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RESEARCH ARTICLE

Financial Risks and Their Influence on Investment Decisions: Insights from Emerging Markets

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ABSTRACT

A number of financial risks normally affect investment decisions in the emerging markets such as exchange rates risk, inflation risk, political risk and liquidity risks. As for the second aim, this paper focuses on how these risks influence investment behaviour and decision making. Employing a survey method with data from some emerging economies, this study establishes patterns of risks and actions taken by investors. The study gives a base of understanding risk adjusted return, portfolio management and the total character of investment in such risky areas.

INTRODUCTION

Emerging Markets are referred as a vigorous and growing economy that hold both immense opportunities and risks to the investors. These markets are made up of countries such as Brazil, India, China and South Africa among others, and have become some of the most attractive due to the high possible returns. They constitutes the fastest growing large economy, They have a growing middle income population and are integrating into the world economy. However, investing in these markets also increases investors' exposure to several financial risks, which can make the choices more challenging (Ahmad, Atta, Alawawdeh, Aljundi, Morshed, Dahbour & Alqaraleh, 2023). It may therefore be said that the financial risks that emanate from emerging markets are easily magnified as compared to those emanating from the developed economies. Situation like increase in currency prices, political risks, inflation, liquidity risks are frequent in these locations making investment decisions far more challenging. For instance, exchange rate fluctuations are rapid in deteriorating the profitability of funds when repatriated, and inflation decreases the service or nominal yields, including on fixed-income products (Al Tarawneh, Alqaraleh, Ali and Bani Atta, 2023). Furthermore, It can lead to unpredictable's policy environments and this makes investment tensions fluctuations as noted by Ahmad (2020). Such risks make investors to adequately weigh potential of high returns with the likelihood of operating/ investing in a relatively risky financial environment.

Thus, the subject of this paper is the impact of financial risks for investments in emerging markets (Alqaraleh & Ahmad, 2018). The initial aim is to determine the principal threats that investors deal with regarding financial risks and to explore the remaining reviews on the strategies that are used mostly in managing the identified risks. In this context, contributing to the identification of the financial context in emerging economies, this work seeks to offer valuable information to be taken into account by investors, in order to enhance their portfolios and achieve sustainable, long-term growth. The findings will help to understand what kind of risks relevant to the emerging markets exist and how they can be managed (Nour, Noor, & Alqaralehc, 2020).

In the last twenty years, the fast growing emerging markets including Brazil, India, China and South Africa have witnessed tremendous FDI flows. Leveraging large population, natural resource endowment and deeper integration into global value chains these countries have opened windows of opportunity for those investors with an appetite for diversification (Thuneibat, Ali, Alqaraleh & Thneibat, 2022). However, it is crucial to name, that these markets are associated with a higher level of financial risk that should also be considered by the company (Chaudary et al., 2024). For example, Brazil has a highly unstable currency, the real, which has been devalued often in connection with political strings and economic instabilities. India although has been portraying signs of growth, political issues including regulatory issues, corruption and changes in policies are causes of concern for investment. China because while it is an economic giant, contains certain political threats such as government interference and unpredictable rules and regulations especially to some industries like IT and Real estate (Alqaraleh, Thuneibat & Nour, 2020). This is the state for the country that occupies a favorable position on the African map and, despite this, suffers from declining economic disparities, a high level of unemployment and political instability that can scare off investors. (Chaudary et al., 2024)

These examples explain why investing in the emerging markets are a challenge to investors especially when entering this markets. Because these areas are viewed as having higher risk, risk management strategies must sometimes be complex. To provide for investors, external factors such as currency risk, political risk and inflation, must be evaluated for investment purposes (Alqaraleh & Nour, 2020). At the same time, they need to be ready to change the ways they are going to attack on their targets due to increasing rate of changes in the economic and political factors. These emerging markets have become more significant in the global economy and their risk features call for more topical research on how financial risks affect investment decision in these zones. (Veerasingam et al., 2023)

