# International Portfolio Investment and Home Bias

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## ABSTRACT

The home bias puzzle—investors' pronounced tendency to underweight foreign equities relative to the predictions of standard portfolio theory—is among international finance's most studied and most debated empirical anomalies. Modern portfolio theory predicts that investors should hold the world market portfolio, with each country's equities weighted by its share of global market capitalization. In practice, investors in every country dramatically overweight domestic equities: U.S. investors held approximately 75% of their equity portfolios in domestic equities in 2020, despite the U.S. constituting approximately 56% of global market capitalization. French and Poterba (1991) in the American Economic Review (81(2): 222–226) first systematically documented this home bias and estimated that implied expected return differentials required to explain it (domestic investors requiring 3–4% higher expected returns from foreign equities than domestic) were implausibly large. This paper reviews the home bias puzzle, theoretical explanations (information asymmetry, hedging demand, regulatory barriers, behavioral), empirical evidence, and the evolution of home bias over time.

**Keywords:** Home Bias; International Diversification; Portfolio Theory; French Poterba; Information Asymmetry; International Finance; Cross-Border Investment.

## 1. INTRODUCTION

The principle of international portfolio diversification is theoretically unambiguous: combining assets from different countries with imperfectly correlated returns reduces portfolio variance without sacrificing expected return, and the gains from international diversification are largest when home and foreign markets are least correlated. Solnik (1974) in the Financial Analysts Journal demonstrated that international diversification could dramatically reduce portfolio variance relative to single-country portfolios. The theory therefore predicts that utility-maximizing investors should hold diversified global portfolios—yet the empirical evidence documents massive home bias that appears to persist despite decades of capital market liberalization.

The magnitude of home bias has declined over time—particularly for institutional investors who now hold larger international allocations than in the 1990s—but home bias remains substantial. Coeurdacier and Rey (2013) in the Journal of Economic Literature document that home bias declined from approximately 80% in 1990 to 55% in 2007 for the U.S. (with 1 = complete home bias, 0 = market-weight international allocation), with similar trends across other developed countries. This reduction is partly explained by the removal of formal capital controls, the growth of low-cost international index funds, and the normalization of international investment in institutional investor practice.

## 2. EXPLANATIONS FOR HOME BIAS

### 2.1 Information Asymmetry

Coval and Moskowitz (1999, 2001) document that even within the United States, institutional investors overweight geographically proximate firms and generate abnormal returns from this local overweighting—suggesting that geographic proximity provides genuine information advantages that motivate geographic concentration. By extension, domestic investors may have genuine information advantages in domestic securities that make international diversification less valuable than pure portfolio theory predicts. Brennan and Cao (1997) formalize this argument: if domestic investors have better information about domestic assets, they rationally prefer domestic assets—producing home bias as an informational equilibrium rather than a portfolio efficiency failure.

### 2.2 Hedging Demand and Real Exchange Rate Risk

Home bias may partly reflect rational hedging of non-traded asset risk: consumption bundles are tilted toward domestic goods, so domestic equities provide a hedge against domestic inflation and real exchange rate risk that foreign equities do not. Baxter and Jermann (1997) in the American Economic Review argue that the human capital component of investor wealth—the present value of future labor income—is highly correlated with domestic equity returns, suggesting that investors with domestic human capital exposure should actually short domestic equities and invest more internationally than market-weight theory implies. This argument suggests that home bias, if anything, may be too low rather than too high for labor income-exposed investors.

## 3. EMPIRICAL EVIDENCE ON HOME BIAS MAGNITUDE

Table 1. Home bias magnitude: actual domestic equity allocation vs. market-weight benchmark.

| Country | Domestic Share of Equity Portfolio | Market-Weight Allocation |
|---|---|---|
| United States | ~75% (2020) | ~56% (U.S. share of world market cap) |
| Japan | ~55% | ~7% |
| Germany | ~40% | ~3% |
| United Kingdom | ~35% | ~4% |
| Canada | ~60% | ~3% |

## 4. BEHAVIORAL EXPLANATIONS

Behavioral finance offers additional explanations for home bias beyond rational information and hedging motives. Familiarity bias—the tendency to prefer familiar objects over unfamiliar ones even when they are objectively equivalent—leads investors to favor domestic equities because they are more familiar: investors see domestic company brands, products, and media coverage daily. Grinblatt and Keloharju (2001) document that Finnish investors prefer stocks whose CEOs speak the investor's native language—a non-information-based familiarity effect consistent with behavioral rather than rational home bias. Huberman (2001) in the Review of Financial Studies shows that U.S. investors systematically overhold local telephone company stocks compared to other Bell system companies—a regional familiarity bias for assets with no plausible information asymmetry advantage.

## 5. CONCLUSION

Home bias remains a quantitatively important phenomenon despite substantial reduction since the 1990s. The evidence suggests it reflects a combination of genuine information advantages in domestic securities, rational hedging demand for domestic assets against non-traded real exchange rate risk, and behavioral familiarity preferences that lead investors to prefer what they know. The relative contribution of these factors varies across investor types (retail vs. institutional) and across countries (capital market development level). The secular decline in home bias as passive international index fund costs approach zero tests the behavioral explanation: if pure low-cost access to global diversification reduces home bias, familiarity is more important than information; if home bias persists even with zero-cost index fund access, information or hedging motives must be driving residual concentration. Future research should examine how digital investing platforms change home bias through reduced information barriers and reduced familiarity constraints.

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