Systematic Risk: The risk inherent to the entire market or an entire market segment. Systematic risk, also known as 'undiversifiable risk', 'volatility' or 'market risk', affects the overall market, not just a particular stock or industry. This type of risk is both unpredictable and impossible to completely avoid. It cannot be mitigated through diversification, only through hedging or by using the right asset allocation strategy.

Unsystematic Risk: Company or industry-specific hazard that is inherent in each investment. Unsystematic risk, also known as 'nonsystematic risk', 'specific risk', 'diversifiable risk' or 'residual risk', can be reduced through diversification. By owning stocks in different companies and in different industries, as well as by owning other types of securities such as Treasuries and municipal securities, investors will be less affected by an event or decision that has a strong impact on one company, industry or investment.

Unsystematic risk includes a new competitor, a regulatory change, a management change and a product recall.

Home Bias in International Investment

Bias: Bias are human tendencies that lead us to follow a particular quasi-logical path or form a certain perspective based on predetermined mental notions and beliefs.

When investors act on a bias, they do not explore the full issue and can be ignorant to evidence that contradicts their initial opinions.

Home Bias: The tendency for investors to invest in a large amount of domestic equities, despite the purported benefits of diversifying into foreign equities. The bias is believed to have arisen as a result of the extra difficulties associated with investing in foreign equities. Such as legal restrictions and additional transaction costs.

Home Bias in International Investment: Though many studies have demonstrated the gain from international diversification, recent research has indicated that investors seem to greatly favor domestic assets and invest much less in foreign assets than one would expect given the expected gains from diversification.

Why do investors seem to have this bias in favor of securities of their home country?

There are several possible reasons: taxes, transaction costs, etc

1. Taxes: If home bias is due to taxes, then the tax on foreign securities would have to be high enough to offset the higher return expected from these securities. However, taxes paid to foreign governments can usually be credited against domestic taxes. Even if there is some net increase in the tax paid on foreign investment, it is unlikely that this increase could be high enough to discourage foreign investment to the extent observed.

2. Transaction costs: The cost associated with buying and selling foreign securities includes explicit monetary costs, like fees, commissions, and bid-ask spreads and implicit costs such as differences in regulations protecting investors, language differences and costs of obtaining information about foreign investment opportunities. Familiarity with domestic assets and lower explicit costs of trading at home may lead to home bias.

3. One possibility is that the gains from international diversification have been overstated. If countries tend to specialize in the production of certain goods and services and trade with the rest of the world for other goods and services, it is possible to imagine a situation where income fluctuate less than one might think based on fluctuations in domestic production. As output fluctuates for certain industries, relative prices change and this relative price change helps to smooth out income fluctuations.

Foreign Direct Investment: Foreign direct investment is an investment in a business by an investor from another country for which the foreign investor has control over the company purchased.

It refers to an investment made by a foreign individual or a company in the productive capacity of another country.

It can be considered as the movement of capital across national frontiers in a manner that allows the investor to have a control over the investment.

Why FDI?

Foreign investment comes in several forms. Portfolio investment, foreign loans and foreign direct investment are the three important types. Of these foreign direct investments in industry and services are the most useful. Foreign loans are generally used for investment in infrastructure. This is important as a serious bottleneck for domestic as well as foreign investment is the poor state of infrastructure. However the development of infrastructure alone would not suffice.

The significance of private FDI is that such investments are risk free to the country and bring with it the advantages of advanced technology, management practices and assured markets. In due course there is a technology transfer as the local workforce gains knowledge of the manufacturing processes and management practices. The value added in these industries is a contribution to GDP and foreign exchange earnings. Therefore FDI contributes to foreign exchange earnings, employment creation and increases in incomes, especially of skilled and semi-skilled workers in these industries.

Advantages of FDI

1.INTEGRATION INTO GLOBAL ECONOMY

A developing country, which invites FDI, can gain a greater foothold in the world economy by getting access to a wider global market

2. TECHNOLOGY ADVANCEMENT

FDI can introduce world-level technology and technical know-how and processes to developing countries. Foreign expertise can be an important factor in upgrading the existing technical processes in a host country.

3. INCREASED COMPETITION

As FDI brings in advances in technology and processes, it increases the competition in the domestic economy of the developing country, which has attracted the FDI. Overall, FDI improves the quality of a products and processes in a particular sector.

4. IMPROVED HUMAN RESOURCES

Employees of a host country in which there FDI get exposure to globally valued skills. The training and skills up gradation can enhance the value of the human resources of the host country.

5. EMPLOYMENT

FDI has also ensured a number of employment opportunities by aiding the setting up of industrial units in various corners.

6. Export

FDI encourages the transfer of management skills, intellectual property and technology. It creates jobs and improves the quality of goods and services produced in the economy. Above all, it gives a boost to the export sector

7. ACCESS TO RESOURCES

FDI is also an effective way for you to acquire important natural resources, such as precious metals and fossil fuels. Oil companies, for example, often make tremendous FDIs to develop oil fields.

