COUNTRY & INDUSTRY FACTOR INFLUENCE ON INVESTMENT IN LATIN AMERICAN EMERGING MARKETS

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ABSTRACT

In this paper, we analyze country and industry factors that influence investment strategies in Latin American emerging markets. This analysis show investors seeks different benefits from their investment, and country-specific political and economic events are very important to investors. In very recent years, the gaining importance of industry effects relative to country effects has come to light. The industry factor, studies have shown, has displaced the country factor as the main cause in the variability of equity returns. This phenomenon appears to be tied to the increase in international investment in general, as well as the ever increasing globalisation of the world economy. This study utilizes the variance approach to test the relative importance of country, industry, size and time specific sources to determine the variation between emerging Latin American markets and to assist investors in optimizing returns from their international portfolios.

JEL: G11, G15

KEY WORDS: Emerging Markets, Equity Return, Industry Factor, Investment Strategies

INTRODUCTION

The importance of industry effects relative to country effects, in terms of diversification benefits has increased over the last dozen or so years. Studies have shown that, the industry factor seems to have displaced the country factor as the dominant explanatory variable in equity returns (Baca et al., 2000; Brooks and Catão, 2000; Cavaglia et al., 2000; Brooks and Del Negro, 2002; L'Her et al., 2002). More specifically, Baca et al. concluded that the influence of the country factor was 2 to 3 times larger than the industrial factor up to 1995, but that this ratio had dropped to 1.23 in 1999. Similarly, Cavaglia et al. and L'Her et al. reported a clear upward trend in the importance of industry effects relative to country effects in explaining the sources of variation in developed market share returns. Many of these studies have linked this phenomenon to the increasing globalisation of the world economy, as well as increased cross-border investment. In particular, it has been suggested that financial market integration and the globalisation of economic activity have impacted the relative importance of country and industry factors in explaining global share returns. There is a broad acknowledgment that the importance of country factors decreases with the increasing degree of international financial integration, while higher international financial integration increases the importance of industrial factors in explaining variations in global equity returns (Grinold et al., 1989; Beckers et al., 1996; Baca et al., 2000).

The purpose of this research is to shed some light on the underlying factors, or combination of factors, that drive diversification benefits from international investment in the emerging market equities of Latin American countries. In particular, an analysis of variance approach is applied to test the relative importance of country, industry, size and time specific sources of variation in emerging market share returns for international portfolio diversification strategies. Chiefly, the study examines the extent to which country and industry factors explain the returns of equities from the sample of Latin American emerging markets.

The reminder of this paper is organized as follows: The next section examines the related literature and the scope of this research study. Section three outlines the method and methodology adopted in this study. Section four discusses the empirical results and section 5 concludes the paper and gives suggestions for future research.

LITERTAURE REVIEW

In 2012, Latin America received approximately $174 billion of Direct Foreign Investment, an increase of 6.7% compared to the previous year. The biggest portion of this Investment, equaling 51 percent of the total, was directed to the natural resource sector, which includes mining. Another 37 percent was invested into services and about 12 percent went to manufacturing. The nation that received the greatest amount of this foreign investment was Brazil which benefited with 38 percent of Latin American investment (Mallen & Mahaparta, 2013).

Investment in Latin America is generally an improving situation with better opportunities in these emerging and growing markets. Countries in Latin America have changed many of their business practices making them more stable, better managed, and thus more attractive to investors. After conducting research about this region, KPMG found that the favorite destinations for investments are Mexico, Brazil, Colombia, Peru, Chile, and Argentina. Also, the study determined that Latin America is appealing to Private Equity investors because of decreased prices, a well-established banking sector, and a healthy natural growth. Therefore, investors have had a good return on their investments in many sectors. Among the more thriving sectors are sales, services, and natural resources (KPMG, 2009).

