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Understanding emerging market equity risk premia: Industries, governance and macroeconomic policy uncertainty☆

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ABSTRACT

The average equity risk premium (ERP) in emerging markets is well-known to be significantly higher than in developed markets. But, key reasons for this remain unclear, contributing to investment strategy uncertainty. Here, we use industry-level data for 19 emerging market countries across three regions of the world to first examine the contribution of each industrial stock market to the extra premium paid by emerging markets to international investors from 1995 to present, and then to explore the relative importance of country-level governance and macroeconomic policy uncertainty in explaining both national and regional industry-by-industry ERP behavior. We conduct separate analyses for the *emerging market crises* period of 1995–2002, and the post-crises period of 2003–2012. Based on both static and dynamic approaches, we find that some industries indeed perform consistently better than others. In particular: (i) the healthcare and basic materials industries mostly contributed to the extra premium paid by the Asian stock market; and (ii) the East European and Latin American stock markets' extra performances were largely driven by the utilities and consumer services industries, respectively. However, our cross-sectional analyses suggest that country-level governance indicators are not strongly correlated with either national or industry-level returns, with the exception of the consumer goods industry. Lastly, using both rolling-window and DCC-GARCH frameworks,

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we find that correlations between industrial stock market excess returns and a measure of global economic policy uncertainty are consistently negative, and follow similar patterns. Our empirical evidence as a whole suggests that industrial stock markets are more highly related both within and across countries and regions than has been suggested previously. Contrary to much existing empirical work, our results therefore suggest there is currently little space in emerging markets to exploit cross-industry portfolio diversification benefits.

1. Introduction and motivations

During the last three decades the emerging market asset pricing and international finance literature has largely focused on the following five issues: (i) the behavior of the emerging markets ERP (i.e. performance measurements); (ii) the predictability of emerging stock markets excess returns (i.e. local vs global information variables, country effects vs industry effects); (iii) the effects of financial liberalization on emerging stock prices, cost of capital and expected returns; (iv) the global integration process in emerging stock markets (i.e. *de jure* vs *de facto* integration, country institutional quality, disaster risks); (v) the effects of macroeconomic shocks on emerging economies.[1]

Although the average ERP in emerging markets is well-known to be significantly higher than in developed markets, the major reasons for this situation remain widely debated, which contributes to investment strategy uncertainty. A conventional wisdom is that emerging markets compensate investors for the inherent risks in terms of high average returns. It is also largely accepted that the structure of the return distribution of emerging markets is potentially unstable. In other words, ERP tends to be less stable through time in emerging markets than in developed markets. Illiquidity, transaction costs, shaky industrial structures, and political instability have often been seen as potential sources of higher compensation and instability.[2] However, existing work has yet to achieve consensus around major drivers of higher ERP in emerging markets.

In this paper we examine the behavior of emerging stock market excess returns in an industry-by-industry context, with an aim to clarify the roles of different industrial stock markets in generating higher emerging markets' ERP. We then undertake a simple assessment of the relationship between governance indicators and average stock market performances on an industry basis, to determine the extent to which country-level governance factors may additionally explain variations in emerging economy industrial stock markets' average excess returns. Lastly, we use a novel dataset on macroeconomic policy uncertainty to examine the co-movement between the global economic policy uncertainty and the emerging industrial stock market average excess returns.[3] The remainder of the introduction section presents a brief review of findings from existing literature for each of these issues, followed by a summary of our major findings.

Much of the recent research around emerging market returns focuses on the relative importance of country vs industry effects. A large part of this literature supports the idea that country effects tend to dominate industry effects (i.e. cross-country diversification is more beneficial than cross-industry in a risk-return framework). Serra (2000) finds that emerging markets' returns are mainly driven by country factors and that cross-market correlation is not affected by the industrial composition of the indices. She argues that geographical diversification dominates, in terms of risk reduction, domestic industrial diversification. Alternatively, Cavaglia et al. (2000) find that industry factors are more

[1] See Bekaert and Harvey (1995, 1997), Bekaert et al. (2007), Bilson et al. (2001), Brooks and Del Negro (2002, 2004), Chambet and Gibson (2008), De Jong and De Roon (2005), Donadelli (2013a,b), Donadelli and Prosperi (2012a,b), Grootveld and Salomons (2003), Harvey (1995), Henry (2000), Jayasuriya (2005), Phylaktis and Xia (2006), Samarakoon (2011), Serra (2000), among others.

[2] See Bekaert et al. (2007), Domowitz et al. (1997), and Donadelli and Prosperi (2012b), among others.

[3] Throughout the paper we use the terms ERP or average excess returns interchangeably.