Investment Home Bias: an Empirical Investigation of Emerging Markets

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Abstract

This study explores the degree of home bias among investors in 22 emerging markets from 2005 to 2019. Home bias is computed as the difference between a country's optimal investment in foreign stock and its actual foreign investments, as derived by the "Capital Asset Pricing Model (CAPM)". The study utilizes data from the World Federation of Exchanges (WFE) and the Coordinated Portfolio Investment Survey (CPIS) from the IMF. The findings reveal that investors in China, Greece, India, Indonesia, and the Philippines demonstrate significant home bias. At the same time, those in Argentina, Mexico, Peru, and Poland show the least home bias. Interestingly, only in Hungary short selling of foreign equities is considered optimal. The regression analysis shows a positive relationship between lagged home bias and current home bias and a negative correlation between trade value and home bias at a 1% level of significance. However, the analysis found no significant impact of the global financial crisis, inflation, institutional quality, or natural resource rents on home bias.

Keywords: *Home Bias, International Diversification, Optimal Foreign Weight, Actual Foreign Weight, Market Capitalization*

1. Introduction

International investment theory suggests that all investors should diversify and broaden their portfolios internationally to attain the objective of potential risk reduction (Markowitz, 1952). Levy and Sarnatt (1970) empirically analysed data from 28 nations, concluding that a globally diversified portfolio yields a superior risk-

return profile when the security returns in the two countries do not have a positive correlation. Solnik (1974), Solnik and Noetziln (1982), and Odier and Solnik (1993) have also provided evidence that validates this theory. The empirical analysis of Grauer and Hakansson (1987) also supports these findings. In practice, investors invest more in domestic securities than modern portfolio theory suggests. In the finance literature, this tendency of investors is known as home bias (hereafter mentioned as HB). Many scholars, such as Ahearne *et al*. (2004) and Levy (2020), define HB as over-investment in securities of the home country concerning an optimal internationally diversified portfolio. Gaar *et al.* (2020) find that home-biased investors invest disproportionately in domestic assets, disregarding the modern portfolio theory. Coval and Moskowitz (1999), also view HB as an inclination of individual and institutional investors towards the stocks of geologically nearby companies. Huberman (2001) and Deshpande & Svetina (2011) also share the same geological proximity idea of 'Home bias'. Kilka and Weber (2000) define HB in affection terms, i.e., the inclination of employees to invest in a company in which they work. The first empirical work in the area of HB was by French and Poterba (1991), who found that investors in Japan, United States America, Germany, United Kingdom, and France were highly prone to HB. Morse and Shive (2011) stress that the stockholders of highly patriotic countries are home-biased during portfolio selection.

Empirical analysis of home bias is mainly limited to the pre-2012 period. We find minimal empirical analysis in this field for the post-2012 period; therefore, we attempt to analyze the extent of HB in 22 emerging markets from 2005 to 2019. Initially, 27 emerging countries included in 'The Emerging Markets Index' of 'Morgan Stanley Capital International (MSCI) were selected for the purpose of analysis, but there were some data discrepancies for five countries; therefore, in our final sample, we calculated the HB coefficient of 22 countries. We have also attempted to identify the determinants of home bias using regression analysis.

The empirical analysis of these countries finds Egypt as the most home-biased country, whereas India, Philippines, and Indonesia rank 2, 3, and 4, respectively. Investors in countries such as Colombia, Chile, Russia, Greece, Pakistan, and Turkey have been found to have less home bias. Some countries also exhibit negative home bias, which implies over-investment in foreign securities. These countries are Argentina, Mexico, Poland, and Hungary. The regression analysis results show a notable positive effect of lagged home bias and a negative effect of trade value (import + export) on current home bias.

The remaining parts of this research article are as follows: First, we have discussed the literature review, which is subdivided into three parts: 1) reasons for HB, 2) empirical works on HB, and 3) evidence of HB in different nations. After the literature review, we have explained the research methodology, which incorporates data analysis techniques and sources. We sum up the article with a discussion and conclusion.

