

Home bias and international capital asset pricing model with human capital

Alain Coën *

Department of Finance and Economics, EDHEC, School of Management, F-59046 Lille, France

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Abstract

We develop an international C.A.P.M. including human capital. We test this model and underline its contribution to the explanation of home bias observed in portfolio choice for nine countries. Human capital positively correlated with the domestic financial assets could worsen the home bias puzzle. Then, we add deadweight costs to the model. Using different levels of risk aversion, we compute the necessary costs to explain home bias. The costs obtained are too high compared to real existing costs. Human capital is an important feature in portfolio choice, but its contribution to the explanation of the home bias is very weak. Home bias is still a puzzle. © 2001 Elsevier Science B.V. All rights reserved.

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1. Introduction

Important literature has been devoted to the study of the benefits of the international diversification. The weak correlation between national financial markets and the idea that the world financial market is more complete than national markets justify two essential motives for international diversification: the search for higher returns and the reduction of risk.

* Tel.: + 33-3-20154489; fax: + 33-3-20154501.
E-mail address: alain.coen@edhec.edu (A. Coën).

The portfolio theory commends international diversification. However, as illustrated by Table 1, the composition of portfolios reveals a strong home bias¹.

Many explanations have been put forward in the financial literature. Inflation hedging motives², institutional barriers³, taxes on international investments⁴ or transaction costs⁵ are the main explanations to the home bias. But the results of these different studies are very poor and seem unable to explain the home bias observed in the composition of portfolios. Under symmetric information, exchange risk, deviations from the purchasing power parity and restrictions to financial markets, often used to justify the existence of the home bias, have a weak power of explanation (Cooper and Kaplanis (1994)). Some studies consider that gains from a well-diversified international portfolio are very often overestimated⁶ and do not justify the holding of foreign assets. However, the inefficiency of some small financial markets (Vienna, Helsinki...), international transaction delays or differences in accounting systems could discourage any international diversification (see Uppal, 1993 and Rowland, 1999).

In fact, the main explanation of the home bias is certainly related to the investors' perception of the international investment. If they are convinced that they have to pay more to hold a foreign asset, everything else being equal, they tend to prefer to hold more domestic assets. The costs they attribute to international investment are real and assumed (or difficult to observe and to quantify). As we

Table 1
Home bias: December 31, 1994^a

Country	Market capitalization (%)	Domestic equities (%)
Germany	4.2	79.83
Canada	1.83	72.54
Spain	1.14	88.09
USA	40.8	92.21
France	4.08	91.91
Italy	1.65	85.01
Japan	34.04	84
UK	11.2	51.92
Sweden	1.06	100
Total	100	

^a Portfolio holdings are described in Section 3.2 (data sources). During the 1980s and before 1995, the holdings of foreign financial assets in Sweden were impossible. Data: O.E.C.D. and Financial Times Database.

¹ See French and Poterba (1991), Cooper and Kaplanis (1994), Tesar and Werner (1995) and Lewis (1999).

² Solnik (1974, 1983), Sercu (1980) and Adler and Dumas (1983).

³ Errunza and Losq (1985, 1989), Eun and Janakiraman (1986), Gultekin et al. (1989), Hietala (1989), Basak (1996),...

⁴ Black (1974), Stulz (1981, 1995), ...

⁵ Dumas (1992), Uppal (1993) and Dumas and Uppal (1999).

⁶ Jorion (1985) and Bailey and Stulz (1990).

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