Chapter 56
The Degree of Home Bias in the Holding of Share Portfolio:
Case of American Investors

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ABSTRACT

The objective of this paper is to measure the degree of Home Bias within the holdings of portfolio and to identify their determining factors. By following an intuitive reasoning, the authors have chosen a number of susceptible factors that have an impact on Home Bias. In fact, they have developed an international CAPM (Capital Asset Pricing Model). This model is estimated for 20 countries, with the use of cross-section econometrics. The authors' results show that all countries have recorded a high level of Home bias in their holdings of portfolio. In order to study whether the Home Bias of the newly emerging markets and that of the developed markets react differently to the determining factors or not the authors have evaluated the model so much jointly for all markets as separately for the developed and the newly emerging ones. In the case of classification of the sample, the results have permitted us to draw an important conclusion and to have cognizance that the volatility of the exchange rate is statistically significant concerning the newly emerging economies at a threshold of 1%, while it is hardly remarkable for the developed countries. This means that this variable prevents the American investors from investing in the former countries. Samely, for both variables of joint- variance and size.

1. INTRODUCTION

Financial markets are characterized by quite an important volatility and an environment that is laden with risks, wherefore the investor finds himself confronted with the problem of [dynamically] managing his portfolio. Within this context, ever since the model theory of portfolio selection has emerges by the founding works of Markowitz (1952, 1959). His research has concentrated on the problem of portfolio selection based mainly upon the gadgets of returns-risk. This theory stipulates that the inclusion of less correlated securities within a portfolio drastically reduces its risk. However, this risk may also be reduced by the geographical diversification of the portfolio across many markets over the world. This very phenomenon is called "international diversification". It is important to allude to the fact that international diversification goes in line with the renowned adage: "Don't put all your eggs in one basket".

Numerous writers, notably Solnink (1974), Harvey (1991), De-Santis & Gérard (1997), Lewis (2000) and Arouri (2005, 2006 b) show that international diversification allows to considerably downsize the risk of portfolio and /or to improve its anticipated investment yields. Nevertheless, despite the recommendations of the financial theory prompting the importance of international diversification, institutional investors show strong preference for national assets. This issue is called "Home Bias". Meanwhile, many researchers have been interested in the study of this phenomenon. We can mention as an example the study of Tesar & Werner (1995); who observed the phenomenon in a dynamic fashion from 1970 to 1990: the weak share of foreign securities in the portfolios of German, American, British, Canadian and Japanese investments. It is to be noted that many studies have focused the attention on the question of factors that are significantly contributing to the existence and justification of Home Bias.

Yet, it is quite clear that this present work contributes to the literature by widening the scope of analysis of Home Bias in the field of shares. Our objective, within the framework of this research, consists in resolving the following question:

What are the benefits of international diversification?
What are the explanatory factors of Home Bias?

The upshot of this article is to study the determinants of Home Bias in connection with the newly emerging and developed markets both jointly and separately. After having presented the objective of our work, we shall bring forward, in the second section, a brief review of the major works and latest developments concerning the topic of international diversification, together with the issue of Home Bias. This is all in accentuating the related explanations presented in the literature of international financial markets. The data being used and the methodology being followed shall be the object matter of the third section. The fourth section exposes the results of our empirical part. At last, we shall finish by discussing our results. In the fifth section, we shall conclude.

2. A SUMMARY OF THEORETICAL LITERATURE

The international diversification is considered as a central area of management that seeks to improve the performance of portfolio. In fact, as we have previously seen with many already done, studies such as those of Grubel (1968), Levy & Sarnat (1970) and Solnik (1974), the international allotment of portfolio's investments constitutes the best way to ameliorate the performance of portfolios.

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