Cracking the Emerging Markets Enigma (Financial Management Association Survey and Synthesis)

G. Andrew Karolyi
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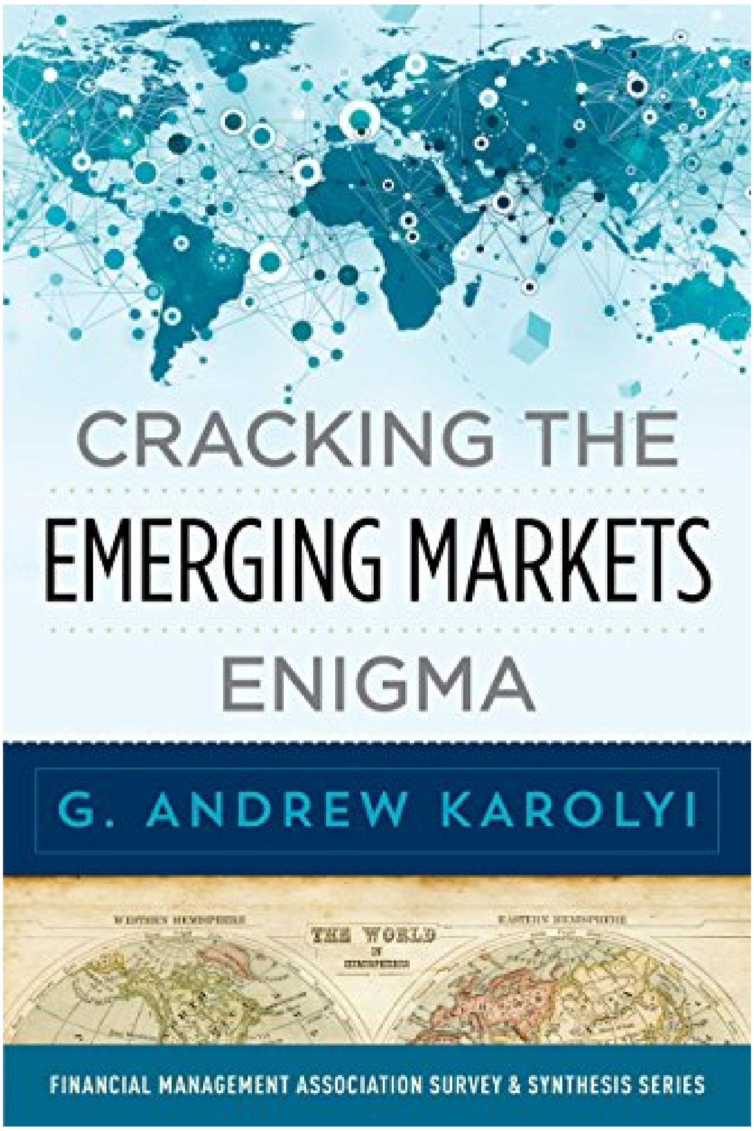

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G. Andrew Karolyi : Cracking the Emerging Markets Enigma (Financial Management Association Survey and Synthesis) before purchasing it in order to gage whether or not it would be worth my time, and all praised Cracking the Emerging Markets Enigma (Financial Management Association Survey and Synthesis):

1 of 2 people found the following review helpful. Useful Risk Assessment Framework for Investing in Emerging MarketsBy Serge J. Van SteenkisteAndrew Karolyi develops a scoring system which helps global asset managers and

corporate financial managers to get a better understanding of the risks involved in investing in emerging markets.Mr. Karolyirsquo;s scoring system is made up of six different fundamental risk indicators:1. Market capacity constraints,2. Operational inefficiency,3. Foreign accessibility restrictions,4. Corporate opacity,5. Limits to legal protections,6. Political instability.Each fundamental risk indicator includes different variables.The author applies his risk scoring system to 24 developed markets and 33 emerging markets. Mr. Karolyi also gives his readers the emerging and developed medians so that they get a better perspective of how each of the 57 markets performs compared to both medians. The author convincingly shows that emerging market risk indicators have significantly stronger correlations with each other than those among developed markets.Mr. Karolyi subsequently tests the validity of his risk scoring system by assessing how the six different fundamental risk indicators can explain the ldquo;home-biasrdquo; and ldquo;foreign-bias.rdquo; The ldquo;home-biasrdquo; refers to the propensity to disproportionately invest in securities at home, say the U.S. The ldquo;foreign-biasrdquo; covers the inclination of investors to disproportionately invest in securities that are familiar or proximate, say Canada and Mexico. The authorrsquo;s risk scoring system better explains the holdings of global institutional investors than the foreign investor holdings of US residents.Mr. Karolyi further tests the validity of his risk scoring system by looking at the impact of the U.S. Federal Reserversquo;s decision to taper its securities purchase program a.k.a. ldquo;quantitative easingrdquo; on US residentsrsquo; exit from emerging markets in 2013. Operational inefficiency, corporate opacity, the limits to legal protections, and political instability played a statistically significant role in the portfolio net flows of US residents across merging markets during that year.To his credit, Mr. Karolyi repeatedly acknowledges the weaknesses of the approach that he takes. As a side note, appendixes A to E include a useful overview of the key data sources used to build the authorrsquo;s risk scoring system.0 of 1 people found the following review helpful. Book is a great read. Quite disappointed author did not list final ...By John GoodellBook is a great read. Quite disappointed author did not list final data for his dimensions for future researchers.5 of 5 people found the following review helpful. A comprehensive look at the risk/rewards of emerging markets.By Wesley Gray (Alpha Architect Blog)A recent IMF World Economic Outlook survey projected that in 2015-2016 advanced economies will grow at 2%-2.5% rate, while emerging and developing markets are growing at a more robust 4%-5%, led by India and China, growing at 7% and 6%, respectively. Indeed, the conventional wisdom is that emerging markets, growing at perhaps double the rate of advanced economies, will lead the ongoing recovery and that we should expect them to exhibit the highest growth rates in the world over the long run.With such encouraging growth potential, why not go all-in on emerging markets?While this is compelling logic, the great potential of emerging markets must be balanced against the potential risks. These risks are related to various restrictions on the free flow of capital that exist in these markets. In ldquo;Cracking the Emerging Markets Enigma,rdquo; Andrew Korolyi attempts to identify and quantify six classes of risk in emerging markets, which allows investors to distill overall risk to a single number, enabling comparison across all countries, from emerging to advanced, and inform allocation decisions.Itrsquo;s a bold undertaking, but Dr. Korolyi certainly has the credentials to back