The Equity Home Bias: Why do Investors Prefer Domestic Investments?

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Abstract
The equity home bias refers to the phenomenon of investors forgoing investing in foreign markets. Foreign investments in investors’ portfolios would result in lower risk and higher returns due to diversification. This is considered an economic enigma to which a clear solution has not been found. It is puzzling because it seems to show that investors are deliberately reducing their returns by not investing in foreign markets and not reducing their risk as well. It was first documented in 1991 and has been shown to be present in not only American investors, but also in Japanese, German, and many other nationalities, showing that is a widespread phenomenon. Several explanations have been used to try to explain this enigma, including information asymmetry and high transaction costs. They point to variables such as investor preference and geographical bias as major reasons for the lack of foreign investment. In recent years, investors have been investing more in foreign markets, showing that the equity home bias may have been resolved.
As financial trading becomes more global than ever, international markets are becoming increasingly interconnected. It is easier than ever for an investor to have a portfolio that is diversified between domestic and international firms. Every finance student is taught that diversifying your portfolio is the best way to maximize returns and minimize risk. Holding assets in firms that are spread amongst various industries and also different countries can be an effective way to diversify a portfolio. While many investors do diversify by investing in companies in different industries, research has shown that investors rarely invest in foreign companies. This phenomenon is known as the equity home bias. The reason this is an enigma is because most, if not all, investors know that diversifying is a good way to reduce risk and maximize returns on investments. Maurice Obtsfeld and Kenneth Rogoff have identified the equity home bias as one of the six major puzzles in international macroeconomics.

French and Poterba first documented the equity home bias in a paper in 1991. In this paper they stated that 94% of American investors’ portfolios consisted of investments in domestic firms. This trend was exhibited by Japanese, British, German and French investors, all of which held 80%, if not more, of their equity domestically.1 This goes to show that the home bias is nearly universal phenomenon across investors in various countries and cultures. Experts had concluded that a mix of 60% domestic and 40% foreign equity would be the optimal mix to maximize returns, the research indicates a sharp skew towards domestic equity, with less than 10% on average being held in foreign equity.2 This seems to contradict the profit maximization assumption we hold to be true for firms and investors because their expected returns on the portfolio are lower because of the lack of diversity.

The reason that the equity home bias is puzzling because it seems to suggest firms and investors are deliberately forgoing maximizing returns and profits by not diversifying their portfolios internationally. Diversifying decreases risk and maximizes returns, so it is puzzling why investors would avoid diversifying in this situation. Also, diversifying internationally can insulate you from larger forces such as government unrest in certain countries, somewhat from recessions and other forces that simply cannot be avoided if your portfolio consists solely of domestic equity. While there are some restrictions put on by governments on foreign investment, many argue that the effects of those restrictions are negligible and shouldn’t be deterring foreign investment.

There are a few hypotheses that attempt to explain the existence of the equity home bias. One reason that investors prefer to keep their capital in domestic markets is that capital is immobile across international boundaries. Yet one only needs to look to the high volume capital that is being moved across international lines on a daily basis nowadays to know that this is not true. Another possible reason is that there are high transaction costs associated with buying and selling international capital. This can be attributed to a few reasons. One is governmental regulation on holding foreign equity and also high taxes on foreign equity. For example, Belgium has double taxation laws on foreign investments, in that they are taxed both in the country of investment and Belgium. Factors such as these diminish the returns from investing abroad and make it more appealing to keep investing domestically. Many countries have restrictions such as Japan, which mandates that only 20% of an investor’s portfolio can consist of foreign investments.3 When the costs of trading internationally are seen as being too high to the point that there is not enough benefit being achieved by the investment, it makes sense that many

investors would seek to keep their investments domestic where they could minimize some of the transaction costs and maximize benefits.

