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# Location of trade, return comovements, and diversification benefits: Evidence from Asian country ETFs

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ABSTRACT

Using data from the Asian country ETFs and their MSCI indices, this paper examines whether trading location affects return comovements and diversification benefits. Our empirical results show that the magnitude of return comovements for the Asian country ETFs is higher than the corresponding MSCI indices. Moreover, our empirical findings indicate that the factors, including investor sentiment, market conditions, and economic fundamentals of the U.S. market, have greater effects on the return comovements for the Asian country ETFs than their underlying MSCI indices. Finally, the evidence presents a higher diversification benefit for the Asian MSCI indices than the Asian country ETFs.

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## 1. Introduction

The objective of this paper is to gain insight into the return comovements for country exchange traded funds (hereafter country ETFs) and the corresponding MSCI indices. Specifically, according to the trading location hypothesis (see Chan, Hameed, & Lau, 2003; Froot & Dabora, 1999), this paper first explores the magnitude of the return comovements for the Asian country ETFs and their corresponding MSCI indices. Then, this paper investigates the determinants of return comovements for the Asian country ETFs and their MSCI indices. Country ETFs are a sub-sector of the ETF market and are designed

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to track the stock market indices of foreign countries. A special feature of country ETFs is that ETF shares and their underlying portfolios are traded in two different markets. The country ETF is traded in the U.S. market, whereas the underlying portfolio is traded in the foreign home-country. Instead of building portfolios of single company stocks for a given foreign country, institutional investors, hedge funds, insurance companies, and individuals are increasingly turning to country ETFs to implement their investment strategies and achieve international diversification benefits.[1] Hence, understanding the impact of the location of trade on the behavior of return comovements for the country ETFs and the underlying portfolios can provide additional information to practitioners in making trading decisions and to financial institutions in developing new financial products.

The impact of the location of trade on asset returns has received considerable attention in the literature. Froot and Dabora (1999) show that the difference between the prices of twin stocks appears to be correlated with the markets on which they are traded most. Chan et al. (2003) also present evidence that the prices of twin stocks are dependent on the location of trades. On the other hand, Pennathur, Delcoure, and Anderson (2002), Zhong and Yang (2005), and Gutierrez, Martinez, and Tse (2009) find that the country ETFs returns are significantly influenced by and sensitive to the U.S. market risk. Levy and Lieberman (2013) show that the S&P 500 index returns have a dominant effect on the returns of country ETFs traded in the U.S. market during non-synchronized trading hours. As such, the findings of Pennathur et al. (2002), Zhong and Yang (2005), Gutierrez et al. (2009), and Levy and Lieberman (2013) imply that the location of trade is an important factor in determining the prices of country ETFs. While prior research has found that the prices of country ETFs are affected by the location of trade, no work has been done on the influence of the impact of the location of trade on return comovements for the country ETFs and the underlying portfolios. Hence, this paper attempts to fill the gap.

Understanding the impact of the location of trade on return comovements is an important issue in the field of international finance. If international financial markets are perfectly integrated, asset price movements should not be affected by their trading location. However, if the share price of an asset is excessively influenced by the market in which the stock is traded, the international markets are partially segmented. Since the country ETFs and their underlying portfolios are traded in two different markets, the different trading locations offer a natural experiment for examining the effect of trading location on return comovements. This paper uses the Asian country ETFs and the corresponding MSCI indices to explore this issue for the reason that the Asian and U.S. markets have no overlapping trading hours. As suggested by Gutierrez et al. (2009) and Levy and Lieberman (2013), the trading schedule differences for international investments allow us to isolate the (public) information of local foreign markets from the (private) information released during the U.S. trading session. As such, the comparison of return comovements for the Asian country ETFs and the corresponding MSCI indices can provide more obvious and direct effects of the location of trade on return comovements and market integration.[2]

Previous studies have presented significant return comovement among assets (e.g., Bekaert, Hodrick, & Zhang, 2009; Forbes & Rigobon, 2002; Kallberg & Pasquariello, 2008; among others). However, we know relatively little about the factors that drive it. Prior literature suggests that the comovement of asset returns is associated with investor sentiment (see Barberis, Shleifer, & Wurgler, 2005; Kumar & Lee, 2006; Peng & Xiong, 2006; among others). Froot and Dabora (1999) and Chan et al. (2003) also suggest that price fluctuations are affected by country-specific investor sentiment. Liao, Li, Zhang, and Zhu (2012) argue that in the United States, the location of corporate headquarters, local economic growth speed, and local investor sentiment and risk aversion can all influence the (co-)movement of stock prices. As such, it is likely that investor sentiment, market conditions, and the economic growth speed for the U.S. market might affect the comovement of the Asian country ETFs returns.

[1] Over the past decade, country ETFs have become the investment vehicle of choice for investors seeking rapid and low-cost exposure to broad equity market indices.

[2] Yu, Fung, and Tam (2010) indicate that the nature of comovements of financial asset returns and return dispersion are similar to those of measures of market integration. Hence, this paper uses "return comovements" and "market integration" interchangeably to represent the evolution of the return relationship across assets.

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