2. Literature Review

French and Poterba, (1991) have performed seminal work in the area of HB and found that despite the global diversification of stocks being proven to be profitable, stockholders tend to invest most of their funds in the stocks of their native country. Uppal, (1992) and Kang and Stulz, (1995) supported their views. The empirical findings of Cooper and Kaplanis (1994) also point to the persistent home bias of investors; Tesar and Werner (1995) further reinforce these findings. Lewis (1999) argues that HB is a phenomenon in which domestic investors' shareholding in foreign stocks and financial assets is very low (in relation to portfolio shares) to evade risks and increase profits optimally. Baele *et al.,* (2007) name it 'Home Bias Puzzle'. Karolyi, (2016) describes HB as a phenomenon in which investors give more weightage to the stocks of their home country in comparison to an optimal internationally diversified portfolio. As a result, investors who give more weight to the stocks of their home country perform poorly compared to those who invest extensively in international assets (Norden, 2010). We have divided the literature into three parts: the first details the reasons for HB, the second explains empirical works in the area of HB, and the third discusses the countries that evidence HB.

2.1 Reasons for Home Bias

Several factors contribute to investors becoming susceptible to HB, these factors include:

1) Mitigating the effects of domestic inflation (Uppal, 1992; Ardalan, 2018),
2) Institutional obstacles, that include the movement of foreign capital, the internal governance structures of firms, and the interplay between markets (French & Poterba, 1991; Ardalan, 2018), 3. Taxation on foreign income (Uppal, 1992),
3) Informational factors, that include differences in accounting and reporting standards (Cooper & Kaplanis, 1994),
4) Psychological biases of individual investors such as optimism bias, risk aversion, patriotism bias, familiarity bias, and overconfidence (French & Poterba, 1991; Riff & Yagil, 2016),
5) Language barriers (Konara, 2020),
6) Investor competency, such as financial literacy (Graham et al., 2009; Karlsson & Norden, 2007), and
7) Transaction costs and taxes on overseas investment (Uppal, 1992; Glassman & Riddick, 2001), although Tesar and Werner (1995) dismiss transaction costs as an acceptable justification for HB.

2.2 Empirical Works on Home Bias

French and Poterba (1991) were among the pioneering researchers who conducted empirical measurements of HB. The analysis focuses on the HB levels for investors in Japan, the U.K., and the U.S.A. in 1989. They found that Japanese investors allocate 98.11% of their equity portfolio within their domestic market, while U.K. investors allocate 82% and U.S.A. investors 93.8% to domestic investments. French and Poterba, (1991) compute HB as a percentage of native assets in a portfolio without considering optimal portfolio weights. Cooper and Kaplanis (1994) calculate HB differently by calculating "domestic equities relative to the proportion of domestic equities in the world market portfolio." Their empirical results aligned with the conclusions of French and Poterba (1991). They find HB to be 98% in the U.S.A., 78.5% in the U.K., 86.7% in Japan, 75.4% in Germany, 64.4% in France and 100% in Sweden for the year 1987. Tesar and Werner (1995) found a strong presence of HB in the United Kingdom, Canada, Germany, Japan, and the U.S.A. from 1970-1990. The authors used data from non-residents' sales and purchases of securities and the value of national stocks held by non-residents to calculate HB. Lau *et al.* (2010) evidence a strong presence of HB among 38 developed and emerging stock markets and its negative influence on the country's cost of capital. Both Lau *et al.* (2010) and Kim *et al.* (2014) find a higher degree of HB in developing markets than in developed markets. Mercado (2013) find a higher coefficient of HB in emerging Asian countries than in advanced countries. Mishra (2015) studied HB in 42 countries during 2001-2011 using five methodologies, slightly different from each other, and found a similar percentage of HB in all methods. Riff and Yagil (2016) found a declining level of HB in 10 advanced countries from 1997 to 2012.Mukherjee *et al.* (2018) also found results similar to those of Mercado (2013); they studied HB in 39 countries from 2000 to 2009 and found a declining HB puzzle in developed nations and an increase in emerging countries. Narayan and Rehman (2021) find that the home-biased investors of Asia can invest within Asia to attain the benefits of international diversification because there exists no stable long-run relationship between Asian countries. Gender also plays important role. Empirical study by Neha and Kumar (2025) reveals that male investors have higher degree of optimism bias, lower degree of home bias, and greater overconfidence compared to female investors. Similarly, home-biased investors can invest inter-regionally to take advantage of the diversification of funds internationally.