A compelling explanation for the equity home bias has been the idea of information asymmetry. The data and French and Poterba examined in 1991 to make their claim about the existence of the home bias were collected before the widespread use of the Internet began. When perfect information is not present and there is more and better information about one market compared to others, it is easy to see why a bias towards domestic markets can develop. When information is scarce, it creates uncertainty about the market and makes it difficult to predict future returns, which is a major component in how investors decide which companies to invest in. Before the widespread use of the Internet, it would have been more difficult to obtain information on foreign markets and it would have taken much longer to gather the information necessary in order to make an informed decision. Information on domestic firms would have been easier to access as it would be reported by domestic news outlets, with foreign companies receiving less coverage. Also factors such as conversion rates between currencies and differences in government regulations and investors’ lack of knowledge about them can lead to information asymmetries. If the lack of information is seen as being too much to account for the risk being undertaken by the investor, then the investor would probably prefer the domestic investments to the foreign ones which creates bias.4

This ties into the assumption that investors seek to minimize uncertainty when it comes to investing. They are more comfortable in domestic markets because the currency is familiar, as well as the business practices and culture of the country, which are shown in Amadi’s paper.5 These forces and feeling of familiarity can play a large psychological role in the decision making

4 Amadi, Equity Home Bias: A Disappearing Phenomenon?, 6
5 Ibid.
A domestic market presents lower uncertainty to an investor because there are less unforeseen variables in the market because the investor is more familiar in most cases with their domestic market. Uncertainty can lead to risk, which investors are always wary of. This speaks to the preferences of the investor, in which if investors prefer domestic investments because they perceive it to be less uncertain and less risky than foreign investments, there will be a noticeable bias towards the domestic investments.

A recent paper shows that in recent years, the home bias has been diminishing as investors across the board are increasing their investments in foreign firms. If we believe that information asymmetry was the primary cause of the bias in the first place, this change in behavior makes sense. In the past 10-15 years, the size and scope of the Internet has expanded immensely and many markets have moved online. This greatly diminishes the information asymmetry that previously existed by giving investors almost instantaneous access to information about companies that are located across the globe. Now an American investor can receive up to date information and stock quotes on Japanese companies. This works to reduce information asymmetry and reduce uncertainty about foreign markets. Also, an American investor can trade in Japanese stock markets online cheaply and effectively. This has reduced the transaction costs of such trades. The trend towards more foreign investments seems to coincide with the increase in the use of the Internet worldwide and the ease of access to information increasing. This relationship seems to indicate that the primary cause of the home equity bias was the information asymmetry that caused many investors to favor domestic markets.

Another phenomenon that has been more recently documented is the home bias at home. This means even in domestic markets many investors have geographical bias and tend to want to

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6 Ibid., 24-25.
invest in companies that are headquartered nearby. This is a very interesting trend because many of the causes of the international home bias previously explained, such as high transaction costs, governmental regulations, and taxes on foreign holdings, are not factors in domestic trading. The explanation can be attributed to a mix of information asymmetry and investor preference. This seems to suggest that an average investor wants to have a higher level of familiarity with the company that they are investing in. By investing in companies that are geographically close to them, investors can do things like speak to employees of the company itself, increasing the level of information the investor has about the company. This also seems to indicate that many investors are predisposed to invest in things that are familiar to them because it reduces their uncertainty.

The home equity bias could be seen as both an economic enigma as well as a financial one. Investors did not maximize their profits by investing internationally. This can be attributed to not having an adequate and equal amount of information about each market. It was also puzzling financially because investors could have been reducing risk and increasing returns by diversifying internationally yet were not doing so. This can also be attributed to the information asymmetry because the lack of information increased the perception of risk about foreign investments.

The enigma of equity home bias is one that seems to have been solved by increasing technology. Economic and international financial theory had stated that foreign investments should have been much higher than they were, which demonstrated a bias. However, once the information asymmetry was eliminated through technology, in this case the Internet, information was more freely available to investors. We are now seeing the results of that as the home bias is

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7 Joshua Coval, Tobias Moskowitz, *Home Bias at Home: Local Equity Preference in Domestic Portfolios*, (Selected Papers) 1.
slowly disappearing. It will be interesting to see the effect of ever increasing amounts of
technology on financial markets in the future and how this will affect overall economic systems.