



Endogenous asymmetric information and international equity home bias: The effects of portfolio size and information costs

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Abstract

Equity home bias is one of the major puzzles in international finance. This paper investigates the impact of asymmetric information on equity home bias in a rational expectation model where portfolio managers differ in their levels of initial portfolio size and information acquisition is endogenous. The model characterizes the information acquisition and investment decisions made by each portfolio manager, and the resulting equilibrium. We find that portfolio managers with larger portfolio size acquire information about the foreign asset; this is consistent with new evidence linking the degree of home bias across portfolio managers to portfolio size.

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1. Introduction

Equity home bias, the observation that individuals hold too little of their wealth in foreign assets, is one of the major puzzles in international finance. In the context of the standard capital asset pricing model, [Levy and Sarnat \(1970\)](#) and [Solnik \(1974\)](#) demonstrate theoretically the advantage of international diversification, and simulations by [Lewis \(1999\)](#) predict that

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American portfolios should have at least 40% of foreign assets. However, estimates of the actual proportion of foreign assets held by American investors range around 10% (French and Poterba, 1991; Cooper and Kaplanis, 1994; Tesar and Werner, 1995; Ahearne et al., 2004).¹

There is a large literature that examines reasons for such equity home bias. One explanation of the home bias is that domestic equity provides a better hedge for risks that are specific to the home country (Lewis, 1999). However, empirical tests indicate rejection of the null hypothesis that home bias in equities is caused by investors trying to hedge real exchange risk (e.g., Cooper and Kaplanis, 1994; Vassalou, 2000). Further, the predicted home bias would be even more pronounced if we consider non-traded goods (Eldor et al., 1988; Stockman and Dellas, 1989; Baxter and Jermann, 1997).

A second explanation of home bias is that there exist international tax and transaction cost barriers in international capital markets (Black, 1974; Stulz, 1981a,b). Empirical tests do support this view that international taxes and government restrictions can affect equity home bias (Bonser-Neal et al., 1990; Hardouvelis et al., 1994; Claessens and Rhee, 1994; Errunza and Losq, 1985). This is especially the case with respect to foreign assets of a less-developed country, where there can exist significant international taxes and government restrictions on the capital account movements (Lewis, 1995, 1999). However, large transaction costs would not only lead to small holdings of foreign assets, but also to low turnover rates, and Tesar and Werner (1995) do not find that portfolio turnover rates are lower for foreign assets than for domestic assets; this view is reaffirmed by Warnock (2002).

A third rational for home bias that is widely cited is the existence of asymmetric information. For example, Gehrig (1993) and Brennan and Cao (1997) develop a noisy rational expectation model to show that home bias arises when domestic portfolio managers have an information advantage over foreign portfolio managers.² Kang and Stulz (1997) present some indirect evidence that foreign portfolio managers primarily invest in stocks of Japanese companies that are better known to them, even when the expected returns are lower than the returns on other Japanese stocks (Lewis, 1999). Similarly, Lang et al. (2003) and Ahearne et al. (2004) highlight the potential role that the cross-listing of securities (foreign firms listing their securities in the U.S.) can play in reducing asymmetric information for specific securities and thus reducing the extent of home bias for such securities.³ These papers establish the important role that asymmetric information can play in explaining the home bias puzzle.

In this paper, we present a home bias model that relies on asymmetric information. However, we differ from earlier theoretical work on home bias in that our focus is on explaining differences we identify in the extent of home bias across portfolio managers. In Section 2, we present evidence that the extent of home bias depends on the size of the portfolio under management by portfolio managers. In particular, an examination of a 2003 survey of pension funds provided by *Pensions & Investment* indicates a significant negative relationship between the size of the portfolio and the extent of home bias, and this bias appears linked to the greater acquisition of information on foreign assets by large pension funds. We use these findings to motivate

¹ Glassman and Riddick (1996), however, provide evidence suggesting that, to some extent, such measures of bias may be overstated.

² Hasan and Simaan (2000) develop a portfolio model that incorporates both the foregone gains from diversification and the informational constraints of international investing. They show that estimation errors for the mean and variance parameters induce a home bias.

³ Asymmetric information is invoked in a similar fashion by Coval and Moskowitz (1999) to explain why U.S. investment managers exhibit a strong preference for locally headquartered firms in their domestic portfolios.

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