Comments on “Long-Term Global Market Correlations” by William N. Goetzmann, Lingfeng Li, and K. Geert Rouwenhorst

- This is a paper that is nice to read. It is clearly written and discusses important questions. It is very transparent what the authors do and why.

- I liked the methodological discussion, including the discussion about pitfalls regarding conditioning biases when comparing correlations in regimes with different volatilities.

- However, it is not clear what a potential investor should take out from it. Given that correlations do not seem to be stable over time, how informative is the past regarding the future? Since past correlations are not likely to remain constant, how much effort should a fund manager undertake in order to achieve something that looks like an internationally diversified portfolio?

Suppose for moment that the recent past is indeed a good guide of the future and assume that the trend witnessed over the recent years, namely that of an increased correlation of stock markets continues. The answer suggested by the authors is that investors may have to keep looking for new emerging markets to diversify their portfolio.

Let me offer an alternative view, and I will have to speculate a bit here. As shown in the tables, the observed increase in correlation among the major stock markets is not associated with an increase in the variance of the individual markets. If anything, one sees a decline in volatility. Therefore, what maybe happening, is that in the era of globalization firms are doing the diversification job for the investor (contrary to the Modigliani-Miller theorem). As discussed earlier by Brooks and Del Negro, companies may be diversifying their productive structures, diversifying their sales, diversifying financially. If that is true, you should observe a decline in national stock price volatility and an increase in international correlation. This mechanism would be consistent with the observation that for mature markets, country factors seem to have diminished in importance vis-à-vis industry factors, whereas for emerging markets, that is does not yet seem to be the case. This would also mean that the investor is indirectly (but not in the most efficient way) reaping the benefits of diversification even though the correlations of national stock markets seem to increase. This would also mean that diversification could be reached more and more by investing at home, and that seeking diversification through investing in frontier markets is not the long-term answer.

- The authors also briefly discuss that diversification benefits may disappear precisely when one needs them, that is, in bad times. I would have liked to see some examination of this type of asymmetries, possibly along the lines of Longin and Solnik (2001).