2.3 Evidence of Home Bias in Different Nations

French and Poterba (1991) have evidenced a strong presence of HB in both advanced and emerging nations. They analyzed strong HB in Japan, the U.S.A., and the United Kingdom. Cooper and Kaplanis (1994) also found the presence of HB in these countries, along with France, Germany, and Sweden. Tesar and Werner (1995) empirically found high levels of HB in Canada, Germany, Japan, the U.K., and the U.S.A. Home bias (HB) in investment behavior has been extensively studied across various countries. Coval and Moskowitz (1999) analyzed HB in the United States, revealing that American investors tend to favor domestic assets, leading to under-diversified portfolios. Similarly, Kang and Stulz (1995) focused on Japan, exploring how cultural and informational factors drive local investment

preferences. Huang and Fu (2014) examined home bias in China, highlighting how rapid economic growth influences investor behavior. In Italy, Bashieri et al. (2016) identified the role of familiarity and trust in local markets, while Lütje and Menkhoff (2007) found comparable trends in Germany, linking home bias to informational asymmetries. Karlsson and Norden (2007) studied Sweden, contributing to the understanding of regional influences on investment decisions. Lastly, Grinblatt and Keloharju (2009) uncovered the relationship between risk attitudes and historical market performance in Finland.

Baele *et al.* (2007) studied HB in 25 markets and found its substantial presence in all of them. Lau *et al.* (2010) find evidence of HB in 38 markets (14 emerging and 24 developed)and also observe a direct correlation between HB and capital cost. Mercado (2013) studies HB in emerging Asian countries and finds India the most home-biased country. Kim *et al.* (2014) examine HB in 20 developing and 22 developed markets for both bonds and equities and find a more substantial presence of HB in emerging countries than in developed markets in both sections of bond and equities. Mishra (2015) studies HB in 42 countries and finds India to be the second most home-biased country after the Philippines. Riff and Yagil (2016) studied the effect of behavior factors on HB in 10 countries. Cooper *et al.* (2018) studied HB in 38 emerging countries and found all of them prone to HB. Maier and Scholz (2018) examine HB in 15 European nations. Mukherjee *et al.* (2018) studied HB in 39 countries. Hu, C. (2020) posits that industrial structure impacts international portfolio diversification, investors from highly specialized economies seeking to mitigate risk are strongly inclined to avoid domestic assets. These studies emphasize the global prevalence of home bias and the importance of local factors in shaping investor behavior, suggesting that a more diversified investment approach could mitigate these biases. Many authors have concentratedon research in multiple countries instead of one country.

3. Objectives of the Study

As discussed earlier, no prior literature discusses empirical examination of HB for post-2012 periods. Therefore, the objective of this research is to:

1) Assess the extent of HB in emerging markets from 2005 to 2019. The reason for choosing this period is that the stock market bang in 2008 was a significant event in the history of the global stock market and India. Consequently, we designate this timeframe to encompass the stock market's pre-crash, crash, and post-crash phases.
2) Identify the potential factors influencing home bias from 2005 to 2019.

4. Research Methodology

4.1 Capital Asset Pricing Model: We follow the research methodology adopted by Mishra (2015) and Riff and Yagil (2016) to measure the level of HB in India. This methodology is founded on the '**International Capital Asset Pricing Model**' (hereafter mentioned as CAPM). This model assumes that an investor's ideal portfolio is similar to an international capital market portfolio, and the HB is the variance between a nation's actual and optimal foreign holdings.

$$HB_i = 1 - \frac{Actual_i}{Optimal_i} \qquad (1)$$

Actual$_i$ stands for **actual foreign holding** of a country, and optimal$_i$ stands for ideal or **optimal foreign holding** of a country. The actual foreign holding is the proportion of a nation's foreign equity investments relative to its total equity investments. A nation's aggregate stock assets comprise both international and domestic equities. Domestic equity holdings are computed by summing the overall equity holdings of the country with the foreign equity assets of domestic investors and then subtracting the total equity held by foreign entities. We calculate optimal foreign equity holding as 1 minus optimal domestic equity holding. We take optimal domestic equity holding as a ratio of India's market capitalization to the world's market capitalization as per International CAPM.

$$\textbf{Actual Foreign Holding} = \frac{\text{Foreign Equity Asset}}{\text{Foreign Equity Assets+ Market Capitalization} - \text{Foreign Liabilities}} \qquad (2)$$

