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Home country bias: Does domestic experience help investors enter foreign markets?

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ABSTRACT

This paper investigates the dynamics of individuals' investments leading up to their decision to make the first investment abroad. We show that investors first invest in domestic securities and only some time later they invest abroad in foreign securities. We also show that investors who trade more often in the domestic market start to invest abroad earlier. Our findings suggest that the experience investors acquire while they trade in the domestic market is a key reason why active investors enter the foreign market earlier. A reason is that highly educated investors as well as investors with more financial knowledge, arguably those for whom learning by trading is the least important, do not need to trade as much in the domestic market before they start investing in foreign securities. Another reason is that investors who start investing in foreign securities are able to improve on their performance afterwards. This improvement in performance constitutes further evidence that the home country bias is costly.

1. Introduction

The home country bias remains one of the most important puzzles in international finance. The relatively low correlation between stock returns of various countries and the potential benefit from international diversification have been known for decades.[1] Yet, the vast majority of investors still do not invest in foreign securities or only hold a very small portion of their portfolios in foreign securities. By investing largely in their home country, investors may accept a far from optimal combination of portfolio return and risk. In this paper, we attempt to contribute to the literature on home country bias by investigating the dynamics of individuals' investments leading up to their decision to make the first investment in foreign equities abroad. Our objective is to find out if investors' experience in the domestic market accelerates their decision to "enter" foreign markets and whether this decision affects their performance.

It is by now well established that investors tend to overweight domestic equities and underweight international equities when they select their investment portfolios.[2] French and Poterba (1991), for example, document that the fraction of US equity portfolios invested abroad is very small.[3] Oehler et al. (2008) provide evidence of home country bias among German investors, and Karlsson and Norden (2007) provide similar evidence among Swedish investors. This bias also appears to extend to Portugal, the country of origin of our data, since only 4% of Portuguese investors have investments in foreign securities.[4]

There is also evidence that home country bias is costly. Lewis (1999), for example, shows that there are substantial gains when moving from investing fully in the S&P 500 index to a partial investment in a fund that emulates the MSCI Europe, Australia and Far East index. Bailey et al. (2008), in turn, show that the mean monthly portfolio return of foreign-inclined investors is only slightly higher than that of their domestic benchmarks, but the later investors experience a much higher volatility and lower Sharpe ratios.

Given the benefits from investing in foreign securities, the natural question to ask is why so few investors pursue these investments? Researchers have proposed several explanations for the home country bias. Cooper and Kaplanis (1994), for example, suggest that this bias arises because home assets provide better hedges against country specific risks. Kang and Stulz (1997), in turn, claim it arises because the costs of international diversifica-

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[1] See, for example, Levy and Sarnat (1970).

[2] Researchers have found other forms of "home" bias. Coval and Moskowitz (1999), for instance, find that US fund managers exhibit a strong preference for firms with local headquarters. Huberman and Sengmuller (2004), in turn, find that employees tend to invest a large proportion of their retirement plans in their own company's stock.

[3] For more recent evidence on US investors' home country bias see, for example, Campbell and Kräussl (2007), and Kho et al. (2009).

[4] This figure includes direct investments in individual foreign securities, investments in ADRs and investments in mutual funds that invest in foreign securities.

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tion exceed the corresponding gains, whereas French and Poterba (1991) argue that it results from systematic differences in return expectations across investors. Graham et al. (2005) put forth an explanation based on investors' competence. They suggest that investors are willing to invest in foreign securities only after they fill competent about the benefits and risks involved in these investments. Lastly, Strong and Xu (2003) provide a behavioral explanation for the home country bias: this bias arises because investors tend to be more optimistic towards home markets than towards international markets.[5]

Researchers have found supporting evidence for some of these theories.[6] Graham et al. (2005), for instance, find that investors with more competence are more likely to invest in international assets. Vissing-Jorgensen (2003) finds that high wealth households are more likely to invest in foreign securities, and argues that this is consistent with high wealth households paying the information cost associated with investing in foreign assets. Strong and Xu (2003) find that investors are more optimistic towards their home markets than they are about foreign markets.

In this paper, we attempt to add to this literature by investigating whether investors' domestic experience help them invest for the first time in foreign securities abroad. We start out by documenting that there is a "life cycle" effect in individuals' investment choices in the sense that investors first invest in domestic securities and only some time later they invest in foreign securities. We then use duration analysis to investigate if investors' domestic trading experience affects the length of time it takes them to start investing abroad. We investigate the effect of domestic trading on the timing of the decision to enter foreign markets controlling for a set of factors the previous studies find help explain the home country bias.

