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THE EFFECTS OF INTERNATIONAL DIVERSIFICATION ON PORTFOLIO RISK

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With the growing global economy, understanding international stock market correlations has become a vital instrument for investors wishing to diversify their portfolios on a global basis. For investors to have effective international portfolio diversification it is important to determine the countries whose stock prices move together, those whose stock prices move in opposite directions and those whose stock prices are unrelated all together. In order to analyze the impact of stock market correlations, this paper will focus on stock market indices in the U.S., Shanghai and the European Union. According to theory, maintaining portfolios primarily in highly positively correlated markets allows for unnecessary portfolio risk due to the presence of diversifiable risk in the portfolio. Through linear regression, results have shown that markets for the most part move together, especially in times of high volatility. Therefore investors should be wary of international diversification.