

What causes home asset bias and how should it be measured?

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Abstract

Many explanations of home asset bias involve intuitions that should affect the data inputs used by investors in optimizing portfolios: (1) transaction costs affecting expected returns, (2) perceived riskiness of foreign assets affecting standard deviations, and (3) omitted assets affecting correlations. Only the first area has been examined empirically. We examine the empirical feasibility of the second and third explanations, as well as whether combining explanations can fully account for home asset bias. We find that no single set of adjustments can explain home asset bias by itself. Combining adjustments is promising but the implied correlation structure among asset returns is puzzling. © 2001 Elsevier Science B.V. All rights reserved.

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1. Introduction

Previous research on international mean-variance portfolio choice consistently predicts that investors should put much more of their wealth into foreign assets than they actually do; i.e., investors appear to engage in a sub-optimal degree of

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international diversification. This preference for domestic over foreign assets is often referred to as home asset bias, and it has been documented for investors in several countries by many authors (including French and Poterba, 1990, 1991; Tesar and Werner, 1992, 1994, 1995; Cooper and Kaplanis, 1994).

Many researchers wishing to explain home asset bias have focused on the inputs to the investor's optimization model, examining such issues as the presence of differential transaction costs between countries, additional sources of risk for foreign investing, or the explicit omission of assets from the investor's opportunity set. We will reference and discuss their work in some detail in following sections, but here we note that the empirical implementation of each of the potential explanations for bias requires directly or indirectly adjusting the inputs to the standard mean-variance model of portfolio choice—the returns, variances, and covariances (correlations) of the assets in the investment list. Only the first category of these explanations has been examined empirically and results show that adjusting returns does not explain the home asset bias.¹

In this paper we first examine the empirical feasibility of the remaining explanations by determining *how much* each of the statistical inputs would have to be individually altered to explain home asset bias. We find that the input values have to be outside reasonable ranges. We then ask whether there are *combinations* of the explanations that can explain observed bias towards domestic assets without resorting to extreme parameter values. In these cases, the required adjustments to expected returns and standard deviations are reasonable in magnitude, but the implied correlations for the omitted asset do not correspond to any single identifiable asset. In particular, human capital, foreign or domestic bonds, and foreign or domestic real estate do not have the same characteristics as the omitted asset we describe in our exercise. We conclude that completely erasing home asset bias requires a model with multiple omitted assets, as well as transaction costs and risk adjustments.

The reader should not view the analysis as merely a tautological exercise. We are not trying to determine *whether* adjusting model inputs can explain home asset bias; mathematically, many such combinations exist. Rather, we are asking if the necessary adjustments to model inputs are consistent with observable data and/or strong intuitions based on earlier research.

The paper is organized as follows. In Section 2, we briefly describe the standard model we use to measure home asset bias. Section 3 addresses the empirical feasibility of the three individual categories of explanations for the home asset bias: adjustments to expected returns, adjustments to standard deviations and

¹ Errunza et al. (1999) have shown that portfolios of US and foreign assets, all listed in the US, can be used to obtain foreign diversification because they replicate foreign market indices, hedging potential. They do not establish that investors actually use these portfolios, but it is an interesting avenue for further research.

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