Ernst & Young (2013) made a survey that revealed the openness of Latin America to global investors. The top investors in the region are from the U.S. and Canada. The return on investments is supported by steady growth and the strategies of the Latin America companies to continue their growth both locally and globally. Another joint study showed that Latin America's entrepreneurial approach of growing business is very attractive to many direct investors (Ernst & Young, 2012). The companies' partners with investors to achieve local and global growth by improving their core business, strengthen management, and enhance financial discipline and corporate governance.

Latin American Private Equity Confidence Survey has determined that Latin America's emerging markets offer the opportunity for increased investments activities. The greatest number of investment opportunities is in infrastructure, power/oil and gas/utilities, and consumer retail (Deloitte, 2009). Welber states despite some uncertainty and risk in Latin American investment, investors may benefit by the consistent growth of Latin America's markets. It is noticeable that GDPs in Latin America are growing, business confidence is increased, and economies are better regulated (Welber, 2011).

A study by Arbelaez, & Ruiz (2013) studies the historical background of foreign direct investment (FDI) by the United States into Latin America. Knowing the antecedents of FDI in the region is currently important because of trade agreements that are either existing or planned. There is also an investigation of the role of foreign exchange market and how it affects FDI. Furthermore, Quazi (2007) examines the relation between FDI and economic freedom across Latin America countries and concludes that FDI inflow is boosted by foreign investors' increased familiarity, better infrastructure and greater trade openness of the host country. Relatedly, Pruefer and Tondl (2008) find that a positive FDI growth in Latin America requires a functioning legal framework and macroeconomic stability.

Conventional wisdom is that poor governance in nations is an impediment to foreign direct investment (FDI). A study by Subasat & Bellos using a panel data gravity model refutes this assertion, at least in the context of selected Latin American countries (2013). Poor governance, the study reveals, can be an attractant for investment by multi-national corporations (MNCs). The reasons lie in better investment

opportunities. Corruption, conflicts and autocratic governments may be endured by MNCs in return for the promise of large profits, especially from natural resources. It may also be due to the fact that countries lagging behind others in attracting FDI have the opportunity to implement policies aimed at improving the investment climate for foreign investors (Sunesen, 2009).

Corruption or rent seeking activities are pursued not just by local politicians, but also the MNCs. The study asserts that this is a relation-based system. Government leaders in these nations prefer big business including MNCs. These types of businesses have the substantial resources to pay for these rent-seeking activities. In turn the businesses have a freer hand to pursue profits. The study also stated that these businesses changed the conditions of the local environment to facilitate their operations. As a result, contrary to what might be believed, MNCs are attracted to nations in Latin America for the investment opportunities.

DATA AND METHODOLOGY

This study examines the country and industry factor influence on investment in Latin American Emerging markets. Employing monthly returns data over the ten-year period ending 2007, this study seeks to determine the role of country, industry, time and size effects in explaining the returns of Latin American emerging market equities. Weekly returns data for the sample of emerging market firms were obtained from Datastream and used to construct monthly returns according to equation (1); lunar months (n=13) were used. Monthly returns data, rather than weekly returns data, were employed due to the large volume of data, computing capacity and time constraints. In so doing, this study decomposes the sources of variation of share returns into their individual components using an analysis of covariance (ANCOVA) technique similar to that used by Fifield (1999). The ANCOVA method belongs to a larger family of models called the general linear model (GLM). This method is used to test the main and interaction effects between explanatory factors (country, industry, time and size) on a continuous dependent variable (Latin American share returns), controlling for sources of variation in the data. This method allows the removal from a dependent variable *(y)*, a term of the form βX_c. X_c is a covariate which is believed to be associated with the dependent variable (*y*) and cannot be predicted from an independent variable *(x)*, and β is a regression coefficient, estimated from the data, which relates changes in the covariate (X_c) to changes in the dependent variable (*y*). Hence, the test obtains a more accurate picture of the proportion of variance in *y* that *x* is capable of accounting for. The study tests whether the individual variables, or interaction between variables, have any detectable effect on the returns earned by equities from Latin American emerging markets and, if so, it determines the importance of these factors, or factor combinations, in explaining the share returns. Therefore, a crossed design was employed because it allows all possible combinations of the independent variables and the covariate to be included in the model. Such a design makes it possible to explore any potential interactions between independent variables and the covariate. Only in a crossed design can the presence of interaction be tested. The analysis employs the following crossed model:

