Study proposes new measure of world equity market segmentation

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A recent study in the *Review of Financial Studies* proposes a new, valuation-based measure of equity market segmentation. Equity market segmentation occurs when stocks of similar risk in different countries are priced differently.

The study, by Columbia Business School Professor Geert Bekaert, Chazen Senior Scholar at The Jerome A. Chazen Institute of International Business at Columbia Business School and the Leon G. Cooperman Professor of Finance and Economics, uncovers the factors that cause variation in market segmentation, both through time and across countries. Although barriers to capital flows often lead to equity market segmentation, a country's political risk profile and its stock market development are two particularly important local factors behind a lack of integration, Bekaert and his coauthors found. In addition, the U.S. corporate credit spread is an important factor on a global level. The study is coauthored by Campbell R. Harvey, J. Paul Sticht Professor in International Business, Fuqua School of Business, Duke University; Christian T. Lundblad, Edward M. O'Herron Distinguished Scholar and Associate Professor of Finance, Kenan-Flagler Business School, University of North Carolina; and Stephan Siegel, University of Washington Business School.

The removal of capital controls in developed countries in the 1980s and in emerging markets in the 1980s and early 1990s has led to a new era of global financial openness and trade. These changes should have had a profound effect on the valuations of stocks across the world, and therefore impact critical economic issues such as the cost of capital. However, although many countries have experienced decreased segmentation, significant levels of segmentation remain in emerging markets, the authors found.

In the study, the authors describe their new way of measuring the degree of effective or de facto equity market segmentation. Unlike most existing measures, the authors' framework is not tied to a specific asset pricing model. Instead, this country-level measure is based on industry earnings yield differentials, aggregated across all industries in a given country. With this new measure, it is easier to understand why one country is more segmented than another, and why this degree of segmentation changes over time.

Using this new measure, the authors test the degree that local and global factors account for valuation, after controlling for a country's global growth opportunities in its mix of industries. A main driver of segmentation is de jure access: some markets are simply closed by law to foreign investment. Yet even when a country is formally open, foreign investors may shun markets with weak corporate governance. The authors found that while equity market openness is the single most important economic variable in segmentation, stock market development is almost as important. Exploring segmentation at the industry level, the authors found that historically heavily regulated industries such as banking and insurance were among the least integrated early in their sample timeframe, but are now among the most integrated.

The authors used data from the United States, an effectively integrated economy, as a benchmark, and applied their new measure to 69 countries using monthly equity industry portfolio data from Datastream and firm-level data from the Standard & Poor's Emerging Markets Database across a time period of more than 20 years. The study documents the extent to which market segmentation has decreased over time, and shows that while developed countries have been effectively integrated since 1993, emerging markets continue to demonstrate levels of segmentation above the U.S. benchmark. As discount rates and growth opportunities become global in nature, this new measure of the absolute difference between local and global valuation ratios will shrink, the authors conclude.

Provided by Columbia Business School

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