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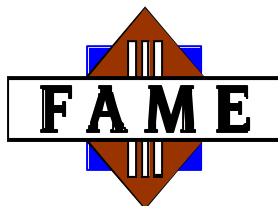

Research Paper Number 72

Are Practitioners Right? On the Relative Importance of Industrial Factors in International Stock Returns

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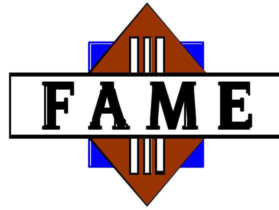
Eric Jondeau, Michael Rockinger, "Are Practitioners Right? On the Relative Importance of Industrial Factors in International Stock Returns", in Journal of Real Estate Research, 2004, vol. 26, issue 2, pp. 161-201.

Abstract:
This paper investigates the relative influences of industrial and country factors in international stock returns. Until very recently, academic research has consistently found that country factors dominate industrial factors. This result is in contradiction with practitioners beliefs. This paper re-examines this issue by analyzing a sample of more than 4000 stocks quoted in 20 developed countries. We find that on average the country effect still dominates stock returns over the period 1997-2000. This result has to be interpreted with caution though, as an analysis that allows for time-varying relative influences demonstrates the rapidly increasing impact of industry effects in recent times. We find, in particular, that this trend is common to all 20 developed countries considered and not only to those that are member of the European Monetary Union. We interpret this result as evidence of the increasing globalization of international equity markets.

Executive Summary:
Different events such as the trend towards a general deregulation of markets, the growing harmonization of economic policies but also technical improvement in information technology have drastically changed the international investment landscape in recent years.
These changes should lead to an increasing integration of equity markets. This in turn should imply an increase of the relative influence of global industry factors over country specific factors



in stock returns. There is strong evidence that practitioners now believe that industry is more important than country in the evolution of stock returns. This is witnessed, among other things, by the reorganization of financial research along industry lines in the most important financial institutions across the world. However, recent academic studies continue to document the relative superiority of national influences over industrial influences in stock returns. The question is therefore: Are practitioners right when they assume that the industrial factor is the main determinant of stock returns? Applying a methodology similar to that used in the previous academic literature documenting the dominance of the country effect, this paper provides new results that indicate that practitioners might very well be right.

This research is based on a method that assumes explicitly that stock returns can be decomposed in four different components: a global component, a pure country effect, a pure industry effect and a firm-specific part. The analysis is performed with a sample including more than 4000 individual stocks from 20 developed markets. We find that, on average over the period from January 1997 to December 2000, the country factor remains the most important of the two factors in the explanation of stock price behavior. As such, our initial findings on more recent data are broadly consistent with most of the previous literature.

Nevertheless, further analysis that allows the relative influence of both factors to change over time shows that the impact of industrial factors on stock returns has increased significantly and, even, that they dominate country factors in recent times.

This research also provides some additional results by repeating the analysis on different datasets. First, countries member of the European Monetary Union (EMU) are more responsive to industrial effects than to country effects. One could think that this result is a consequence of convergence of economic and fiscal policies within EMU countries. However, we find that this does not seem to be the case since all developed countries have witnessed an increase in the significance of industry factors and seem to be now extremely integrated, probably even as much as the European markets are. Therefore, this trend is more likely to be attributable to an increasing globalization of the world economy rather than to convergence of EMU economies. Second, we document that small capitalization stocks are more sensitive than large caps to national influences. Third, we document an atypical behavior of information technology and telecommunication stocks since 1998 in the sense that these industries have a very strong effect. Removing stocks from these industries lowers the relative influence of industrial factors. Finally, we find that the results are robust to the definition of industries by comparing results obtained with stocks grouped according to MSCI classification to those obtained with FT-TF Datastream industry definitions. The results are also unchanged when the number of industries taken into account is increased to provide a finer decomposition of industrial structure.

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