CHAPTER I

INTRODUCTION

1.1 Background of the Study

Since the stock market liberation on developing countries started in 1990s, the barriers for investors to invest their money had been perished. In Indonesia, stock market liberation started in 1989 when the Decree of the Minister of Finance No. 1055 / KMK.013 / 1989 led to opening of domestic stock market to foreign investors. Over the time, those liberations have been leading Southeast Asia toward financial integration. A study conducted by Park and Song (2001) found a little evidence of financial integration among the five Southeast Asian countries-Indonesia, Malaysia, Philippines, Singapore, and Thailand in the 1990’s. Some international portfolios, especially emerging equity market portfolios, are popular among US and European investors leading to financial stock market integration.

Afterward, guided by the ASEAN Economic Community or AEC, 7 exchanges from Malaysia (Kuala Lumpur Stock Exchange), Vietnam (Hanoi Stock Exchange and HoChiMinh Stock Exchange), Indonesia (Indonesia Stock Exchange), Thailand (Stock Exchange of Thailand), and the Philippines (Philippines Stock Exchange) established collaboration called ASEAN Exchange to brings more opportunities for investors. On 18 September 2012, ASEAN Exchanges collaboration introduced a gateway for securities brokers to offer investors easier access to connect exchanges called as ASEAN Trading Link. Thus it has led them into market integration and efficiency among countries. These
investment opportunities would be making investors easier to maximize international diversified portfolio, especially among countries of South East Asia. Eventually, the opportunity of investors to build a higher expected return with lower risk towards international diversification is now widely opened.

The idea to maximize portfolio expected return for a given amount of portfolio risk was started in 1952. Modern Portfolio Theory was introduced by Markowitz (1952) to point “geometrical relations between beliefs and choice of portfolio according to the expected returns-variance of returns rule”. The return of an investment is not perfectly correlated with returns from other investments, the returns of a diversified portfolio will be lower in variability compared to the return of a single investment at the same market risk (Fooladi & Rumsey, 2002 in Hasman, 2009).

Although initial concept of modern portfolio is for the closed economy (domestic economy), following years later in 1968, Grubel applied modern portfolio theory to international investment. In his research, Grubel found that from 1959 to 1966; US investors could get the opportunity superior risks and return by investing part of their portfolio to foreign equity markets (Gupta, 2006).

Risk reduction through international diversification in foreign securities has been recognized for long time ago. An internationally diversified portfolio is likely to carry a much smaller risk than a typical domestic portfolio (Solnik, 1974). However, an international diversified portfolio contains currency risk. One way to mitigate the existence of currency risk from international diversification investment is to hedge currency risk.
The idea of international diversification was to have low correlation compared to domestic portfolio performance. In other word, the diversification benefits that comes from investing in other countries with low cross-correlations can result in both an increase in return and a reduction in volatility at the total portfolio level over the long term of period. Although the issues from low level of correlation in equity market are documented by Solnik (1974), the factors drive low correlation between countries in equity market have been controversial issues to be argued among academics and professional portfolio managers. Some argued that the different exposure of exchange rates is the factor. Meanwhile many have claimed low correlation between equity markets in countries arise from differences in economic conditions across national boundaries due to variation of regulatory environment, economic policies, and growth rate (Gerard et al., 2002).

However, from Indonesian perspective, domestic portfolio is more superior to international portfolio. Two important factors become foundation for the superiority of domestic portfolio are the low level of correlations between stocks in domestic portfolios and the high level of risk per unit return of domestic assets compared to international assets (Hasman, 2009). Nevertheless international portfolio is not in favor for Indonesian, but it is not a certain unbeneificial for Indonesian to invest in international Southeast Asia countries portfolio. This research is focused on evaluating whether international portfolio in Southeast Asia countries is more beneficial than domestic portfolio from Indonesian perspective, or not.
1.2 **Problem Identification**

This study will focus on finding the potential return and risk in different kind of portfolios. Therefore, the following problem statements in form of questions of this research would be:

1. In comparison to domestic performance, is international diversification with hedging strategy in Southeast Asia stock markets considerably more beneficial for Indonesian investors?

2. In comparison to domestic performance, is International diversification without hedging strategy in Southeast Asia stock markets considerably more beneficial for Indonesian investors?

3. In comparison to international diversification without hedging policy, is international diversification with hedging policy considerably more beneficial for Indonesian investor?

1.3 **Objectives of Research**

The objectives of this study are to solve the problems based previous questions. The objectives of this study are to find out:

1. Potential return and risk of international portfolio in Southeast Asia with hedging policy compared to domestic portfolio
2. Potential return and risk of international portfolio in Southeast Asia without hedging policy compared to domestic portfolio

3. Potential return and risk of international portfolio in Southeast Asia with hedging policy compared to international portfolio in Southeast Asia without hedging policy

1.4 Research Contribution

This study hopefully can contribute to academicians and practitioners in finance field. The information that contains in this study would be a reference to Indonesian investors as a consideration for international investment decision making or investment manager to create an internationally financial product. Although the information of international investment is limited in Southeast Asia sub region, however, this study can be helpful for anyone who intends to see the general overview of SEA equity markets.