The motivation for this research stems from the growing attention that institutional investors have paid to the emerging markets as traditional investment destinations in the developed economies have lower return associated with them in the prevailing low interest rate environment (Alqaraleh, Almari, Ali & Oudat, 2022). With the integration of the markets in the global system the investor especially the individual and institutional investors need to have an understanding of the specific risks of emerging markets. In this way, they are able to manage the risks associated with the volatility of these markets and maximize the potential that these markets possess (Alqaraleh, Thuneibat & Nour,2020). This paper aims to identify several critical research questions that underpin the link between financial risks and investment decisions in emerging markets. These questions include: Nine important financial risks that bear threats to investors in the emerging markets include the following; The features and major financial risks of which are discussed below, generally define emerging markets. These are; fluctuations in exchange rates, high levels of inflation, instabilities in government, a shortage of funds for financing, and regulatory risks. This is important for investors because it is some of the things they need to consider especially in making the decision whether to continue being in the market or to exit from the market. Which of these risks affect the investment decision making process? Financial risks can also create other risks that influence decision making in investment processes. For instance, currency risk could force investors to manage their positions through hedging, political risk could compel investors to postpone investments until after an election or particular political event. Inflation is used in the process of shifting stock and bond investors to other markets such as equities or commodities. This paper will aim at identifying how each of these risks influences the portfolio 投資 strategy and the asset allocation in the emerging economies. Originally, it is important to understand what measures are used to manage risks in emerging markets. Since these risks are apparent in the emerging markets, investors have devised various techniques of managing and minimizing them. Such may include currency management, geographic diversification, political risk mitigation measures, and employing the use of other investment products like real estate and infrastructure. The extent to which these strategies helps overcome financial risks will be evaluated as well as its contribution to overall investment goals.

By addressing these research questions, this study aims to provide valuable insights into the complex relationship between financial risks and investment behaviour in emerging markets. It will also offer practical recommendations for investors seeking to maximize returns while managing the higher risk profiles of these economies

Research design

This research employs both qualitative and quantitative analyses since the research questions require both approaches in order to gain an understanding of the financial risks associated with emerging markets and how they impact investment decisions. The research approach comprises both primary and secondary data sources. The first-hand information is gathered from questionnaires, and interviews with the investors to get a direct experience of their respective experiences. Conversely, secondary data involves the information pooled from the financial institutions of consumption and other financial outlets, market analysis, and some academic research provides a clear picture of market trend risks involved. To be more precise, adopting a mixed method approach, the study plans not only to illustrate the effects of financial risks on investment decisions in emerging economies with use of quantitative data, but also to identify and describe the latter using qualitative evidences.

Using quantitative methodology, the research aims at evaluating the financial data of the emerging markets for fluctuations in the exchange rate, inflation rates, stock markets and raw material and interest rates. The data for these metrics is collected from reputable worldwide financial organizations such as IMF, the World Bank, and other national statistical agencies. Besides, it enables recognition of certain patterns and chronology of the changes which can take place in the market which in its turn helps to determine the impact which these changes have on the investment returns. Secondly, the quantitative part is useful for identifying the connection between total risk measures of a particular economy and investment returns or for getting a numeric view how investors manage with specific financial risks in emerging markets.

For the qualitative part of the study the study administers a series of in-depth interviews with respondents who are portfolio managers and financial analyst with over two years of experience in emerging markets. The aim of these interviews is to assess how these professionals experience the concept of financial risk and how they practice when addressing such risks. The qualitative data therefore complements the quantitative analysis by revealing the social side of investment decision making process focused on how external factors influence risk perception including political risks, economic risk and regulatory risk. They also elicit information on how investors manage change in market conditions and the measures or instruments used in this process.

The sampling technique for this research focuses on investors with adequate exposure to emerging markets including Brazil, India, China, and South Africa. Of a pool of participants that includes individual and institutional traders that participate in these four markets, a minimum of half has been trading for at least five years. This criterion makes sure that the participants are aware of all the financial risks you intend to take and that they have been exposed to market volatility to some extent to give their opinions. Hedge funds, asset management companies and pension funds are included based on the premise that they tend to have better risk management standards than do sole players. Thus, both groups' inclusion provides a vast picture of how they perceive financial risks and how they manage them across different settings.

