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Drivers of Portfolio Equity Flows to Emerging Market Countries

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ABSTRACT
In recent decades, international diversification has increased the portfolio investment flows to Emerging Market Countries (EMCs). This paper examines why investors diversify in EMCs and what drivers of portfolio investment flow. This paper employed descriptive analysis with a literature review approach. The finding is that international investors are interested because EMCs offer higher returns than countries of origin, with less risk. Drivers of portfolio investment flow to EMCs are classified into push factors, namely global conditions that encourage investment EMCs and pull factors that are domestic conditions in EMCs that are attractive to investors. The main driver that has the most influence on the portfolio equity flows to developing countries is the Fed Funds rates, which are part of push factors.

Keywords: *Portfolio Investment Flows, International Diversification, Push Factors, Pull Factors, Fed Fund Rates.*

1. INTRODUCTION

Globalization increases the flows of portfolios investment in equity and bond cross-border region with the primary goal of finding higher returns and price rises, without the aim of managerial control. This phenomenon is a revival of Adam Smith's invisible hand concept regarding the loosening of control over capital supported by rapid capital market growth accompanied by the many privatizations of state-owned companies [1].

The rapid growth of the global financial market began with developed countries' policies that deregulated the foreign exchange and capital markets in the late 1970s. For example, Japan liberalized its foreign exchange market in 1980, leaving its citizens free to invest in foreign securities. Even developing countries such as Brazil, China, India, Korea, and Mexico helped enact policies that allow foreigners to invest in their capital markets by offering state bonds and even registering local shares on international stock exchanges. Advances in telecommunications technology have significantly contributed to international investment through the speed of information and transactions in the cross-border region [2]

Research on international diversification in equity began in the 1970s, when globalization and international investment were considered necessary, deter-mining the relative benefits of diversification to build an international stock portfolio [3]–[5]. The development of international financial markets has encouraged investors to diversify their portfolios internationally, according to the principle of "Do not put all your eggs in one basket," which is the basis of investing [6].

International diversification aims to reduce the level of risk at a specific rate of return. This happens because economic, political, institutional, and even psychological factors that affect security returns tend to vary significantly in different countries, resulting in a relatively low correlation between inter-national securities. The relatively low international correlation implies that investors can reduce portfolio risk more because the magnitude of the benefits of international diversification in terms of risk reduction depends on the structure of international correlations [1], [2], [7].

Risk reduction is an essential thing for investors. This paper analyzes the factors that influence international diversification and concludes the main factors that influence it using a literature review approach.

2. METHODS

This study uses a descriptive method, collecting data on drivers of portfolio equity flows to emerging market countries from various books, documents, and reputable journals and then analysis using literature review techniques.

3. RESULTS AND DISCUSSION

3.1 Results

Portfolio equity flows are related to cross-border portfolio investments which can be seen from a country's balance of payments. A country's balance of payments is a systematic record of all economic transactions that have occurred during a specific period between residents of the reporting country and residents of foreign countries. These records are usually kept in the domestic currency based on a particular period according to the balance of payments of the compiling country so that it is a flow concept [8].

Balance of payments reports consists of a current account, capital, and financial transactions. Portfolio equity flow recorded in the balance sheet in the capital and financial transactions in the form of portfolio investment is a flow of foreign investment in shares without changing the company's control that distinguishes it from Foreign Direct Investment [9].

Portfolio flow is influenced by the Tax Rates on Interest or Dividends, Interest Rates, Exchange Rates (Madura, 2018). Specifically, portfolio equity flows to emerging countries are influenced by many factors, which can be simplified into push factors and pull factors [10], [11].

The push factors are simplified into three main factors: global risk, External Interest Rates, External Output Growth. First, portfolio flow is strongly influenced by the transfer of global risk, which is seen when the global financial crisis occurred in 2008-2009. Various empirical studies found a significant and robust relationship to increased global risk in the portfolio equity flow [12]–[18]

Second, external interest rates proxy with fed fund rates have a negative impact on portfolio equity flow [10], [19]–[27]. Third, external GDP growth in which economically developed countries [19], [28], [29].