8. REDUCES COST OF PRODUCTION

FDI is a means for you to reduce your cost of production if the labor market is cheaper and the regulations are less restrictive in the target foreign market.

DISADVANTAGES

- In developing countries, some times profits repatriated by multinationals exceed total FDI. This untoward outcome is exacerbated by principal and interest repayments where investments are financed with debt and by the outflow of royalties, dividends and fees
- Multinational companies exploit the resources of a host country and misplace the local players in the long run and drains the local pool
- FDI will be make the host country lost the control over domestic policy

- FDIs may increase the aggregate demand of the host economy in the short run, but in the long-run balance of payment position of the host economy is endanger when the investor manages to recover its initial outlay
- FDI brings inflow of money which would tend to raise the inflation in the economy
- FDI would give rise to cut-throat competition rather than promoting incremental business

- Promoting cartels and creating monopoly
- The financial strength of foreign players would displace the unorganized players.
- Absence of proper regulatory guidelines would induce unfair trade practices like predatory pricing
- Once monopoly sets in market, small-time retailers, consumers and farmers get exploited
- FDI will create more employment than displacing people of small stores.

International Investment Opportunities

As with domestic markets, there are international investment opportunities in stocks, bonds and mutual funds. The United States is the largest market, with financial investment opportunities well in excess of the next largest market, Japan. The difference in size of the various national markets can prove problematic for investors seeking to trade quickly in the smaller markets.

A good example of the problems that can arise in turbulent times is provided by the stock market collapse of October 1987. In mid-October, prices collapsed dramatically in all stock markets around the world. The price fall brought huge orders to sell stocks as investors liquidated their positions and mutual funds raised cash to pay off customers' redemption requests. Stock exchanges in the United States are relatively deep – meaning that there are enough potential buyers and sellers and a large number of securities traded so that the market permits trading at all times. Other markets are relatively thin – with a much smaller number of Potential buyers and sellers and a smaller volume of securities traded.

It is not always necessary to transfer funs abroad to buy foreign securities. Many foreign stocks are traded in the Unites States in the form of American depositary receipts or ADRs. ADRs are negotiable instruments certifying that shares of a foreign stock are being held by a foreign custodian. ADRs have become increasingly popular because they offer an easy way for U.S. investors to diversify internationally and allow non-U.S. firms access to raising money in the United States.

Even though these stocks are bought and sold on the U.S. market, they are still subject to foreign exchange risk because the dollar price of the ADR shares reflects the dollar value of the foreign currency price of the stock in the foreign country of origin. Furthermore, foreign government policy will have an impact on the value of ADRs.

For instance, in April 1987, the British government imposed a 5 percent tax on conversion of British stocks into ADRs. Trading in these ADRs dropped dramatically until the British government reduced the tax.

Firms that list their stocks as ADRs have some choice as to what type of listing they desire. The available types of ADR programs include the following:

Level I ADR:

No requirement to file financial statements that conform to U.S. accounting standards

Traded in the so-called over the counter (OTC) market and are not traded on an exchange like NASDAQ or the New York Stock Exchange

Created from existing shares in foreign market, no new capital can be raised

Level II ADR:

Must file financial statements conforming to U.S. accounting standards

Traded on organized exchanges like NASDAQ or the New York Stock Exchange

Created from existing shares in foreign market, no new capital can be raised

Level III ADR:

Must file financial statements conforming to U.S. accounting standards

Traded on organized exchanges like NASDAQ or the New York Stock Exchange

New issues of stock in order to raise new capital for firm

Rule 144A ADR:

No requirement to file financial statements conforming to U.S. accounting standards

Not traded on OTC or exchanges; strictly for private trades among qualified institutional buyers

New issues of stock in order to raise new capital for firm.

In addition to ADRs, there are also global depositary receipts or GDRs, which are traded in more than one market location. For instance, a firm may have a GDR that is traded in the United States, London and Tokyo.

Why do non-U.S. firms list their shares in the United States?

The U.S. listing provides the following benefits: an enlarged investor base, the ability to raise new capital in the world's largest financial market and lower transaction costs than in the home market. In addition, a firm generally finds that the price of its home market shares raise with a U.S. listing. This is likely due to the greater liquidity of trade in the firm's stock, meaning that there are more counterparties with which to trade and the ease of buying or selling at a good price is enhanced.

In addition, a firm that is located in a country with weak accounting standards sends a signal to investors of its quality when it lists in the United States and files financial statements conforming to U.S. accounting standards. In addition, non-U.S. firms may list on a U.S. exchange to use the ADR as a means to take over a U.S. firm. For instance, when Daimler Benz bought Chrysler Corporation, Daimler exchanged ADRs for shares of Chrysler stock.