The processing of the obtained results involves the application of both statistical and thematic approaches. According to the result: quantitative data uses statistical methods to analyze the correlation between the financial risks and investment returns. More specifically, regression analysis takes place to establish the degree of bond between such factors as exchange rate volatility on the one hand and investment returns on the other. This goes a long way in establishing an approximate fact of the effects of financial risks on the efficiency of investments in emerging economies. On the qualitative side, the study uses thematic synthesis to examine the patterns in how investors approach the management of financial risk. Thus, setting up the themes, the study gets the opportunity to make general conclusions regarding the risk management activities and how they are subjected to the impact of political events, economic policies or market conditions. This dual method of analysis of the impact of financial risks on investment decisions in emerging markets makes it possible to avoid limiting preconceptions due to the use of only one methodology, and to achieve a more complete and accurate analysis of the problem.

RESULTS AND DISCUSSION:

This study's findings give a clear understanding of how financial risks affect investment decisions in emerging markets. This study brings out the following findings out based on the exploration of the quantitative as well as the qualitative data which captures the nature of investing in these areas. Thus, these results show the problems investors, experience, tactics of risk management, and the significance of financial risks for investment outcomes.

Analysis of the quantitative data yields one of the most important results related to the relation between exchange rate volatility and investment returns. The currencies of many emerging markets present higher fluctuation risks, and these risks are quite unwelcome by investors. (Rahayu et al., 2021) Fragile currencies have been seen in the countries such as Brazil and South Africa over the last decade political instability, economic mismanagement, and external shocks. The Brazilian real has depreciated significantly and the South African rand has followed the same line the depreciation has diseased the returns to foreign investors. An examination of net currency returns of these markets established that those investors who had not hedged their foreign exchange exposure incurred remarkable deficits irrespective of the furious local returns. (Mhlanga, 2021)

Many times, these fluctuations are as a result of external shocks such as international interest rate changes, movement of international prices of commodities and geo-political conflicts. For instance, when the US Federal Reserve decided to raise interest rates people shift their money from emerging markets and invest in safer more developed nations. This capital outflow causes fluctuations in the value of the emerging market currencies and thus increasing the risk on investor's portfolio. (Epstein et al., 2003) This study also pointed out that exchange rate volatility is one of the most important drivers of decision making as currency devaluation adversely impacts on the realization of investment in emergent economies enormously. These risks inevitably affect investors who trade in these markets are compelled to manage risks that come with such investment by seeking to hedge against such risks for instance through fixing on dollar-based instruments.

However, inflation emerges as one of the biggest threats to investors in the emergent markets apart from currency risks. The research noted that high and unpredictable inflation is a characteristic of many emergent economies with emphases to Latin America and Africa. Some of its neighbors like Argentina and Venezuela in the recent past have suffered from hyperinflation, which has hugely eroded the real value of the returns that investors get on their investment. (Ahmad et al., 2022) The analysis of inflation data in terms of quantity reveals a clear negative correlation between inflation and investment effectiveness with increasing inflation depriving investment of real returns. This finding re-emphasizes Macro-economic stability as an essential component of FDI. With inflation well checked in the Asian markets such as India and China investors are more confident than in the other countries, and capital mobility is more constant than the flow. (Sachs et al., 1996)

These real-world investigations are supported by 28 qualitative interviews with portfolio managers and financial analysts to better explain how investors allocate capital and identify risks in emerging markets. Some of the key issues mentioned by the interviewed investors included currency risk that appeared to be a major issue while investing in emergent economies according to the investors. Managers and the directors conducting portfolio analysis also noted that currency hedges are used to temper effects of exchange rates. For instance, forward contract or put options are used to hedge exchange rates for an expected future transaction since immediate conversion of an amount that is depreciated exposes the investors to large losses. But they do not work similarly in all the market environments, thus changing the situation can impact the efficiency of the strategies. Having a hedge can still be dangerous as many investors found out during the global financial crisis as well as the COVID-19 outbreak. (Bekaert et al., 2007)