$$R_{j(m,d,n,r)} = \mu + a_m + \beta_d + \gamma_n + \delta_r + (\alpha\beta)_{md} + (\alpha\gamma)_{mn} + (\alpha\delta)_{mr} + (\beta\gamma)_{dn} + (\beta\delta)_{dr} + (\delta\gamma)_{rn} + (\alpha\delta\gamma)_{mrn} + (\beta\delta\gamma)_{drn} + \varepsilon_{j(m,d,n,r)}$$

(1)

where
$R_{j\,(m,d,n,r)}$ is the mean return of firm *j* in market *m* and industry *d*, for month *n* of year *r*;
μ is the overall mean return for all markets and all time periods;
α_m denotes the main effect for market *m*, where *m* = 1,2,… 7;
β_d denotes the main effect for industry *d*, where *d* = 1,2,… 6;
γ_n denotes the main effect for month *n*, where *n* = 1,2,... 13;
δ_r denotes the main effect for year *r*, where *r* = 1,2,… 10;

$(\alpha\beta)_{md}$ denotes the interaction effect for market m and industry d;
$(\alpha\gamma)_{mn}$ denotes the interaction effect for market m and month n;
$(\alpha\delta)_{mr}$ denotes the interaction effect for market m and year r;
$(\beta\gamma)_{dn}$ denotes the interaction effect for industry d and month n;
$(\beta\delta)_{dr}$ denotes the interaction effect for industry d and year r;
$(\delta\gamma)_{rn}$ denotes the interaction effect for year r and month n;
$(\alpha\delta\gamma)_{mrn}$ denotes the interaction effect for market m, year r and month n;
$(\beta\delta\gamma)_{drn}$ denotes the interaction effect for industry d, year r and month n; and
$\varepsilon_{j(m,d,n,r)}$ represents the random error term for firm j.

To account for firm size, the log of the market value of each firm was included in the model as a covariate. The F-test of significance is used to test each main and interaction effect. In particular, the F-test is employed to test the null hypothesis that there is no interaction between returns earned by shares from Latin American emerging markets and any particular factor, or combination of factors, considered. This test statistic is computed according to the following ratio:

$$\frac{Mean\,Square\,of\,Effect}{Mean\,Square\,of\,Error}$$

$$(2)$$

A large F-ratio indicates that the variable, or combination of variables, contributes significantly to the variation of returns earned by equities from Latin American emerging markets and that the null hypothesis should be rejected. The ratio indicates precisely how much of the variation of emerging market share returns is explained by the factor, or combination of factors, examined.

Industry classifications defined by the FTSE Actuaries Industry Classification Committee and adopted by Datastream was used to assign each emerging market firm into one of seven broad industry categories based on the FTSE Level 3 classification scheme: Consumer Goods, Financials, General Manufacturers, Investment Trusts, Mineral Extractions, Services and Utilities. As the investment trusts sector failed to represent any of the sample firms considered in the analysis, this category was omitted from the analysis and six broad industry groupings were used to classify the data. Appendix 1 provides a detailed description of the industry classification scheme.

The following tables contain data and analysis using the model (See Table 1 and Table 2).

Table 1: Distribution of Firms across Countries and Industries

	COUNTRY							
	ARG	BRA	CHI	COL	MEX	PER	VEN	TOTAL
Industry								
Consumer Goods	2	4	13	2	5	2	0	28
General Manufacturers	8	28	20	2	15	0	4	77
Mineral Extractions	1	8	3	0	0	5	0	17
Services	0	3	3	1	8	1	0	16
Financials	1	16	10	3	1	3	0	34
Utilities	2	8	18	0	2	1	1	32
Total	14	67	67	8	31	12	5	204

The table shows the distribution of the Latin American sample firms across countries and industries. There are of seven broad industry categories based on the FTSE Level 3 classification scheme: Consumer Goods, Financials, General Manufacturers, Investment Trusts, Mineral Extractions, Services and Utilities. Each sample company was assigned to an industry grouping according to the Datastream industrial classification scheme.