up the attempt. Andrew Karolyi is an internationally known scholar, and a professor at Cornellrsquo;s Johnson Graduate School of Management, and has done extensive research into international investment management. In many ways, this book is a synthesis of the many research papers he has published, and the culmination of the many years of study he has devoted to emerging markets.Karolyi presents the overall framework, and then offers a separate chapter to explore each of the six risk factors he identifies. Along the way, he takes us through the voluminous academic research in these areas and offers great local case studies that highlight the issues at play.What I like about the book?I enjoyed the balance Karolyi sought and achieved in presenting both the big picture, as well as a more granular discussion of the various dimensions of risk. The bookrsquo;s scope and broad reach across the many areas of risk that international investors face provided me with a new perspective on emerging markets investing. Institutional and retail investors alike can benefit from exposure to the body of academic research upon which Karolyi draws, and which he carefully organizes for us. Although each risk area is practically a field of study unto itself, Karolyi takes us through each one in detail while describing his methodology.Market Capacity ConstraintsFirst up is market capacity, which relates to a countryrsquo;s domestic credit markets, the size of its equity and bond markets, the number of listed companies, and trading volumes and liquidity. These factors collectively facilitate the efficient allocation of capital and financial development of a country. The output from the model is fascinating. I learned that Venezuela is terribly constrained, with weak credit markets, no bond markets, and a tiny illiquid stock market versus its GDP. By contrast, Taiwan has established bond markets, and has many participants in its vibrant equity market, which is larger and more liquid than those found in many developed economies.Operational EfficiencyOperational efficiency relates to the various transactional costs involved when trading in these markets. These include explicit trading costs, such as commissions, fees and taxes, as well as implicit costs such as bid-ask spreads, market impact costs, market depth and breadth considerations, other measures of market liquidity, restrictions (such as on short selling), clearing and settlement systems, and market integrity.Restrictions on Foreign AccessibilityThis risk category involves capital controls generally, and the direct legal and indirect practical factors that affect foreign investment. Direct factors include consideration of investor frictions such as foreign investor registration requirements, currency convertibility, and withholding taxes. Indirect factors include ldquo;hasslerdquo; factors such as ownership restrictions, taxes, or position limits for foreign investors. These kinds of restrictions impose costs on foreign investors, and are a deterrent to investing.Governance/TransparencyTransparency as a risk factor has to do with corporate governance practices within countries. Governance issues include things like minority shareholder rights, disclosure standards, board structure and independence, the existence of large blockholder interests, and analyst coverage. Another interesting way to view transparency is via ldquo;synchronicity,rdquo; which describes how stocks in a market commove together. China scores especially poorly on this measure, which contributes to its dead last ranking in corporate transparency.Legal Protections for InvestorsThis measure of risk deals with the structure and attributes of of a countryrsquo;s legal system. It includes consideration of the general environment of law and order, minority shareholder rights, creditor rights, dispute resolution mechanisms, and regulatory and supervisory powers. These legal protections, or lack thereof, can protect shareholders, or limit their ability to pursue action.Political InstabilityMany investors consider political stability to be a primary source of risk when investing. Measurements of political stability might include constraints on policy change, and commitments to business and real estate ownership. Karolyi also considers inputs for civil unrest, violence and corruption.It's quite a ride through these risk factors, but be have unifying theme at the end bringing the analysis into focus for the reader. At the end of the book there is a great chapter that discusses how well the model describes investor behavior. Karolyi