

Potential Barriers To International Diversification In Finance Industry 10

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Introduction

Investing in a share or bond at times can give negative returns to an investor, which is a loss. It is difficult to predict whether the current market price of a share will increase or reduce in the future. Investors seek advice from an economist who uses derivatives to predict market prices in the future. Every investor aims to generate good interest from his investment, thus profit. People purchase securities with a possibility of high return, such as global investment or international diversification and local investments. It is at times advisable for investors to acquire a guard when its market price falls and sell it when market prices rise, thus making a profit. This paper evaluates potential risk and uncertainty in financial markets and investments, the relationship between risk and return, and critically demonstrates an understanding of the investment planning process and designing an investment approach for Jerold Munoz.

Case Study

Part 1

For example, if Munoz reallocates 30 percent of his current U.S. equity portfolio to the international portfolio, Chen recommends the standard deviation of the collection. Variability of returns determination is through standard deviation calculations.

Expected return= Security weight * earlier return estimates

Munoz security weight =30% = 30/100 =0.3.

The standard deviation of all securities = 10.4%=10.4/100 =0.104.

Standard Deviation = (variance) $^{1/2}$

10.4= (variance) $^{1/2}$

Variance=20.8% or 0.208

Variance= expected return multiplied by allocation

20.8%= 100%*expected return

$0.0208 = E$

Expected return = 0.0208 or 2.08%

30% allocation = $100 \times e = 0.0208 \times 0.3$

= 0.00624 or 0.624%

100% securities = standard deviation of 10.4%

30% securities = ? SD

Current allocation standard deviation = $SD \times 100\% = 10.4\% \times 30\%$

SD (30% allocation standard deviation) = 3.12.

Comprehensive data gives a high deviation value, and variance square root gives rise to standard deviation. Standard deviation determines the volatility of an investment thus used by investors to gauge volatility expected for securities. Munoz's standard deviation is low, indicating high finance has reduced volatility, which is beneficial to an investor. These securities are safe for an investor with an interest in trading securities. The expected return is not an investment return guarantee, but it is useful for calculating future portfolio value and actual returns measures guide. Investors like Munoz will become interested in securities with high return probability in the future. Some investors purchase many securities from companies that are likely to offer good returns tomorrow (Bekaert & Ravina et al. 2017, p. 86). Chen is an experienced and competent investment advisor, as she carefully takes Munoz through his investment details and gives the best investment suggestions.

From Munoz's perspective, calculate the contribution of currency risk to the international stock investment in Chen's example.

Return on Currency risks = $(1 + r_{CAN}) = (1 + r_{FM}) (1 + r_{FX})$

Market rate = 9

Exchange rate risk = 6

Correlation = 0.4

The exchange rate of the United States dollar against the sterling pound

= 1.4008

Expected exchange rate of 0.4 correlation = ?

0.5 correlation = 0.00624 expected return

$$0.4 \times 0.0624 = \text{expected rate} \times 0.5$$

$$\text{Expected return} = 0.04992 \text{ or } 4.99\%$$

$$= \{1 + 0.0499\} \times \{1 + 0.06\}$$

$$= \{1.0499 + 1.06\}$$

$$\text{Contribution of currency risk} = 2.10\%$$

Munoz should invest in the international market when currency risks show positive outcomes in the future. The value of currencies fluctuates with time, which makes it advisable to calculate before buying a share or a bond in the international markets. Before investment, an investor should study the market trends of a currency. The expected return of Munoz's security is high, thus tempting him to acquire more stocks and bonds in the international markets. There is always a risk when an investor buys stock from a foreign market due to exchange rate fluctuations. In Chen's example, currency contribution risk is minimal, meaning it is safe to invest.

Of the three statements Munoz makes about currency risk, Chen should be least likely to agree with Statements 1, 2 or 3. Please justify your answer. Chen is expected to disagree with statement 1 that there is difficulty in eliminating current risks. Eradicating currency risks through hedging international investments is possible. Hedged indices make it possible to measure currency-hedged equity index performance. The exchange rate of money affects the performance of a bond if investing abroad. Calculating currency risk helps investors not to make losses when they spend in international markets. Currency risk computation encourages investors to buy foreign bonds. Every investor wants to have a positive return on their investments. Political instability is among the significant contributor to the depreciation of a country's currency value. In case an investor purchases a bond in Euro, and the political temperature rises in the future, during its maturity date, the money given back to him is minimal compared to the initial amount.