Optimal Domestic Equity Holding $= \dfrac{India's\ Market\ Capitalization}{World\ Market\ Capitalization}$ (3)

Optimal Foreign Equity Holding = 1- Optimal Domestic Equity Holding (4)

HB coefficient lies between 0 and 1 when actual foreign portfolio holding is less than ideal. Zero HB indicates towards equality of optimal and actual foreign portfolio weight. HB coefficient takes the value 1 when stockholders invest only in native assets. Here,

HB (=0) → Optimal Foreign Portfolio Holding

HB (=1) → Zero Foreign Portfolio Holding

When the actual foreign portfolio weight exceeds the ideal foreign portfolio weight, we do not apply equation 1 to determine home bias. Instead, we used the modified equation provided by Baele et al. (2007) and Mishra (2015) to calculate HB.

$$\mathbf{HB_i} = \frac{\min(|Optimal_i|\ Actual_i)}{sign(Optimal_i)\max(|Optimal_i|\ Actual_i)} - 1 \quad (5)$$

Here, if **HB (= -1)** → Over Investment in Foreign Portfolio Holding

The aforementioned equation addresses instances of over-investment in foreign assets, namely negative home bias. If the value of the HB_i coefficient is less than one, it suggests that short selling of foreign equities is the most effective strategy. (Baele *et al.*, 2007).

To discover the home bias determinants, we use regression analysis adopted by Baele *et al.* (2007) and Mishra (2015). The dependent variable of the study will be the home bias quotient calculated using equations 4 and 5. Independent variables are selected from standard literature, including trade, inflation, institutional quality, natural resources rents, global financial crisis, and lagged value of home bias quotient.

4.2 Variables Influencing Home Bias

We adopt the factors influencing home bias as outlined in established literature. Variable 1, denoting the global financial crisis, is a variable in binary form that assumes the value of 1 for the years 2008 and 2009; and 0 for all other years. Mishra (2015) identifies a negative effect of the global financial crisis on home bias. Inflation is the second variable that represents the proportional change in the consumer price index. According to Cooper and Kaplanis (1994), a significantly low degree of risk aversion is necessary for inflation to have an impact on home bias. Variable 3 is the Institutional quality that serves as an indicator of governmental effectiveness. We anticipate that institutional quality may have a detrimental influence on home bias. The fourth variable, the lagged value of home bias, represents the home bias quotient from the previous year. Baele et al. (2007) illustrates a significant positive relationship between lagged home bias and the current year home bias quotient. Variable 5 encompasses natural resource rents, which aggregate the rents obtained from natural gas, coal, forests, minerals, and oil, expressed as a percentage of GDP. Mishra (2015) identifies a negative effect of natural resource rents on home bias. The sixth and final variable, trade, denotes the total of exports and imports expressed as a percentage of GDP.

International Capital Asset Pricing Model

According to the International Capital Asset Pricing Model (CAPM), all investors have securities that are in line with the world market portfolio. This portfolio is a portfolio in which the allocation of each asset corresponds to its proportionate share in the valuation of the worldwide market.

4.2 Data Collection

The data regarding foreign equity assets and liabilities is sourced online from the Coordinated Portfolio Investment Survey (CPIS) of the International Monetary Fund (IMF). The market capitalization data is sourced from the World Federation of Exchanges (WFE). We have designated 27 Emerging Markets that constitute the Morgan Stanley Capital International Emerging Markets (MSCI EM) index as emerging markets. This selection includes 06 countries

from the Americas, 12 from Europe, the Middle East, Africa (EMEA), and 09 from Asia. Unfortunately, data for five countries, the Czech Republic, Kuwait, Qatar, Taiwan, and the UAE could not be analyzed due to discrepancies from the IMF/WFE. Consequently, the final sample for our study consists of 22 out of 27 emerging markets. The countries included in the final sample are Turkey, Thailand, South Africa, Saudi Arabia, Russia, Poland, the Philippines, Peru, Pakistan, Mexico, Malaysia, Korea, Indonesia, India, Hungary, Greece, Egypt, Colombia, China, Chile, Brazil, and Argentina. Data from Worl Bank (2022) for market capitalization has also been used for analysis.

5. Data Analysis

Home Bias Measurement: Using the data collected from CPIS of IMF and WFE, we calculate India's actual and optimal foreign equity holding using equations 2, 3, and 4. Then, we calculate the HB coefficient using equation 1 or 5. Table 1 shows the HB coefficients of 22 emerging markets for 2005-2019 and their average.