Table 2: Firm Summary Statistics by Industry

Industry	Mean	Std. Dev	Min	Max	Skew	Kurt
Consumer Goods	0.0024	0.0665	-0.4181	0.4477	0.0740	4.951**
General Manufacturers	0.0041	0.0731	-0.4009	0.4305	-0.4429***	2.867***
Mineral Extractions	0.0067	0.0833	-0.5974	0.5155	0.1156	4.174***
Services	0.0032	0.0637	-0.4326	0.3699	-0.0701	2.805***
Financial	0.0051	0.1009	-1.162	0.4380	-4.440***	44.899*
Utilities	0.0038	0.0674	-0.4227	0.3566	-0.2070	3.997***

*Descriptive data for each of the six industry sectors are included in the table. The Mean is the equally-weighted average of all weekly return observations over the ten-year period. Std.Dev, Min and Max represent the standard deviation of weekly returns, the minimum weekly return and the maximum weekly return, respectively. Skew is the Kendall-Stuart measure of skewness, and Kurt is the Kendall-Stuart measure of kurtosis. An * indicates significance at the 10 percent level, an ** represents significance at the 5 percent level, and an *** designates significance at the 1 percent level.*

RESULTS FROM THE ANCOVA

The results from estimating equation (1) are summarized in Table 3. The variables are grouped in sections highlighting the results of each main factor, or interaction of factors, being examined. For each section, the total sum of squares and the residual variation for each major factor, or combination of factors are reported. The degrees of freedom, the sum of squares, the incremental R^2, given by the ratio of the between level sum of squares for each main effect and the total sum of squares is included in Table 3 in order to show the contribution of each main effect in the model, and the mean sum of squares estimate of variance, given by the ratio of the between level sum of squares and the degrees of freedom, are also reported for each main factor or combination of factors. Finally, the table highlights the F-ratio, which tests the null hypothesis that the various factors, or factor interactions, are not significant in explaining share returns in Latin American emerging markets. A large proportion indicates a significant factor effect and allows for rejection of the null hypothesis. The table details the analysis of covariance of the monthly dollar returns of the seven Latin American emerging stock markets over the ten-year period Sig. of F represents significance of the F-ratio.

An analysis of the table indicates that 35 per cent of the total return variation in the Latin American emerging market equities is explained by the model as a whole. In particular, the results from the analysis reveal that the year factor is the most significant main effect. The month factor and the interaction between year and month are also important. Thus, the results suggest that there is significant variation in the Latin American emerging market share returns from one year to the next and from one month to the next; a strong time effect was found. This finding is consistent with prior research which has examined the importance of time in explaining the return variation of emerging market shares (Sinclair et al., 1996; Fifield, 1999). For example, on examining 17 emerging stock markets over the period 1991-1996, Fifield found that returns varied significantly from year-to-year, quarter-to-quarter and month-to-month. Consistent with the conclusion drawn from this current analysis, the author suggested that fund managers should review their portfolios periodically and frequently.

Country factors also play an important role in explaining the variability in Latin American emerging market share returns. This finding is consistent with previous results which have established the presence of a dominant country component in the share returns of emerging markets (Divecha et al., 1992; Zervos, 1996; Fifield, 1999; Serra, 2000, Bruner et al., 2003, Estrada et al., 2004) and developed markets (Lessard, 1974; Grinold et al., 1989; Drummen and Zimmermann, 1992; Heston and Rouwenhorst, 1994, 1995; Griffin and Karolyi, 1998). For example, Griffin and Karolyi showed that country effects accounted for virtually all variation in the country index returns of 25 developed and emerging markets. Specifically, less than 4.0 per cent of the variation in country index returns was explained by industrial composition. Divecha et al. also found that country factors were the major force in explaining the returns of emerging as well as developed markets.

