated during the upswing of the global economic cycle, and less correlated during downturns. Thus, he says, investors tend to under-estimate the potential for diversification strategies when the economic going is tough, and to over-estimate it when things are booming. If he is right, investors cannot properly judge the merits of international diversification unless they know which way the world economy is heading. That is extremely difficult to know, so his insight may not prove particularly valuable.

Measuring average stockmarket performance, however, may obscure the most important details. John Campbell, an economist at Harvard University, contends that the world's stockmarkets tend to become more correlated at times of high share-price volatility, such as last week.

This synchronisation is hard to explain. If it reflects economic fundamentals, then it implies that when important global news occurs, it is usually the sort of news that makes markets more volatile rather than stabilising them. This seems unlikely. Alternatively, stronger correlation may reflect a change in the willingness of investors in different countries to accept price volatility: if investors are more risk averse, they will insist on a higher return for the risks they bear by holding shares, so share prices would have to fall. But it is not clear why their appetite for risk would fall then rise again so quickly as to explain last week's share-price turbulence.

There remains a powerful economic case for international diversification, but only as a long-term strategy. That does not mean merely long enough to avoid exceptional events such as last week's. It may mean decades. For instance, by some calculations, during the 1990s Americans who diversified into foreign shares have done less well in terms of risk-adjusted returns than those who, defying economic wisdom, invested only on Wall Street. And whatever else the merits of international diversification, it offers no answer for investors who want protection against a worldwide stockmarket crash. For them, the best advice is don't buy shares.