

## **Comment on Liljeblom and Löflund: The euro and portfolio choices—a Nordic perspective**

Pehr Wissén\*

This paper deals with a set of very interesting questions. Today, portfolio choices are important problems not just for specialists but also for the general public. A growing portion of the population saves in funds and the supply of funds to the market increases rapidly.

One of the questions any portfolio manager has to answer concerns international diversification. Does it pay? The general public has typically invested in domestic assets; it has had a “home bias”. There are compelling theoretical arguments for diversification. But do these arguments carry empirical weight?

Another slightly related issue that faces the investor concerns the consequences of forming the EMU. Suddenly it becomes harder to achieve diversification in Europe. How should this fact alter the investment strategies? How should it specifically affect a Nordic investor? The Nordic countries have, after all, different approaches to the EMU. So should investors in different Nordic countries employ different portfolio weights?

The paper attempts to answer these questions. The questions are highly relevant from an academic and a practical viewpoint.

### **1. The questions**

The paper addresses the problem of portfolio choice for an investor in Sweden, Denmark, Finland, or Norway. It raises four questions:

1. How beneficial is international diversification now and after the EMU?
2. Are the benefits lower during periods of high market volatility?
3. How important is currency risk for the Nordic countries with their distinctly different currency regimes?
4. Should Nordic investors follow different optimal portfolio strategies because of their home country’s special status regarding the EU and EMU?

\* *Executive vice president at Handelsbanken.*

The questions are answered using a data set with stock market returns during the September 1974 to May 1998 period. During the sample period, the world changed dramatically. When interpreting the results, changes during the sample period should be kept in mind. Also, the difficulties in drawing conclusions from historical data about the future effects of the EMU should be considered. Some stylised facts can describe the changes during the sample period.

## 2. Stylised facts

1. There has been growing internationalisation during the period. This has meant, among other things, that the number of internationally diversified portfolios in the world has increased. Today, many countries could still be described as domestically oriented, but their number is decreasing over time. At the same time, the firms have also become more international in the sense of producing and selling in more countries. Portfolio managers with internationally diversified portfolios pay much attention to correlations between different countries. So it seems likely that correlations have been affected by the internationalisation during the sample period.
2. The increasing diversification has meant that portfolio managers have become quicker to reallocate portfolios in periods of turbulence in the markets. They used to be locked into their domestic markets but are increasingly shifting assets around during periods of turbulence. Not least during the 1990s, we have often witnessed a tendency to “flight to quality” during periods of disturbed markets. Such a behaviour should imply that the correlation between different markets increases in turbulent periods. This has obvious implications for the answer to the second question in the paper.
3. The effects of the creation of the EMU are uncertain. But there are some observations that can be made. The limit structures for portfolio managers in Europe will most likely be changed. Today, many portfolio managers are not allowed to invest in currencies other than their domestic currency. This naturally limits the set of assets in which they can invest. When the euro is created, they will have a larger home currency. So they will also have access to a much wider range of assets than before.

It is probable that the nature of competition in the funds management industry could change as a result of the creation of the EMU. Funds will become less domestic than they have been up until now. Since there are certain economies of scale in managing the funds, we could see a tendency to concentration in this industry. This in turn could mean that the effects of "home bias" are decreased, i.e., investors do not only choose assets from their home country but look instead over the whole of Europe for their investments. Such behaviour could affect correlation between different assets in the region, most likely increasing it.

### 3. The conclusions

On the first question: *how beneficial is international diversification currently, and after the EMU*, the paper concludes that it is beneficial now, particularly outside Europe and that the coming of EMU will not really change it. Since the EMU can be expected to lead to quite dramatic changes in the structure of the European markets, one cannot draw far-reaching conclusions from a data sample from a pre-EMU period. But the authors are careful in not doing this.

Are the benefits lower during periods of high market volatility? This seems to be the clearest result of the study. Yes, the benefits are lower during periods of high volatility. This is consistent with "flight to quality" phenomena in the market.

Should Nordic investors follow different optimal portfolio strategies because of their home country's special status regarding EU and the EMU? Here the answer seems to be "no". This conclusion also may turn out to be premature. If the non-EMU countries stay out a long period of time, they may develop very differently from the "in" countries, and therefore it may turn out to matter a lot, although this is not captured in the data sets we have today. But here too, the authors are careful in not going too far with their conclusions.

