The Gains from International Investment Diversification: the Korean Case

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This paper attempts to estimate the gains from stock market liberalization from the Korean investors' perspective, using monthly stock price data of 215 companies in 6 Asian countries. By varying the number of stocks in the investor's choice set, this paper estimates the gains from international diversification when the set is expanded to include foreign stocks. We find that the estimated gains vary sensitively depending on whether or not short sales of stocks are allowed. When short sales are allowed, i.e., when investors can borrow funds by short-selling stocks, the gains from international diversification disappears as the number of stocks held increases sufficiently. As the number of stocks held increases, the portfolio diversification effect which can be achieved through international investment can be attained to an extent through domestic investment alone. However, when short sales are not allowed, the gains from international diversification do not diminish even though the number of stocks held increases.

Our finding that the gains from international diversification are small when short sales are allowed contradicts with the results in previous studies. For example, Brennan and Solnik (1989), Eun and Resnick (1985), French and Poterba (1990, 1991), Solnik (1974), Wincoop (1994) find significant gains from international diversification. However, most of these studies rely on the data of the national composite stock price index. By assuming that only the composite stock price index of each country can be invested in, they implicitly restrict the scope of risk diversification which can be attained by changing the number of stocks held in the portfolio. On the other hand, by using individual company data and varying the number of stocks in the investor's choice set, this paper can avoid the above shortcoming and estimate more realistic gains from international investment.

Our finding that the gains from international diversification are small when short sales are allowed has an important policy implication. It implies that the true gains from capital market

opening comes from its positive impact on international lending and borrowing opportunities, not its risk diversification effect. Therefore, once international lending and borrowing are liberalized through banking and bond market transactions, marginal gains from further opening of the stock market must be small. As for the order of capital market opening, it implies that it is the bond market, not the stock market, which has to be opened first. Our finding also helps to explain the empirical puzzle of why in reality the extent of international diversification is too low even among industrialized economies with a high degree of cross-border capital mobility. (French and Poterba (1991), Howell and Cozzini (1990), Solnik (1974))