Table 1 shows Egypt is the most home-biased country, followed by India, the Philippines, and Indonesia. Columbia, Chile, Russia, Greece, Pakistan, and Turkey are among less home-biased countries. Negative HB in Argentina, Mexico, and Poland show the cases of overinvestment in foreign securities. A negative coefficient of less than -1 in Hungary shows that the short sales of foreign equities are optimal.

Table 1: Home Bias in Emerging Markets from 2005-2019

Year/ Country	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Avg.
Argentina	0.16	0.00	-0.01	-0.44	-0.39	-0.15	-0.59	-0.78	-0.22	-0.20	-0.09	0.00	0.25	-0.18	-0.19	**-0.19**
Brazil	0.73	0.76	0.86	0.64	0.81	0.73	0.56	0.50	0.35	0.16	-0.05	0.10	0.20	0.23	0.35	**0.46**
Chile	0.46	0.46	0.51	-0.01	0.34	0.49	0.29	0.35	0.20	0.10	-0.14	-0.16	0.15	0.03	0.40	**0.23**
China	0.83	0.93	0.97	0.90	0.93	0.92	0.87	0.85	0.84	0.84	0.86	0.81	0.78	0.71	0.72	**0.85**
Columbia	0.59	0.50	0.80	0.59	0.80	0.84	0.77	0.83	0.65	0.09	-1.29	-1.04	-0.92	-1.27	-0.97	**0.06**
Egypt	N/A	0.99	0.99	0.99	0.99	0.99	0.98	0.99	0.99	0.99	0.99	0.98	0.98	0.99	0.99	**0.99**
Greece	0.79	0.75	0.71	0.38	0.46	0.27	0.05	0.23	0.53	0.37	0.13	0.07	0.13	-0.15	-0.12	**0.31**
Hungary	-3.72	-2.15	-1.37	-1.15	-1.10	-1.29	-1.14	-1.05	-1.06	-1.09	-1.25	-1.21	-1.18	-1.34	-1.41	**-1.43**
India	0.97	0.96	0.98	0.89	0.94	0.94	0.89	0.91	0.90	0.93	0.92	0.92	0.94	0.93	0.93	**0.93**
Indonesia	0.99	0.94	0.95	0.79	0.85	0.91	0.92	0.88	0.65	0.82	0.70	0.70	0.79	0.76	0.76	**0.83**
Korea	0.88	0.84	0.80	0.65	0.72	0.75	0.71	0.69	0.67	0.65	0.64	0.61	0.64	0.55	N/A	**0.70**
Malaysia	0.88	0.84	0.80	0.63	0.70	0.73	0.69	0.70	0.70	0.66	0.63	0.62	0.65	0.57	0.54	**0.69**
Mexico	-0.61	-0.07	0.20	-1.72	-0.45	-0.24	-0.18	-0.16	-0.37	-0.47	-0.73	-0.85	-0.70	-0.93	-1.05	**-0.55**
Pakistan	0.96	0.96	0.96	-6.60	0.88	0.92	0.89	0.92	0.94	0.95	0.94	0.96	N/A	N/A	N/A	**0.31**
Peru	0.19	0.52	0.64	-0.54	0.53	0.62	0.36	0.39	-0.30	-0.31	-1.01	-0.57	-0.36	-0.54	-0.53	**-0.06**
Philipines	0.91	0.93	0.93	0.80	0.89	0.93	0.94	0.93	0.92	0.91	0.89	0.89	0.88	0.87	0.85	**0.90**
Poland	0.25	0.62	0.57	-2.17	-0.39	-0.20	-0.80	-0.66	-0.50	-0.81	-0.77	-0.85	-0.69	-1.40	-1.75	**-0.64**
Russia	N/A	N/A	N/A	N/A	0.47	0.47	0.44	0.41	0.29	0.10	0.22	0.26	0.18	0.16	N/A	**0.30**
Saudi Arab	N/A	N/A	N/A	N/A	0.68	0.59	0.53	0.46	0.61	0.56	0.50	0.48	0.32	0.37	0.85	**0.54**
South Africa	0.81	0.83	0.83	0.76	0.78	0.75	0.71	0.71	0.71	0.70	0.64	0.69	0.67	0.61	0.67	**0.72**
Thailand	N/A	0.79	0.82	-0.71	0.67	0.78	0.66	0.77	0.73	0.74	0.63	0.68	0.68	0.62	0.61	**0.61**
Turkey	0.87	0.79	0.85	0.52	0.70	0.74	0.53	0.69	0.00	-0.49	0.04	-0.01	-0.19	-0.32	0.05	**0.32**

