International Diversification A Small Equity Market Perspective
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Abstract:
Investors can reduce their overall portfolio risk by diversifying into equities from other markets. Emerging markets have attracted significant interest because of their low correlations with the equity markets of the developed countries and with each other. Studies recently indicate that the correlations between equity returns of the developed markets with that of the emerging markets and between the emerging markets are increasing over time. Furthermore, research thus far has concentrated on looking at the benefits of diversifying into emerging markets from the perspective of an investor from the developed market. This paper contributes to the existing literature by using a multivariate GARCH model that allows correlations to change over time and incorporates asymmetrical effects. To overcome the problems of changes in correlations we use an Asymmetric DCC GARCH model to estimate time-varying correlations and include these correlation estimates in the portfolio optimization model. We look at the benefits of diversifying investments into emerging markets from the perspective of an investor in Taiwan to estimate the benefits of diversification by using the weekly returns for the period of June 1997 to May 2009. This study finds that, despite increasing correlations, there are still potential benefits for an investor from smaller emerging markets diversifying into international markets.

Keywords: Taiwan, Emerging market equities, Time varying correlations, Asymmetric Dynamic Conditional Correlation (DCC) GARCH models, International diversification.

JEL Classifications Codes: G11, G15, F37, F21