EQUITIES

Home Bias at Home: Local Equity Preference in Domestic Portfolios

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The strong preference for domestic equities exhibited by investors in international markets, despite the well-documented gains from international diversification, remains an important yet unresolved empirical puzzle in financial economics.

Though such behavior appears to be grossly inefficient from a diversification standpoint, academics have offered a variety of explanations for this phenomenon.

Home bias explanations can be assigned to two groups: those that rely on national/governmental frictions and those that rely on frictions associated with distance. As we demonstrate in this study, since the latter set of frictions is not unique to the international economy, the distance effect can be gauged by examining domestic investment portfolios. Indeed, judging from the domestic evidence in this paper, geographic proximity plays an important role in determining investor portfolio choice. On an international scale, investment proximity may account for a large portion of the observed abstinence in holdings of foreign securities.

Furthermore, we identify several firm characteristics that account for a substantial fraction of the local equity preference. Specifically, local holdings tend to be in small, nontraded-goods-producing firms with high degrees of financial leverage. These results suggest that information asymmetries may be driving the observed preference for geographically proximate firms.

Moreover, they may indicate an important link between local equity preference and the cross-sectional asset pricing implications associated with size and firm distress. Finally, these results are common across a variety of manager types and fund classes.

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