Another powerful threat category that was identified from the qualitative analysis includes political instability. Political risk is arguably most common in emerging markets because the governments in such markets are typically less stable and may change policies, for instance, at short intervals. These include political corruption scandals in Brazil, rapid fluctuations in economic policies which trigger capital flight and low investors’ confidence. Likewise, in South Africa, political instabilities that include discussions on the land and the economy have always affected investment stability. Such risks cannot be avoided; investors in these regions should always check the political situation and redesign their investment portfolios based on it. Some portfolio managers pointed out that they invest in several emerging markets in order to minimize possible losses resulting from country-specific politics. The issue of political risk in any particular country is avoided because investors can diversify across various regions hence the impact of the risk is minimized for various investment portfolios. (Lathief et al., 2024)

For emerging markets, the research also focuses on liquidity risk. Liquidity risk means being locked in investments and being unable to sell those investment to avoid big losses especially at a time of high volatility. It was established that they usually possess a relatively less efficient infrastructure with regard to financial trading as well as considerably less trading activity compared to developed markets, meaning that investors are not always capable of effecting sales at a reasonable market price. This issue became especially pronounced during the COVID-19 crisis when various financial markets all across the world been interrupted. The exit problem became painful for investors in emerging markets, resulting to lower prices of their assets and huge losses. (Udo et al., 2024) The results for liquidity data prove that when there are shocks in global stock market, the bid-ask spreads of other emerging market exchanges actually become very large: this means that there is in effect a lack of liquidity.

For instance, to control for liquidity risk some investors will choose to have more cash or funds invested in cash-like instruments or invest in security types like Exchange Traded Funds or ETFs. ETFs are more advantageous than regular equities or bonds, which are constrained by value in an equities market as they can be bought or sold several times during the day like regular shares. But even ETFs can suffer from liquidity mismatches when the market is under stress, and this became evident in the case of some emerging markets ETFs during the COVID-19 crisis while outflows and wide spreads. (Suresh, 2024)

The second theme identified from the analysis of the qualitative data is the risk-return relationship in emerging markets. As it is clear these markets present higher return opportunities compared to developed economies, the risks involved are also much higher. Individual investors though facing relatively higher risks than professional ones, investing in emerging markets are always weighed between hunger for high returns and the risks or portfolio risks. The result of the study reveals that investors willing to accept higher risk tend to concentrate on value-based sectors for long term gains specially in the sectors like technology, consumer goods and infrastructure. These sectors are regarded as potential growth engines of future emergent economies, particularly in Asia, and other rapidly developing countries of the world such as China and India in the future decades. (NguyenHuu et al., 2024)

Nevertheless, this long-term view can only be achieved with a high threshold for short-term fluctuations. Investors who invest in emerging markets need to have the ability to manage through periods of high volatility such as the economic crisis in Argentina or Turkey or the ravaging effects of the COVID-19 pandemic. Such downturns, as the figures reveal, result in harrowing declines of assets, which requires the investor to have a long-term view and the capital to absorb adverse moves in portfolios. A particular focus was made towards the rationale that many portfolio managers apply when investing in the emerging markets as these usually undergo cyclical slowdowns accompanied by consolidation.

Therefore, there are external variables that critically influence investment results particularly in emerging markets most of which are overwhelmingly influenced by the state of the global economy as well as geopolitical events that affect the flow of funds to emerging markets. The paper also establishes that changes in the global interest rate, trade relations, and commodity prices affects emerging economies more than others. For instance, an increase in interest rate in the developed countries, especially in the United States act as a pull factor for capital outflow in the emerging market. This is because higher yields for better risks reduce the attractiveness of the emerging markets' equities, and increase demand for risk-free assets, such as the US government bonds. This work concluded that whenever interest rates in any given country rises internationally, the currency of emerging markets usually weakens and, in effect, reduces the returns on the investment. In the same way, the current geo-political tension between global superpowers like the US and China affects emergent markets, especially those countries whose economies are fixed on the exportation of products. For example, the nations such as Mexico and Vietnam, which have positioned themselves as producers for the global network of manufacturing, negatively affected by the trade disputes between the key world's economies.

