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SECTOR VERSUS COUNTRY RISK

What drives stock price movements in emerging and developed markets?

A significant amount of analysis has been done to determine the dominant factor driving stock price movements: sector, country or stock-specific factors. This is relevant because it speaks to the efficacy of top-down versus bottom-up portfolio management, the importance of stock calls versus industry calls for a portfolio manager, and the appropriate framework for monitoring plan risk. Many of these analyses have come to contradictory conclusions due to differences in methodology such as the choice of equal-weighted versus cap-weighted indices or using hedged or unhedged returns, etc. Further difficulty has been added by the market environment in recent years, with the Asian crisis in the late 1990s increasing country factor, followed by the inflating and subsequent bursting of the TMT bubble, which drove the sector factor higher.

We performed a regression analysis of 100 randomly selected developed market stocks representing all countries and sectors in the MSCI World Index. We then compared the results for the past five years to those for the past two years to see if there were any trends in the portion of stock returns explained by country and sector.

The results showed that country explained about 30% of stock price movements and that this factor has grown in importance in a majority of countries, particularly Australia and Canada, presumably due to the rally in commodity prices. In general, larger, more globally integrated countries (i.e., the UK and U.S.) have lower country factors while Japan continues to have a very high country factor.

The increase in the country factor in the past two years compared to the past five years could be due to the different market environment. The five-year period included the bear market as well as the recovery, while the two-year period only included rising markets. We also looked at the changes in correlations between individual countries over time. In general, correlations have declined between countries, meaning the potential benefit (or cost) of making country bets has risen. The

amount of stock price movement explained by a stock's sector has remained fairly consistent over the past five years at about 25%. The energy and materials sectors are generally more affected by the sector factor, which has grown in importance in the past two years in these groups due to the rally in commodity prices. The correlation between different sectors has risen in the past two years, meaning the potential benefit (or cost) of sector bets has fallen.

EMERGING MARKETS

We performed a similar regression analysis of emerging markets stocks, an asset class that is generally viewed as being dominated by the country factor. However, we found that, on average, the country factor explained more stock price movements than in the developed markets (roughly 32% versus 25%), but there was very wide variation in different countries. For instance, in the Turkish market, country explained 70% of stock price movement, while in the fledgling China market country only explained 8%. Sector explained about 25% of stock price movements, similar to the developed markets. Technology and utilities had particularly strong sector factors while movements in industrial stocks were not related to sector.

Most analyses of longer-term trends in factors that drive stock prices shows a trend toward greater importance of sector at the expense of country in both the developed and emerging markets as the world becomes more global in both capital flows and business operations. These trends are modest and will be impacted by the environment, with events like the global rally in commodity prices driving up the sector factor and regional geopolitical crises driving up the country factor. The active manager and plan sponsor will continue to have to assess risk from both a country and sector perspective. However, the factor that has consistently dominated stock movements has been stock-specific risk, showing that the utility of bottom-up company analysis persists. ■