Through investment advisors like Chen, investors, make a sound decision, thus reaping good benefits on securities. Companies that operate internationally are exposed to exchange rate risk, as sometimes there are unpredictability losses and gains due to currency value change in relation to another currency. For example

$$1 + r_{CAN} = (1 + M) (1 + X)$$

Where:

I_{CAN} = Return on the foreign investment in United States Dollars

FM = Return on the foreign market in local currency

r_{FX} = Return on the foreign exchange

Example: Foreign investment return in American Dollars

Initial Investment: \$35,000

Initial Exchange Rate: \$2.13 / Pound Sterling

Final Exchange Rate: \$1.99 / Pounds Sterling

Return on British Security Investment (rFM): 11%

$$(1 + r_{CAN}) = (1 + r_{FM}) (1 + r_{FX})$$

$$(1 + r_{CAN}) = (1 + .11) (1 + .9342)$$

$$(1 + r_{CAN}) = (1.11) (.9342) = 1.036$$

$$r_{CAN} = 3.6\%$$

Do you agree with Chen's statement regarding a hedged and unhedged return, and why? -Chen states that there is a small difference between hedged and unhedged returns correlations, which is right? International bond hedging refers to translating foreign bond hedged back to an investor's home currency. The global obligation in unhedged relates to the translation of a diplomatic relationship and the currency return back to an investor's home currency.

Hedging the risk of a currency allocated to an international bond minimizes the volatility of an asset as significant risks get introduced to stable relationships. Currency return is through hedging an investment. Hedging gives investors good returns, which are different from currency return hedged and underlying bonds return. Investor's total performance comes as a result of hedged return or hedging currency risk. Implementation of a hedging program by international bond investors helps to adjust returns to their expectations in the long term. Inflation and interest levels, due to the long-term impact of the hedge return, make investors interpret that the yield maturity of a hedged investment is small. Domestic and international markets yield become meaningless (Bekaert & Ravina et al. 2017, p. 112). Fixed-income assets are a significant portion of investments for investor's local market bonds. For investors to play a role in the portfolio, they invest in international or foreign bonds, thus benefiting from diversification. Changing political regimes, unstable interest rates and economic cycle risks are most likely to be experienced by fixed-income international bond investors compared to domestic markets. Diversification benefits make investors exposed to currency movements, which determine the risk and return of a global bond. The impact of currency fluctuations is offset by investment managers in a case where the portfolio is fully hedged. It ensures capital gains/losses and income are the only factors influencing return.

Some people say that investors should adopt currency hedging, as it results in long-term international bond returns, together with local bond returns and abandons diversification of global bonds.

Diversification potential is most likely to be unaffected by little volatility of hedge return. The central

bank aims to manage inflation and the output of an economy, thus picking short-term interest rates by hedging investments. In currency hedging, two parties decide to exchange one currency for another at a specific exchange rate for a future date.

Unhedged returns on foreign bonds have two pieces: the return on relationship and the return on foreign currency for purchasing bonds. Co-variance returns of a bond can either be positive or negative, which can vary over a period. European investors with unhedged international securities experience a negative impact on their profits when the Euro currency value increases. On the other hand, European investors suffer a positive effect on returns when the currency value depreciates. Trying to improve your profits at times is costly and time-consuming, which, in the end, may yield minimal benefits; an economist and investment experts wrongly forecast as much as they are right. There are additional diversification benefits if investors hedge or unhedged investments in foreign countries. For example, if a person invests in an unhedged United States share fund and later the Australian dollar value decreases relative to the US dollar, the cost of the investor's portfolio would rise. Investors will receive more for their investment if it's converted back into Australian dollars. (Topaloglou, Vladimirov & Zenios 2017).

(Average Annualized Returns of MC Hedged Indices and Their Unhedged Parent Indices, Gross Monthly Return)

	Unhedged	Hedged	Unhedged	Hedged
Mc World	5.09%	3.32%	-5.02%	-4.93%
Mc EAFE	6.16%	2.37%	-11.73%	-11.69%
Mc Emerging Markets	15.82%	11.65%	-18.17%	-14.12%
Mc Brazil	23.53%	-2.00%	-21.59%	-17.44%
MC Canada	10.91%	8.08%	-12.16%	-9.88%
MC Japan	4.02%	0.60%	-14.19%	-18.36%

Source: Mc Data for Brazil begins in September 2010.

Which part of Chen's statement about emerging markets is least likely correct? What elements might affect emerging markets? Chen states that expected returns and risks are low in developed countries compared to emerging markets. Emerging markets are growing with time, meaning investment will also increase, thus, positive profit returns. Brazil, Chile, China, Colombia, Hungary, Indonesia, India, Malaysia, Mexico, Peru, Philippines, Poland, Russia, South Africa, Turkey and Thailand are the major emerging markets. Developed countries are the United States, Sweden, Germany, Japan, France, Canada, Netherlands, Australia and Denmark. Emerging markets or developing countries are concentrating on increasing investment in productive capacity and abandoning traditional economies.

Most developing countries' securities increase their value as time passes, giving good returns to investors. In an emerging market segment, people establish new industries which open other branches internationally. Emerging markets lack strict accounting standards, securities regulations and market efficiency to reach the status of developed countries. The above markets have banks, stock exchange and a unified currency referred to as physical financial infrastructure. The emerging market's economy grows faster, thus, high returns, which makes them a target for investors. Political instability, currency volatility, infrastructure problems, state-run or private companies and limited equity opportunities in emerging markets put investment at high risk. Liquidity for outside investors may not be available on the local stock exchange. Developed countries have advanced technology infrastructure and a highly developed economy compared to developing countries. Gross domestic (GDP), per capita income, gross national product (GNP), the standard of living and industrialization level mostly determine the degree of a country's economic development. Service sectors are more productive than industrial areas, thus, post-industrial economies. (Liu 2016, p. 959).

Part 2

Currency risk in international markets is colossal; investors may not be sure about the stability of an economy tomorrow. In countries like Syria, Pakistan and Ethiopia, chaos erupts more often due to radical groups. In these countries, it becomes difficult to invest as a person may lose all his investments. When the value of a foreign currency depreciates, investors shy away from buying shares and bonds. On the other side, the investor gets attracted to purchase securities in foreign countries with increasing currency value.

Potential Barriers to International Diversification in the Finance Industry

There are some constraints experienced when investing in the foreign market, which is mainly imposed by the government. Regulations by the government make currency trading difficult. Some of these barriers are taxation, foreign exchange controls, capital markets controls and nonexistence and weak laws protecting minority stockholders' rights.

Taxation

Taxes are an obstacle and an incentive in activities of cross-border international diversification. The government alone makes rules regarding taxation where they benefit from revenue and motivate investors negatively. Countries determine the tax rate paid on each investment return, for example, dividends, capital gains and interests. Taxation laws differ in each state, and the government drafts laws that benefit them. Securities taxation is different; some securities income have exemptions in a portion or entirely from taxes of a salary. Japan has exemptions on interest income of a particular

amount, which is of domestic securities of received interest. Many countries tax returns on portfolio investment of residents, on both local and foreign investments, which is called the income worldwide concept. In some countries like the United States and Singapore, tax returns from foreign securities abroad of people who migrate back to their home country.

It creates offshore investment and jurisdictions known as tax havens (Biener, Eling & Wirfs 2016, p. 353). The financial industry benefits tax heavens, thus accepting the law provision of confidentiality. Through tax havens, people at times hide finances gained through theft, illegal drug sales proceeds, political corruption revenue and robbery. High-rate taxing countries have organizations like OECD and FATF that help reduce the power of tax havens. Qualifying foreign financial intermediaries system by the United States holds banks responsible for tax collection on securities by American taxpayers, believing they want to run business in the country's financial markets. International portfolio investment barrier sometimes is through tax withholding, which many nations obtain from foreign investors, interests, dividends and royalty residence borrowers pay.

Foreign Exchange Controls

Currency control's aim is to restrain the flow of capital. Reservation of financial capital for domestic use and balance of payment contributes to foreign exchange controls. Currency control achievement is through the prohibition of local money conversion to foreign funds to obtain securities abroad. When economic trends are confident and stable, countries hesitate to get rid of controls. Many nations are armed to restrict significant capital outflows and inflows. For example, in Japan in the seventies, Japanese investors are limited by exchange controls to buy foreign securities. Later, Japanese liabilities prevention from continued rise is through foreign purchases of Japanese investments. Some countries make people trade a part or all foreign investments to exchange the money for local funds. Domestic company's equity to be accessed by external investors are few, due to constraints of inflow. Inflow constraint, which is bidding, makes people's domestic asset prices different. For example, Sweden Markets companies have foreign ownership of 20% (voting rights) and 40% (equity), which results in the presence of a foreign and domestic class of stocks. The capital amount of an internal investor and outflow constraint make them spend little on foreign investments.

Capital Markets Regulations

Regulations goal is to safeguard financial securities buyer and to make an individual transaction which is fair and competitive. Regulatory and examination bodies put measures in place to regulate foreign investments. Supervision and controls are beneficial to foreign investors with less potential abuse knowledge and have limited ability to judge factors affecting securities return. Foreign securities are absent to local investors due to restricts of securities in international markets by national entities during the issue. Some countries decide on the amount; investors can invest abroad. A small number of nations prevent the purchase of securities by an investor. A Financial institution,

pension funds and insurance companies have rules and regulations in every country preventing them from investing abroad. For example, the United States' various federal government regulations prevent a significant proportion of investment of insurance companies in foreign countries. Commercial banks adhere to state banking regulations. Other countries mostly have the same control or different restrictions.

Transaction Costs

At times foreign securities are much expensive compared to local guards, which is a challenge to investors with little money. Financial intermediaries add more funds to trade in international markets. The cost of data transfer between foreign, domestic, and overheads rises, thus making them transfer these costs to investors. Provide liquidity breadth, depth and strength of various capital markets as mitigation factors. Thus, an international country investment is induced. Security price stability differs in each country. The United States and Britain markets have a considerable amount of foreign investments, as they are known to be experts in financial markets trading. They attract and absorb many types of securities like bonds, preferred shares, convertibles, ordinary shares and instruments of money markets. Continents such as Europe and Asia experience securities thinness, thus having price volatility. If the market has reduced the cost of borrowing and lending, investors come in to purchase various securities. The most efficient market in the world is in the New York state. Non-United States securities are more expensive compared to American stocks. (Chernov, Graveline and Zviadadze 2018, p. 34).

Foreign Markets Familiarity

During investment abroad, an investor requires adequate knowledge of foreign markets. Countries have different procedures for trading, customs reporting and time zones. The investor has to apply good effort in the understanding economy and international company performance. Deviations in methods like depreciation and standards of accounting make companies' security costs vary and hard to interpret (Yu and Lindsay 2016, p. 771). Currently, companies publish the statement of finances in English on their websites and newspapers. Intermediaries give information about foreign companies to investors due to the essence of international securities gains.

International Portfolio Diversification Channels

An investor can place an order for the security of his choice in a security company at home, thus through a broker, obtaining investments from a foreign issuer. Secondly, investors purchase assets in a local or international country through investment account establishment in the country. Through brokers, an investor is protected from domestic regulations and laws, with only transaction cost payment (Biener, Eling & Wirfs 2016, p. 703). Some investors with substantial investments trade securities through mutual funds dealing with foreign assets.

Conclusion

Investors should read the company journal to get more details about the financial stability in the past years. Investment advisors are always present to aid in making sound decisions. The government should minimize regulation and eradicate laws that prohibit foreign investments. A stable economy attracts investors, thus further benefiting the country. Stockbrokers are essential as they carry the investor's burden. Investors should always pay attention to the market trend of different securities for future investments. Fear of foreign currency value decrease, at times, makes investors shy away. The government should exempt foreign investment from taxation to encourage more investment in the country, especially in developing countries. Leaders should avoid bringing up the political temperature to make the environment conducive for foreign investors. Bond issuing is a way to raise money for the company to enable daily operations progress.

Bond buying is, at times, between the investor and the company, meaning no restriction from an institution like a bank and raised interest rate, which comes as a result of third-party involvement. Bond issuance is better compared to obtaining a bank loan. Investors who are already in existence protect their interest which at times is frustrated by new shares sales to new investors. The sale of Bonds at times generates positive returns, thus a rise in the company's equity. A company reduces taxable income by the issuance of bonds since the interest expense on obligations is taxed. If a company issues relationships, they have an agreement; thus, at the maturity date, payment terms will remain the same.

An investor buys a warrant at a premium or discount, and as the tie nears maturity date, declines to zero with its return to full face value payment. Sales of a bond are either at a discount, premium, or face value, determined by the interest rates currently available in the market. Every investor aims to reach a high-interest performance in addition to the initial amount of money invested. Political stability is one of the primary keys to currency value increase thus making people migrate from their home countries to establish a business.

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