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Portfolio Diversification in Europe

Authors:
Kpate ADJAOUTÉ - HSBC Republic Bank (Suisse) SA & FAME
Jean-Pierre DANTHINE - HEC-University of Lausanne, CEPR & FAME
Dušan ISAKOV - HEC-University of Geneva & FAME

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Abstract:
Have the euro and accompanying measures of financial integration had a discernable impact on the degree of diversification of European investors? This is an empirical question that this paper tries to answer by exploring four alternative avenues. First we focus on the final outcome: If European investors are indeed better diversified, their consumption should be increasingly correlated. Second we check more directly what is known about the composition of Europeans' portfolios. A third perspective focuses on the evolution of returns and prices. If indeed European investors are attempting to exploit new arbitrage opportunities opened up by the euro and European financial integration, then it is likely that these behavioral changes will be matched by significant changes in returns or in the nature of the return generating process. Finally, we explore the possibility that the answer to our question may be better revealed by examining the changes that have taken place in the investment process itself.

Executive Summary:
Are Europeans better diversified than 5 or 10 years ago? The importance of this question is obvious in the face of converging evidence that Europeans have been insufficiently diversified in the past – across asset classes and on an international basis - and that this situation has potentially important welfare consequences. Moreover, the recent structural changes observed in Europe

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40 bd du Pont d'Arve • P.O. Box 3 • CH-1211 Geneva 4 • tel +41 22 /312 0961 • fax +41 22 /312 1026
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such as the introduction of the euro as well as the accompanying measures of financial integration should provide favorable conditions to increase the level of diversification.

To assess if the degree of diversification of European investors has changed recently, this paper explores four alternative avenues. We first focus on the final outcome: If European investors are indeed better diversified, their consumption should be increasingly correlated. A second approach, at the opposite end of the logical spectrum, consists of simply checking the composition of Europeans' portfolios. A third perspective focuses on the evolution of returns and prices. If indeed European investors are attempting to exploit new arbitrage opportunities opened up by the euro and European financial integration, then it is likely that these behavioral changes will be matched by significant changes in returns or in the nature of the return generating process. We look at this hypothesis from two perspectives. The first approach is based on the CAPM and decomposes equity returns as the sum of the risk free rate and a risk premium. In the second approach, we use a multi-factor model that assumes that the return generating process has two components: the country where the firm is located and the industry in which it operates. Finally, we explore the possibility that the answer to our question may be better revealed by examining the changes that have taken place in the investment process itself.

The results of our paper show some modest evidence of favorable changes. This evidence relates mostly to the behavior of institutional investors who almost certainly have, to some extent, seized the opportunities opened by the disappearance of relevant currency matching restrictions within the euro-area. We have also proposed new, although fragile, evidence suggesting that the equity risk premia, across European stock markets, are converging. This is consistent with ex-ante reasoning on the effect of European integration and with complementary evidence that the cost of capital has decreased in Europe. There is also robust evidence that the structure of equity returns has changed, in Europe specifically. In particular the country factors now appear to be dominated by the factors associated with industry or sector and this finding is more robust – across data bases and methodologies – than it is elsewhere. This latter result may, however, be simply the result of macroeconomic and monetary integration and at this stage we cannot make strong inferences on the degree of portfolio diversification from these observations. However, we also obtain results that show that there is still room for additional diversification in Europe. In particular we find that the relationships between national consumption patterns within the euro area do not reveal as strong a degree of international risk sharing as one would expect from an area that is economically and financially integrated.

The conclusions of this paper are not clear cut and while we are leaving the reader free to choose his or her own appreciation of the uncovered reality, we cannot conceal our bewilderment at finding ourselves in the incapacity of justifying the most important change associated with the euro by practitioners. This leaves us with the suspicion that Europeans continue to be seriously undiversified.

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