Our findings show that *ceteris paribus* investors who trade more often in the domestic stock market wait a shorter period of time before they start to invest in foreign securities abroad. Our findings also show that married and female investors as well as older investors wait a longer period of time before they start investing in foreign securities. In contrast, wealthier investors, as well as investors with more education and those with access to more financial information start to invest in foreign securities earlier. Lastly, we find that performance in the domestic market has a nonlinear effect – investors with the worst performance as well as those with the best performance wait for a shorter period of time before they start investing in foreign securities.

In the second part of our paper, we try to explain why investors who trade more often in the domestic market tend to enter the foreign markets earlier. This finding is unlikely the result of an investment strategy which picks stocks randomly because investors in our sample need to invest abroad in order to acquire foreign securities.[7] We posit two hypothesis for our finding. Following Nicolosi et al. (2009) and Seru et al. (2008), who show that investors learn by trading, we conjecture that investors who are active in the domestic market learn faster the advantages of investing in foreign securities and consequently start investing abroad earlier. Following Odean (1999) and Barber and Odean (2000, 2002), who argue that investors tend to trade too often because they are overconfident, we conjecture that investors who are active in the domestic market are overconfident and their pursue of new trading opportunities leads them to enter foreign markets earlier.

Our results generally support the learning explanation but not the overconfidence explanation. A reason is that we find that highly educated investors as well as investors with more financial knowledge, arguably those for whom learning by trading is the least important, do not need to trade as much in the domestic market before they start investing in foreign securities. Similarly, we find that investors who enter the foreign market by making their first investment in Spain, probably the country with the closest cultural affinity with Portugal, also do not need to trade as much in the domestic market before they go abroad. Another reason is that these results continue to hold when we account for overconfident investors. Finally, and still in support of the learning explanation and contrary to the overconfident explanation, we find that investors who enter the foreign markets are able to improve on their performance afterwards.

Our paper adds to the literature on home country bias in some important ways. Our investigation of the dynamics of individuals' investments leading up to their first investment in foreign securities is novel. Understanding investors' decision to undertake this investment is valuable because it is arguably the most important decision they make once they decide to pursue the potential benefits from investing abroad. Our focus on individual investors (as opposed to institutional investors) and on their investments on individual securities made abroad (as opposed to investments in mutual funds of foreign securities or in ADRs) is also important because it requires more expertise and it is more revealing of investors' intent to pursue the potential benefits from foreign investments.[8] Our finding that investors learn while they trade in the domestic market and this helps them accelerate their decision to start investing in foreign securities adds support to Graham et al. (2005) competence theory for the home country bias, and suggests that programs aimed at improving investors' financial literacy could help reducing this bias. Further, our finding that investors who enter the foreign markets are able to improve on their performance afterwards confirms that there are gains for investors from entering the foreign markets earlier, and corroborates Lewis (1999) and Bailey et al.'s (2008) finding that the home country bias is costly.

Our findings also parallel evidence uncovered in the international literature on the internationalization of firms.[9] Our evidence on the dynamics of investors' choices showing that investors start to trade in the domestic market and only some time later they enter the foreign markets, for instance, parallels the Uppsala school of internationalization's insight that firms' internationalization is a stepwise process: firms begin their activity in the domestic market before they penetrate foreign markets.[10] Our finding that more active investors in the domestic market start to invest in foreign firms earlier, in turn, parallels the evidence in international trade literature that more active and productive firms go abroad first.[11]

The remainder of the paper is organized as follows. The next section presents our methodology and our data sources. This section also characterizes our sample. Section 3 presents our results on

[5] Other explanations for the home country bias, as reviewed in Lewis (1999), include barriers to international investments, such as international taxes and government capital restrictions, information asymmetries between domestic and foreign markets (investing in foreign equity markets may require understanding foreign accounting standards and legal environments), and the prevalence of closely held firms in most countries causing the world float portfolio to be significantly different from the world market portfolio.

[6] Several empirical studies, including Cooper and Kaplanis (1994) and Baxter and Jermann (1997), argue that the effects detected in this literature are too small to account for the degree of home bias observed in the data.

[7] Since we want to focus on foreign investments, we left out from our sample those investors who invest in ADRs. This does not have any material effect on our findings because only a tiny number of ADRs trade in the Portuguese stock exchange.

[8] Bailey et al. (2008), Graham et al. (2005) and Karlsson and Norden (2007) all investigate the home country bias based on data on individuals' portfolios. However, in Bailey et al. (2008) investors invest in foreign securities through ADRs which enable US investors to buy shares in foreign companies without undertaking cross-border transactions. Graham et al. (2005) use a survey, not actual trading data and Karlsson and Norden (2007) study portfolios which are formed as a part of the pension plan in Sweden, not direct investments in foreign equities.

[9] We thank the referee for calling our attention to this parallel.

[10] See Johanson and Vahlne (1977).

[11] See, for example, Helpman et al. (2004).