Figure 1 Extent of Home Bias Among Emerging 22 Economies across the Globe
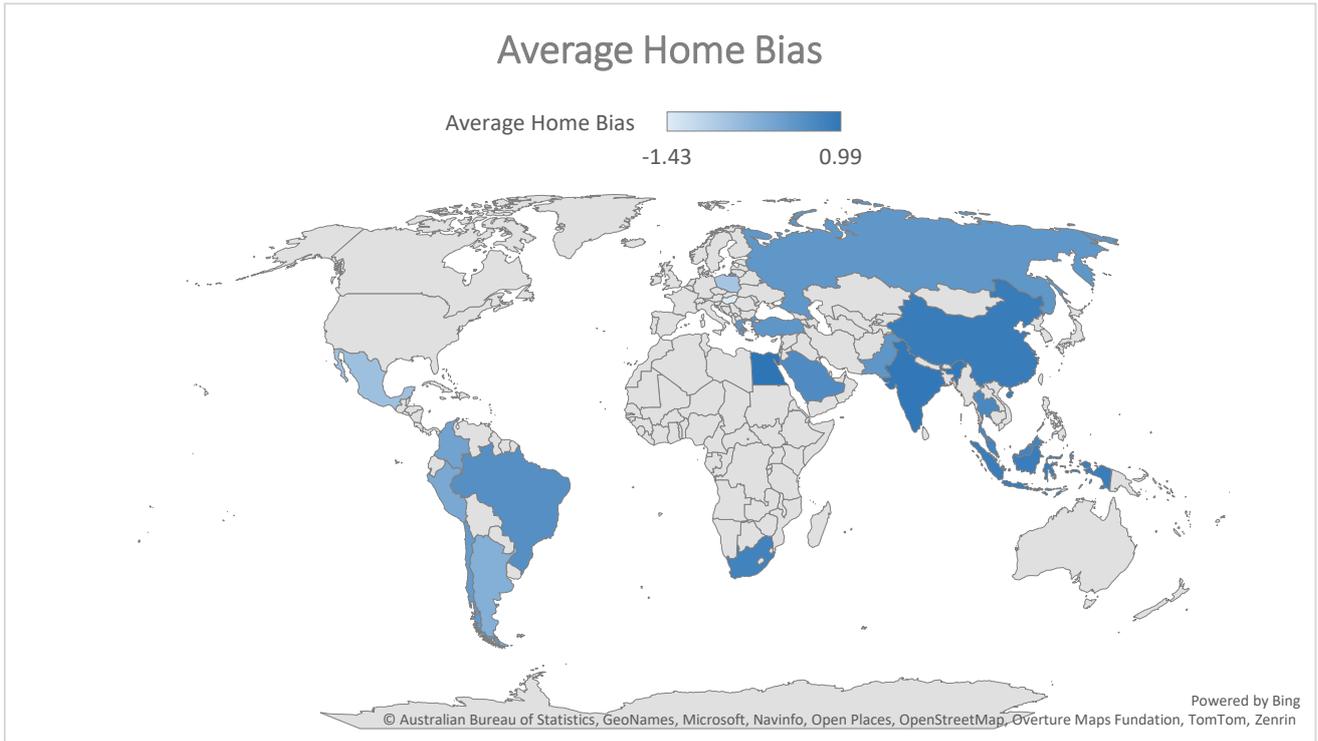
Credit: Prepared by the researcher