Table 3: Analysis of Covariance (ANCOVA) of Monthly Returns

Variable	Degrees of Freedom	Sum of Squares	Incremental R^2	Mean Square	F-Ratio	Sig. of F
ln(mktval)	1	0.2403		0.2403	10.934	0.0009***
Country	6	8.992	0.0107	1.499	68.199	0.0000***
Sector	5	0.0696	0.0001	0.0139	0.6334	0.6743
Country by Sector	21	0.4122		0.0196	0.8933	0.6006
Residual Firm	171	3.162		0.0185		
Firm Total	**203**	**12.635**				
Year	9	45.240	0.0538	5.027	228.75	0.0000***
Month	12	5.859	0.0070	0.4882	22.218	0.0000***
Year by Month	108	74.285		0.6878	31.301	0.0000***
Time Total	**129**	**125.38**				
Country by Year	54	50.720		0.9393	42.742	0.0000***
Sector by Year	45	5.409		0.1202	5.469	0.0000***
Residual Firm by Year	1,728	32.860		0.0190		
Firm by Year Total	**1,827**	**88.988**				
Country by Month	72	10.612		0.1474	6.707	0.0000***
Sector by Month	60	2.305		0.0384	1.748	0.0003***
Residual Firm by Month	2,304	53.934		0.0234		
Firm by Month Total	**2,436**	**66.850**				
Country by Year by Month	648	68.828		0.1062	4.834	0.0000***
Sector by Year by Month	540	20.350		0.0377	1.715	0.0000***
Residual Firm by Year by Month	20,736	458.07		0.0221		
Firm by Year by Month Total	**21,924**	**547.25**				
Error (combined residuals)	24,939	548.03		0.0220		
Model	1,580	293.08				
Total	**26,519**	**841.17**				

The table details the analysis of covariance of the monthly dollar returns of the seven Latin American emerging stock markets over the ten-year period Sig. of F represents significance of the F-ratio. The variables are grouped in sections highlighting the results of each main factor, or interaction of factors, being examined. For each section, the total sum of squares and the residual variation for each major factor, or combination of factors are reported. A large proportion indicates a significant factor effect and allows for rejection of the null hypothesis. The analysis demonstrates that there is a strong time effect and the single most significant main effect is the year factor. Also important are the month factor and the year and month interaction.

In particular, the proportion of variance explained by the country index was 46.0 per cent for the emerging markets and 30.0 per cent for the developed markets included in the sample. The proportion of variance explained by the industry index was only 16.0 per cent for the emerging markets and 22.0 per cent for the developed markets in the sample. The findings indicate that investors should direct their diversification efforts to selecting the *'right countries'* rather than choosing appropriate industries. The relationships between country and year and between country and month are also important, although to a much lesser degree for the latter. The results from this analysis confirm the findings of Fifield (1999) which indicate that, not only do emerging market share returns vary significantly on a geographical basis, but that country returns also change from year to year and from month to month.

The industry factor is least significant in explaining the sources of variation in emerging market share returns. The F-test clearly shows that this industry effect, and the interaction between industry and country, are statistically insignificant (at the 5.0 per cent level) in explaining the cross-sectional variation in share returns. Specifically, the F-tests for these factors had p-values of 0.6743 and 0.6006, respectively, according to Table 3. Again, the results from this analysis support the findings of Divecha et al. (1992), Zervos (1996), Fifield (1999) Serra (2000), Bruner et al. (2003) and Estrada et al. (2004) which confirm the greater importance of country factors relative to industry factors in the returns of emerging market shares. For example, Serra found that industry effects accounted for, on average, only 0.7 per cent of the variance of emerging market returns. Furthermore, Zervos found that the industry factor only represented between 2.0 per cent and 8.0 per cent of the total variation in the share returns of emerging markets. These results suggest that portfolio diversification across countries is a more effective tool for risk reduction than is diversification across industries.

The results of the analysis also indicate the presence of a size effect, as represented by the market value covariate. Thus, firm size can, in part, explain the cross-sectional variation of returns in Latin American emerging markets. In particular, the results indicate that larger emerging market firms earn higher returns than do smaller firms (coefficient 0.001732, t-value 2.57).