shows how global investors allocate, and observes that his model better describes holdings of non-US investors than it does for US residents. He then goes on to test the model out of sample, in the emerging market swoon of 2013, which sheds some light on which risk areas investors appear to have prioritized at that time. It's an absorbing analysis, and while it clearly explains a lot of what occurs in emerging markets, it also raises some interesting questions about how investors allocate and why.Constructive CriticismI found Mr. Karolyirsquo;s style to be somewhat overly academic at times. For example, he attempts to assess his risk measures by comparing the predictions of his model to how global investors actually allocate to different emerging markets, including a discussion of home bias and foreign bias. So does his model explain how investors allocate? Well, yes, it does a reasonably good job, as the regression yields an R-squared of 20%. Yet, what are we supposed to make of this data? Sure, we can see the implied home and foreign bias, and that U.S. investors under-allocate to Chile, but what exactly does this tell us about the integrity of his risk framework? Is the goal of the model to predict how investors allocate? Why should this be a basis for determining whether the model ldquo;works?rdquo; Given various biases, perhaps we could conclude that his model offers a better way to measure risk, and therefore investors may be misallocating?I was looking for more help with these questions, although perhaps we'll see more as Karolyi does follow-on analysis in the years ahead. The methodology is also just generally academically dense, with casual references to obscure statistical methods, such as ldquo;eigenvalues,rdquo; which is term I forgot shortly after taking linear algebra in high school in the 80s. Yikes. Maybe this lowly Wharton MBA is in the wrong book.SummaryWhile this book is probably better geared for the more academically inclined, or for institutional investors, the comprehensive risk framework Karolyi presents is well-reasoned and is generally comprehensible to the lay reader. While I was familiar, at least anecdotally, with many of the issues covered in this book, it was fascinating to see a quantitative mind attempt to corral these issues in a coherent way, and integrate them into a general framework. And while big picture is great, the detail is also quite stunning. Thinking about investing in Slovenia? You may be surprised to see it ranks ahead of Japan and Germany for governance and corporate transparency.Another takeaway I had after reading this book is that while we tend to lump countries into different buckets, each with a descriptive label that describes its risk, the truth is that risk measures are much more fluid and have more gradation than we assume. A country that is labelled as an "emerging market" may not be an emerging market from a risk standpoint. And Koralyi's model seems like a reasonable place to start for thinking about these issues. I look forward to seeing what Koralyi delivers in the form of additional out of samples tests as the future unfolds.Finally, this book is a great addition to the bookshelf for the educated investor.

Forward-thinking investors are constantly looking for the next BRIC-what foreign market is on the brink of expansive growth? Will these investments payoff, or are the potential risks too great? Investing in these emerging markets requires a careful analysis of potential risks and benefits which vary greatly from country to country and even from day to day.In Cracking the Emerging Markets Enigma, emerging markets expert Andrew Karolyi outlines a practical strategy for evaluating the opportunities and-more importantly-the risks of investing in emerging markets. Karolyi's proposed system evaluates multiple dimensions of the potential risks faced by prospective investors. These categories of risk reflect the uneven quality or fragility of the various institutions designed to assure integrity in capital markets-political stability, corporate opacity, limits placed on foreign investors, and more. By distilling these analyses into a numerical scoring system, Karolyi has devised a way to assess with ease emerging markets by different dimensions of risk and across all dimensions together.This novel assessment framework already has been tested in the market to great success. Researchers, students, firms, and both seasoned and novice investors are poised to gain a clear understanding of how to evaluate potential investments in emerging markets to maximize profits.