The pull factor is a factor from the domestic country that attracts portfolio flow to enter the country. First, internal economic growth is the relationship between domestic growth and portfolio investment flows which provide evidence for the role of growth in domestic output [19], [26], [30]

Second, domestic market returns are associated with an increase in portfolio equity and bond inflows [15], [25], [31]–[36]

Third, country risk indicators for portfolio flow show that a higher ratio of foreign debt to GDP tends to reduce portfolio equity flows [23], [37].

Portfolio equity flows are predominantly influenced by push factors, especially the Fed Funds Rate. A general interpretation of the empirical findings is that low fed fund rates tend to "push" capital to EMCs, while higher interest rates reduce this flow (Fernandez-Arias, 1996).

The Fed tracks macroeconomic indicators to capture the current state of growth and future potential and adjust to policies, one of which is the Fed's interest rates. In most cases, the central bank is the sole information expert on economic health. Thus, when issuing policies, the market will react, one of which investors make trading decisions. The capital market reacts to the Fed's interest rate, which is one of the essential statistical and economic drivers of financial markets and significantly impacts asset prices [38], [39].

Another connection developed between the Fed's policies and the capital market lies in the methodology of industry valuation. It has become the leading standard practice for financial institutions to consider the movements of the central bank when producing asset valuations, using the Fed Model, which integrates Fed Fund rate data into stock price evaluations. The Fed Model is a standard tool for institutions such as J. P. Morgan, ING, and Prudential. Influential market participants embrace the Fed model and make it a critical valuation tool used by leading investors to check whether they should buy shares or bonds [39].

3.2 Discussion

Why emerging market countries? The main criteria of EMCs emphasize the shifting of a country from an economy with a closed market to an open market, reforming economic development, and economic progress. It is expected that reform and restructuring will strengthen the economy and make it more competitive in the international market. Often the visible results of reforms are reflected in a fast-growing economy as evidenced by an increase in GDP growth rates, per capita income levels, and investment. These results make the economy attractive to local and foreign investors and increase portfolio investment and direct investment [40].

EMCs generally are net recipients of foreign capital in recent decades (Institute of International Finance, 2015). This is due to economic, political, institutional, and even psychological factors that affect the return of security tend to vary significantly in different countries, resulting in a relatively low correlation between international securities [1], [2].

EMCs have a low correlation with most developed markets, as well as a low correlation among themselves. Low correlation means that adding portfolios in emerging markets can reduce risk and provide higher returns, makes EMCs of the main objectives of international portfolio flow [5], [41], [42].

The primary purpose of investors when investing in EMCs is to rebalance their international portfolios. Rebalancing can be driven by two motives. First, to reduce foreign currency exposure when foreign portfolio ownership outperforms domestic ownership, which leads to foreign capital outflows from emerging markets and second, to pursue higher returns in markets that are performing well, leading to inflows of foreign capital into emerging markets, a motive for tactical reallocation to increase returns rather than reduce risk [31].

The difference in economic and legal reforms carried out by EMCs in various regions shows the difference in attracting foreign capital. The portfolio of equity flows is significantly attracted by the ability of the government to implement policies effectively, strengthen the quality of institutions, and control corruption, governance measures from the rule of law, property rights, and institutional quality and political stability [7], [43], [44].

4. CONCLUSIONS

Portfolio equity flows to emerging countries are influenced by many factors, which can be simplified into push factors and pull factors. Portfolio equity flows are predominantly influenced by push factors, especially the Fed Funds Rate. Low-fed fund rates tend to "push" capital to EMCs, while higher interest rates reduce this flow. The capital market reacts to the Fed's interest rate, which is one of the essential statistical and economic drivers of financial markets and significantly impacts asset prices.

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