It is essential to acknowledge that the breadth of the industrial classification employed in this analysis may be biased. The 6 broadly defined sector classifications may not have provided sufficient cross-sectional variation in share returns across industries to extract proper country and industry sources of return variation; the results may have biased industry variation downward. This notion stems from Griffin and Karolyi (1998) who suggested that studies should employ a narrow industry classification so that information on the cross-sectional variation of returns due to industry effects is not lost. In particular, the study found that finely partitioned industries exhibited more than 3 times the variation of broadly defined economic sectors. However, although Griffin and Karolyi noted that a finer industry classification scheme may yield a more accurate measure of industry effects, their main result – the dominance of country-specific effects – hardly changed with the move to a finer industry breakdown. Griffin and Karolyi compared the importance of country and industry effects using 9 broad industry categories and the more refined industry classifications of the Dow Jones World Stock Index, which covers 66 disaggregated industry groupings. Furthermore, the results of Heston and Rouwenhorst (1995) were based on only 7 broad industry groupings. Further evidence on this issue is documented by Serra (2000) who found that industrial factors were more important when a finer industry partition was used, although the study did find that even when this finer industry classification was employed, country factors still dominated. However, there was a greater loss of diversification benefits when industrial diversification was ignored. The results of this analysis are therefore consistent with the results from studies which have employed a narrower industrial categorisation.

CONCLUSIONS AND FUTURE RESEARCH

There is growing conviction amongst the investment community that as markets are becoming more integrated; industrial effects are playing an increasingly important role in explaining return variation at the expense of country-specific factors.

Empirical data obtained from Datastream used to construct monthly returns over the ten-year period to determine the role of country, industry, time and size effects in explaining the returns of Latin American emerging market equities. However, the results from this current study indicate that country selection, rather than industry selection. The evidence strongly suggested that diversification across country is a much more effective tool for risk reduction than diversification across industry is still more important in determining portfolio returns for emerging market investment strategies in the Latin American region.
These determinants of emerging market returns may provide a valuable insight to investors who are in search for more refined investment strategies. In particular, the results from the analysis indicate that, for investors seeking diversification benefits, knowledge of the legal, institutional and regulatory frameworks, as well as local politics and local economic events in a given country, is important for valuing and selecting equities traded in the (Latin American) emerging market country (Bruner, 2003; Estrada et al., 2004).

The study could extend the finding of a large country specific effect in Latin American emerging market share returns by examining a selection of certain economic factors, both global and local that might influence Latin American emerging market share returns. Furthermore, as the availability of Latin American emerging country data improves, as trading becomes increasingly active and as 'newer' Latin American emerging markets grow and become more developed, future research could focus on a more comprehensive dataset by means of a wider coverage of Latin American emerging market countries and

firms. This would enable issues to be explored in greater depth, resulting in a more precise and thorough analysis of the potential diversification gains available from investment in Latin America.

APPENDIX

Appendix 1: Industry Classification

Industry	Constituent
Consumer Goods	Breweries
	Spirits, wines & ciders
	Food manufacturers
	Household goods
	Health care
	Pharmaceuticals
	Tobacco
Financials	Banks
	Insurance
	Life assurance
	Merchant banks
	Other financial
	Property
General Manufacturers	Building & construction
	Building materials & merchants
	Chemicals
	Diversified industrials
	Electronic & electronic equipment
	Engineering
	Engineering, vehicles
	Printing, paper & packaging
	Textiles & apparel
Investment Trusts	Investment trusts
Mineral Extraction	Extractive Industries
	Oil, integrated
	Oil exploration & production
Services	Distributors
	Leisure & hotels
	Media
	Retailers, food
	Retailers, general
	Support services
	Transport
	Other services & businesses
Utilities	Electricity
	Gas distribution
	Telecommunications
	Water

Source: FTSE Level 3 Industry Classification Scheme, Datastream.

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