

Sector Effects in Emerging Market Returns: Evidence from India

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This paper sheds light on the implications of the changing structure of stock returns for asset management. Using latest stock market data, under Engle Granger (EG) cointegration framework, it finds absence of stock return correlations among industrial sectors in India. The findings provide clear evidence of the diversification over unrelated sectors which yield more efficient portfolios than diversification over firms. Mean-variance analysis of a set of experimental portfolios further confirms the prediction on portfolio choice with multi-sector consideration. The study suggests analysis of the risk return indifference curves of the investors for matching the portfolio performance with investor utilities.

I Introduction

Identifying the co-variations among sectoral stock returns is highly significant for efficient portfolio strategies. Financial theory suggests that the distinct behaviour of sectoral stock returns in a market even under the same economic conditions offer diversification benefits to investors. Even though industry groups may find it difficult to 'buck the trend' in the general economic conditions, they do not necessarily respond to the same degree. Hence, the industry factors could be significant fundamentals in explaining the extra-market correlations in stock returns (Fabozzi and Francis 1979). Later studies like Cavaglia *et al.* (2000), and Isakov and Sonney (2002) proved the dominance of industry factors in earning extra returns to investors. Here the analysts and scholars alike have tried to trace the key factors that influence the performance of particular sector and its relative strength or weakness compared with other industrial groupings.

This paper does not intend to discuss the relative significance of industry factors in explaining the variability of stock returns. Instead, it describes the importance of asset allocations over unrelated sectors that are essential to get the most out of the potentials of efficient wealth management in emerging market context. This constitutes our main contribution to the literature in the field. Hence, we examine the consequences of changes in the sectors for better