Figure 1: Average Home Bias of Different Counties
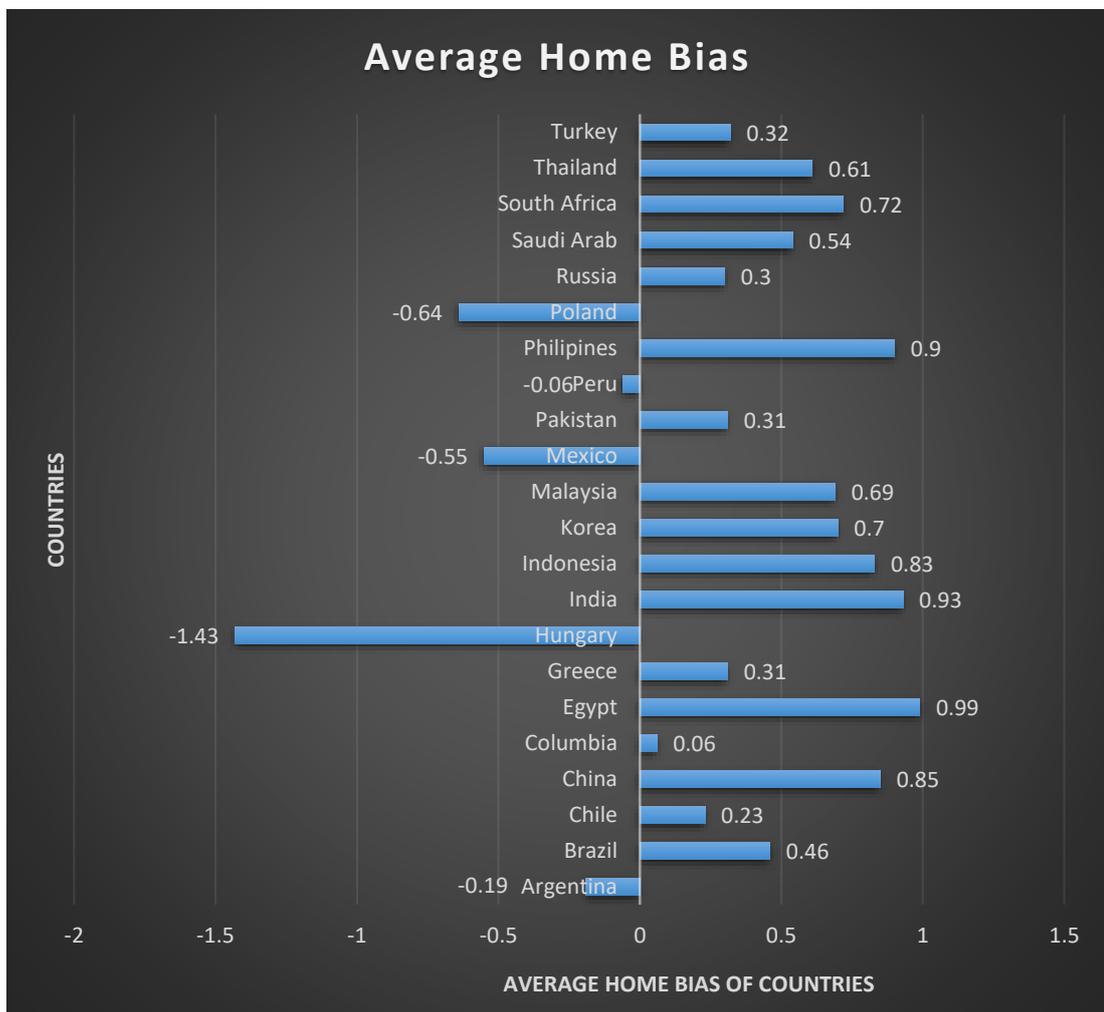
Source: Computed by the researcher
Analysis of Determinants of Home Bias

Using regression analysis, we find the effect of variables such as the global financial crisis, inflation, institutional quality, lagged home bias, natural resource rents, and trade-on-home bias. The results are presented in Table 2.

Table 2: Determinants of Home Bias

Determinants	Coefficient	Std error	p-value
Intercept	0.397***	0.109	0.00
Global financial crisis	0.040	0.139	0.77
Inflation	-0.012	0.011	0.24
Institutional quality	0.102	0.075	0.18
Level (-1)	0.535***	0.050	0.00
Natural resources rents	0.043	0.026	0.11
Trade	-0.004***	0.001	0.00
No. of observations			276
Adjusted R square			38%

*** Significant at 99 % significance level.

The regression analysis results indicate a significant effect of lagged home bias quotient and trade on home bias. Previous home bias quotient positively contributes to current home bias. Trade negatively affects home bias. As the import and export of goods and services increase, the home bias decreases. