There’s No Place Like Home … Is There?

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The best opportunities are usually found among things most others won’t do.

—Howard Marks

Many investors exhibit a strong preference for domestic equities despite the integrated nature of financial markets that nowadays offers widespread access to capital. This observed lack of international diversification is commonly referred to as home bias and has been described as one of “six major international macroeconomic puzzles” (Obstfeld and Rogoff 2000).

In this article, we examine why failing to globally diversify a portfolio can be costly. We also consider the potential merits of investing in local assets. The persistence of home bias suggests that the familiarity of domestic markets adds an additional benefit, perhaps in the form of emotional comfort, that is not usually factored in by a theoretical framework. This concept is not novel: John Maynard Keynes, in 1934, stated that it is inefficient to place faith in stocks that present “no reason for special confidence.”1 In the context of behavioral finance, attempting to create an optimally diversified portfolio may result in investors demonstrating other biases, in particular the failure to invest, leading to outcomes that are more costly. This leads us to a discussion of why, despite the importance of international diversification, a home-biased portfolio may not always be the most costly choice.

Benefits of International Diversification

Traditional financial theory states that an average investor optimally should hold domestic assets in proportion to the home country’s share of world capitalization.2 The segmented nature of capital markets means that investors have the ability to reduce exposure to specific risks by adding an appropriate allocation of foreign securities to a portfolio. As a result, the international diversification opportunities gained from holding assets with lower correlations are likely to lead to greater risk-adjusted returns. This concept is central to modern portfolio theory.

Comparing the strategies of two hypothetical U.K. equity investors provides an example of the benefits of international diversification. Investor A is fully invested in U.K. equities, while investor B holds a diversified selection of equities across developed international markets.

Figure 1 shows the average annual return (excess over cash) for a selection of equity markets and an internationally diversified equity portfolio during 1970–2014. Some countries exhibit higher average excess returns than the diversified portfolio; U.K. equity returns are

![Figure 1: Average Excess Returns and Volatilities of Selected Equity Markets, 1970–2014](image)

Note: Average annual (in excess over cash) returns for the period extending from 1970 to present. Annual volatility for the period extending from 1970 to present. All indexes measured as total returns (in GBP) in excess over Bank of England rates.

Source: Barclays, Bloomberg
relatively close to the average returns for developed countries. These figures may lead one to conclude that pursuing a domestically oriented investment strategy may not be a bad option.

However, risk reduction is the key element of international diversification. Figure 1 also illustrates the volatility of equity returns. The internationally diversified portfolio exhibits much lower annual volatility than the individual country portfolios, thus evidencing the potential for risk reduction when investing in a range of global equities. Investor A (the home investor) may have, on average, achieved higher or lower returns than an internationally diversified portfolio, but investor B (the global investor) likely attained better risk-adjusted returns over the same investment horizon.

The Cost of Not Diversifying Internationally
Historically, home bias has been costly in terms of risk-adjusted returns. Such a measure of returns is consistent with standard mean-variance theory, which states that investors seek to maximize returns and penalize volatility.

In the same spirit, we use a forward-looking international asset pricing model to approximate the cost of equity home bias within a multi-asset class portfolio. For this purpose, we quantify the expected returns for U.K. equities in terms of their covariances with the returns of an optimized international market portfolio. Based on our a priori forward-looking estimate for the international equity risk premium (6.4 percent) and the previous pricing model, we estimate that the fair risk premium for U.K. equity is approximately 4.8 percent. The cost of home bias can be measured now by taking the difference in risk-adjusted returns between the optimal international portfolio and a home-biased portfolio, which we define as having all international equity replaced solely by U.K. local equity.

Figure 2 shows the cost of holding a 100-percent home-biased portfolio for varying risk profiles, where RP1 refers to a risk-averse investor holding largely fixed-income assets and RP5 refers to a more risk-tolerant investor with a higher allocation to developed equities. The annual cost endured by the risk-tolerant (RP5) U.K. investor is close to 1 percent, and for a moderate-risk investor (RP3)—holding a balanced mix of fixed income and equity investments—the cost is around 0.6 percent. A similar forward-looking analysis for the United States suggests that the risk-adjusted cost is approximately 0.5 percent and 0.3 percent (RP5 and RP3, respectively), because the expected risk premium for U.S. equity is about 5.7 percent according to our current market assumptions.

Both our historical and forward-looking estimates support the case for international diversification by showing that an internationally diversified portfolio systematically reduces risk and provides more-consistent portfolio returns over time.

Why Home Bias Persists
Given that home bias is costly, the question remains as to why so few investors pursue a globally diversified approach to investing.
French and Poterba (1991), who were among the first to evidence home-country bias, partly attribute its puzzling persistence to the suboptimal behavior of investors. Investors may have a tendency to shy away from foreign investments because they perceive that foreign investments have more uncertainty when it comes to expected risk and returns than domestic assets. When individuals face a set of choices, they more often than not exhibit aversion to the option with unknown probabilities (Ellsberg 1961). Furthermore, investors often add a risk premium to foreign assets simply because they are harder to understand. This risk premium attached to foreign investing captures lack of familiarity with company names, overseas corporate governance standards, or foreign political risks. So although the normative explanations may play some role, the home-country bias problem is likely driven by individual behavior rather than financial-market trends.

Overcoming Fear of Foreign Equity Investing

Unfamiliarity of foreign markets may make international diversification less appealing for some investors. Given that lack of diversification can be costly, a solution for investors to reduce their bias toward the perhaps more-familiar home assets may be to hold a globally diversified portfolio in line with the optimal weights suggested by classical finance.

International diversification may provide efficiency gains, but it can be challenging, especially from an investor-behavior point of view. These dynamics point to a trade-off between the theoretical gains from international diversification and the practical approach an investor takes when addressing the issue of home bias. As such, we draw attention to four points that investors should be aware of when tackling home bias in a portfolio:

Failing to invest at all is more costly than home bias. Analyzing portfolios in terms of risk-adjusted returns may make sense from a theoretical perspective, but this is not necessarily a concept that many investors understand. What investors really want is the best return achievable for the additional stress of taking on additional risk. Many individuals seek to avoid this stress by not investing at all; this is a suboptimal solution to overcoming fear of investing because the loss of long-run returns can be detrimental. In Barclays Wealth and Investment Management (2013), we established that for an uninvested U.K. investor with a moderate risk tolerance, the costs of being too uncomfortable to invest at all—therefore sitting on cash—are around 4–5 percent per year averaged over the long term. For these investors, the financial inefficiency of forgoing the benefits of international diversification and investing in familiar home assets might make sense, because returns would be reduced by an average of only 0.6 percent per annum for a moderate-risk investor—cheap if the alternative is as extreme as not investing in anything. Investors that are reluctant to put cash to work must strike a balance between the costs of home bias and the benefits of making that initial step into investing. However, once this has been addressed, the gains from diversifying should certainly be acknowledged.

Diversification benefits fluctuate over time, so focus on the long term. The estimated cost of home bias is subject to changes across shorter time horizons. For example, since the peak of the financial crisis, U.S. investors would have realized higher returns and lower volatility by holding greater allocations to domestic stocks. This is not an argument for home bias, but one should be aware that in recent decades the correlations among equity markets have fluctuated over time (figure 5). The systematic increase in correlations over the past few decades has given rise to the so-called

Figure 4: Home Bias in Selected Developed Countries across Time

Note: Home bias is calculated as the domestic overweight (%) divided by the maximum possible domestic overweight (equal to 1 minus the theoretically optimal domestic holdings (%)). See figure 3 footnotes for definitions.

Sources: IMF Coordinated Portfolio Investment Survey (CPIS), World Federation of Exchanges, Thomson Reuters
The impact of home bias can be felt in other asset classes too, particularly fixed income (Fidora et al. 2007). For example, investors seeking inflation protection prefer domestic inflation-linked bonds, especially in countries such as the United Kingdom where tax-related benefits are associated with holding these assets. For low-volatility fixed-income assets the impact of foreign-exchange fluctuations forces international investments to be hedged, which may be expensive for the investor to implement and therefore may reduce potential diversification gains. Because of this, it is always worth questioning the benefits that can be obtained from extending the portfolio internationally before making an investment decision in any asset class.

Strategy Depends on the Type of Investor
We have highlighted the significant gains that can be attained from international diversification. We also note that failing to invest at all is the most costly solution for any investor because the loss of long-run returns can be detrimental. Home bias is costly but not as costly as remaining uninvested.

Home bias may be less expensive, however, than our analysis suggests because of further normative reasons that we have not explored here such as potential tax benefits related to domestic investments. At some point the diversification gains become marginal and this will depend largely on the investor’s financial characteristics (e.g., ability to withstand the stresses endured from investing) and location (we have shown how home bias is likely to be less costly for U.S. investors in comparison to U.K. investors).

When pursuing the gains of diversification, it is paramount to tailor the investment strategy to the investor’s individual financial traits. Investment managers dealing with first-time investors or those that exhibit a low degree of composure and market engagement may have greater success in helping an individual with any reservations by phasing investments into more familiar asset classes and geographies. The emotional comfort gained from exhibiting a home bias may help overcome the inefficient outcome of remaining uninvested.

Financial development has made constructing an internationally diversified portfolio easier. The low cost and transparent structure of exchange-traded funds has resonated well with investors and provides easy access to a range of asset classes and geographies, including emerging markets. These instruments can alleviate some of the emotional discomfort of nondomestic investing and can be easily accessed to mitigate the costs of home bias.

Achieving an optimal portfolio can be difficult for the average investor. Our behavioral overlay shows that in the absence of perfect information, trying to achieve an optimally weighted global portfolio can induce other, potentially more costly biases such as overtrading, panic selling, or underinvesting. If you can avoid home bias, then it certainly is worth doing so once invested, because the benefits of international diversification are evident. In reality, investors need to strike a balance between striving for the perfect international portfolio and the costs that result from imperfect behavior.
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Endnotes

1. Keynes made this point in a letter sent to a business associate in 1934; Warren Buffett included this quote from Keynes in a letter to Berkshire Hathaway shareholders in 1991.

2. See Sharpe (1964). This holds true when one assumes that markets are reasonably efficient and that stock prices reflect all the available information and expectations of investors.

3. Return is calculated in excess of the Bank of England base rate. We represent an internationally diversified portfolio via the MSCI World Index.

4. We use the capital asset pricing model (CAPM) in a Black-Litterman framework.

5. We calculate cost as the international risk-adjusted return minus the home risk-adjusted return. Note the cost estimate depends on the internationally diversified benchmark used.

6. See note on figure 4 for home-bias calculation details.

7. As well as no transaction costs, taxes, and other assumptions of theoretical asset pricing models.

References


