Global Financial Management
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An Introduction to Dynamic
Global Financial Management

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1. Goals

1. Explore the definition of risk in international context.

2. Explore the implications of risk for financial management.

3. Explore the role of the U.S. economy in world financial markets.
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2. Resources

Global Financial Management Module in WWW site:

http://www.duke.edu/~charvey

Information on:

- Java-based tools for mean-variance analysis
- Lecture modules from my Global TAA course
- Distribution of returns in many world markets.
- Expected returns and volatilities for 135 countries.
- Analysis of risk-return relations in developed and emerging markets.

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3. What is Risk?

Possible definitions:
• Volatility
• Beta
• Skewness
• Downside exposure
• Forecast uncertainty
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3. What is Risk?

Sources of risk:
- Industry
- Country
- Company
- Project
- Experience
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4. Implications of Risk

Why do we care about risk?

- Only want to accept projects which enhance shareholder value.

Project value to shareholders is the discounted value of the expected future cash flows.

While the firm may be used to accepting a 15% IRR project in the U.S., it is possible that a project offering a 25% IRR originating in another country should be rejected!
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5. Why Dynamic Management?

There are two decisions: strategic and tactical

- The strategic decision determines the composition of the firm's portfolio of international projects.

The strategic decision is based on analysis of individual markets and the firm's expected competitive position.
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5. Why Dynamic Management?

The tactical decision is a dynamic entry/exit decision based on current and expected business conditions

- The tactical decision determines the timing of the firm's investments.
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5. Why Dynamic Management?

For many years, the dynamic or tactical decisions were ignored because stock prices were assumed to follow a random walks.

- A random walk implies that the best forecast of next period's price is today's price.

  → Implication is that stock returns are unpredictable.
  → Implication is that static management is the best you can do (i.e. long-term buy and hold strategies)
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5. Why Dynamic Management?

Considerable new evidence that stock returns are predictable and sensitive to the business cycle.

- International -- Harvey 1991 (J. Finance)
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5. Why Dynamic Management?

Implication is a strategic/tactical approach to global financial management.

- Timing is important for making both portfolio and direct investments in a country

- Both risks and rewards shift through time

- U.S. business cycle plays crucial role
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5. Why Dynamic Management?

Consider the behavior of the ex post returns during U.S. recessions and expansions.

- Calculate average returns during U.S. recessions
- Calculate average returns during U.S. expansions
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5. Why Dynamic Management?

Country Equity Returns Based On U.S. Economic State

Annualized Total Returns

-60.0% -40.0% -20.0% 0.0% 20.0% 40.0% 60.0%

WORLD EAFE WORLD X US AUSTRALIA AUSTRIA BELGIUM CANADA DENMARK FINLAND FRANCE GERMANY HONG KONG IRELAND ITALY JAPAN NETHERLANDS NEW ZEALAND NORWAY SINGAPORE SPAIN SWEDEN SWITZERLAND UK AVERAGE USA

- NBER Expansion
- NBER Recession

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5. Why Dynamic Management?

Country Volatility Based On U.S. Economic State

Annualized Volatility

- NBER Expansion
- NBER Recession

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5. Why Dynamic Management?

Country Correlation With U.S. Based On U.S. Economic State

Correlation

WORLD  EAPE  WORLD X US  AUSTRALIA  AUSTRIA  BELGIUM  CANADA  DENMARK  FINLAND  FRANCE  GERMANY  HONG KONG  IRELAND  ITALY  JAPAN  NETHERLANDS  NEW ZEALAND  NORWAY  SINGAPORE  SPAIN  SWEDEN  SWITZERLAND  U.K.  AVERAGE

■ NBER Expansion  □ NBER Recession

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5. Why Dynamic Management?

Country Covariance With U.S. Equity On U.S. Economic State

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6. Lessons

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1. To enhance shareholder value, we must work hard to understand country risk and its role in determining project discount rates.

2. A structure needs to be established in each corporation to quantify country risk and to feed information to the project evaluation process.

3. While it is obvious that 'timing is important', the firm's capital must be tactically allocated to capture the highest value opportunities in a changing global environment.