Another factor evident in emerging markets is influenced by the volatility in the price of commodities especially to those with many of their exports comprising of natural resources. Many of the emerging market economies especially in South America, Asia, and Africa such as the Brazil, Russia and South Africa are highly dependent on sales of oil, gas and minerals and therefore receive a big blow whenever there is a decline in the prices of these commodities. Thus, the study ascertained those contractions in these states' economic activities during periods of drops in global commodity prices such as the 2014 oil price drop expanded investors risks and reduced their returns. Investors who invest in the emerging markets where commodity risks are prevalent, have no option but to keep abreast with the changes in the global market for the specific commodity and the reposition their portfolio accordingly. (Chowdhury, 2024)

Therefore, the findings presented in this paper prove that financial risks significantly influence investment choices in EMs. Fluctuating currency exchange rates, rising inflation rates, and factors that lead to investor insecurity in a country are some of the most vital risks to be investigated when investing in these markets: These risks include; Currency fluctuations, inflation rates, instabilities in political systems, and a shortage of cash in the economy. Though they include currency hedging, diversification and liquidity management, some of these risks are beyond perfect control. That's why the processes must be flexible as investors have to keep changing their strategies depending on the environment. The study also shows the need to have long-term view for companies investing in emerging markets because short-term problems are nearly inevitable. However, it still remains that the emerging markets remain a rich ground on investment that needs to be harnessed by those with the capacity to tackle the challenges on their way. (Chowdhury, 2024)

This study's findings have the following implications for investors: However, before the investors can successfully survive in the emerging markets, they have to come up with effective risk management techniques. This involves practice like currency hedging, diversification and liquidity management. Still, investors also bear in mind that such approaches are not perfect; they must be ready for any unpredicted predictions of any market. Second, investors need to sought for high returns in the emerging markets, but they should not anticipate short-term gains with long-term prospects to make up for any short-term losses. Last but not least, investors need to track the changes in global economic environment and political situations since they are also important for the performance of the EMs. (Suresh, 2024) Future research should focus on extending this model to include other intelligently endogenous variables, contextualized in relation to the richer realities of emerging markets, globalization processes, technological and climate changes in the world economy, among others. Since emerging markets are expanding and developing, it will also become more relevant for investors to consider these markets for portfolio and sustainable returns management.

CONCLUSION

In summary, financial risks help to determine investment decisions in emerging markets to a significant extent. These regions on one hand contain high growth potential and good investment opportunities on the other hand they are surrounded by many risks which dilute the returns on investments. High volatility, inflation, political risks, and access to funds appear to be the most frequently reported hurdles that investors encounter in emerging market countries. The study evidence from both quantity and quality analyses demonstrate that these risks are not only short-term investment-related, but they are complex and need innovation in risk management strategies in order to achieve long-term goals. These risks are relatively high and poses a great challenge to investors in the emerging markets through risk management techniques such as hedging using foreign exchange, diversification both in countries and sectors and liquidity management. Fluctuations in local currencies are especially sharp, and any fluctuations immediately influence the financial outcome, so having a strong finance plan is crucial. Another is inflation, which has been, especially in current year in certain countries such as Argentina and Venezuela, contributes to the proof on macroeconomic risk, which stresses the necessity of macroeconomic stability to achieve investment success.

Furthermore, there is still considerable political risk in most of the emerging markets due to the volatility and ability of policy shifters to change the business environment drastically leading to sell offs and lower asset value. Political risks such as investor garnishing, for instance, can be best avoided or at least well managed by those investors will well diversified portfolio and who keenly follow political changes. Liquidity issues are even more problematic when investing in emerging markets because unlike the advanced economies, these markets do not possess a well-developed financial infrastructure, and so it becomes very difficult to sell these assets during episodes of financial turmoil.

Nonetheless, there are still great opportunities for investment in the emerging markets if the future risks accompanying them can be effectively controlled, and investors look at the long-term horizon. As the above highlight E.A, sectors of technological exposure, infrastructure and consumer goods are some of the biggest opportunities for investors to penetrate as these economies continue to expand. However, investors have to be ready to go through short-time fluctuation and other global economic changes that may include; change in interest rates or change in the prices of some commodities that may have a large impact on the emerging markets.

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