Return Comovement

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Summary

In this paper, we use a simple gauge of within-market return comovement that relies only on a variance decomposition of the market return, and not on any particular model of returns, to explore the behaviour of stock return comovement.

Applying the simple gauge to a recent international panel, we observe that return comovement is not, as had once been thought, tied to whether a country is rich or poor. Nor is it tightly tied to traditional measures of investor protection and country risk. Instead, it is more closely related to variables that may reflect different, shorter-term aspects of institutions, including international macroeconomic policy stability. These variables help explain the dramatic changes in the behaviour of countries' return comovement over the last several decades.

We also challenge findings that attribute the long-term downward trend in US comovement to compositional factors. We find that the trend appears even in a sample that has a nearly constant composition. Finally, we attribute much of the recent US comovement uptick to

cyclical factors, rather than to a reversal in the long trend observed over much of the 20th century.

Many existing cross-country comparisons of return comovement highlight differences in the quality of the markets' financial institutions – differences that correspond to variation in informational efficiency. Our findings suggest that institutional quality and its link to informational efficiency should be considered in a broad context, one that includes the stability of macroeconomic institutions as well as financial ones. Future firm-level research linking return comovement to other variables, such as analyst following, foreign ownership, corporate structure, and corporate culture, would benefit from also considering interactions with broader and more transitory economic conditions, such as international macroeconomic policy instability.