"Andrew Karolyi has a long track record of distinguished scholarship on international financial markets. This important book on the fundamental risks associated with investing in emerging markets shares many of the lessons of his writing. Anyone who cares about investing in emerging markets should consider Karolyi's new framework. This is an especially important book because it lets data and evidence talk loudly and clearly. Cracking the Emerging Markets Enigma provides a practical framework that highlights for asset owners, consultants, and professional asset managers the fundamental risks of investing in emerging markets. Readers will be inspired by the lucid arguments and, as investors, will be better prepared for the next hard decision they will face in the emerging market space." David Booth, Chairman and Co-CEO, and Eduardo Repetto, Co-CEO and Co-CIO, Dimensional Fund Advisors"Conventional wisdom about emerging markets fluctuates between breathless optimism about opportunities they offer and despondency about their flaws. Instead, Andrew Karolyi offers a sober, quantitative, and thoughtful analysis, which could do great service to scholars and investors alike." Andrei Shleifer, Professor of Economics, Harvard University"Building on decades of academic grounding, Professor Karolyi proposes an innovative and useful framework for evaluating emerging market opportunities and risks. This book should be on the shelves of every EM investor in the asset management industry." Ken Kroner, Chief Investment Officer and Head of Scientific Active Equity, BlackRock"Funding the higher growth potential offered by the emerging markets will only be truly realised with the more active engagement of direct and portfolio investors in developing the governance infrastructure and removing operational inefficiencies. Dr. Karolyi's considered and thoughtful approach to key risk indicators backed with compelling case studies, advances our understanding of the available investment opportunity and market capacity." Michael Cole-Fontayn, Executive Vice President, Chairman of Europe, Middle East Africa, The Bank of New York Mellon"This book is a must read for investors allocating to emerging economies. Andrew Karolyi is one of the most respected scholars in international finance and has produced an immensely readable and practical guide on emerging market investing. The book offers insights and data on the challenges of emerging countries, which contrast with the conventional romantic notion of EM growth. It also offers an easy to use scoring system to help investors improve their odds for success." Jason Hsu, Co-Founder and Vice Chairman, Research Affiliates"Karolyi develops an intuitive but rigorous process to assess the operational risks, expropriation risks, and other impediments foreign investors face in markets around the world. The result is an easily understood framework that organizes what would otherwise be an overwhelming amount of information. The general conclusions make sense, but there are also many interesting and important surprises to reward the reader. Karolyi's comfortable, intuitive style makes the book accessible to anyone interested in the challenges foreign investors face in emerging markets." Kenneth R. French, Roth Family Distinguished Professor of Finance at the Tuck School of Business at Dartmouth College"Investors have many reasons why they find emerging markets to be attractive but they also know that these markets have risks that they are not exposed to within developed markets and that they have to master if they want to be successful. Cracking the Emerging Markets Enigma provides investors with an implementable approach to master these risks built using the most advanced research in financial economics. The book is written by a leading researcher who knows how to communicate with investors and whose approach has already passed the market test. I highly recommend it." Reneacute; Stulz, Professor of Finance, Fisher College of Business, The Ohio State University"The courageous attempt of Prof. G. Andrew Karoly to 'crack the emerging markets enigma' must be commended. After years of work, he concludes that he is 'not sure' that he has actually achieved it. However, his contribution provides a methodology to identify the source and future of emerging markets by focusing on six factors in a 'rigorous, comprehensive and practical way.' Those who work, academically, financially and professionally in emerging markets will recognize immediately some of the most important impediments to further or better growth of those markets. Not surprisingly, most of them are the result of the legal and regulatory structure of those countries. Overcoming these obstacles is a common challenge of local governments and their business community.Andrew Karolyi certainly moved the ball forward in the direction of an enigma that, contrary to the British Bletchley in World War II, might never be completely cracked. It is quite an achievement and he initiated here a sizeable and useful progress, and he managed to make it eminently readable." Georges Ugeux, Chairman and CEO, Galileo Global AdvisorsAbout the AuthorG. Andrew Karolyi is Professor of Finance at the Samuel Curtis Johnson Graduate School of Management at Cornell University. He consults for investments firms and teaches executive development courses to educate investors on portfolio management and emerging markets. He also currently serves as executive editor of the of Financial Studies, one of the top journals devoted to the study of financial economics.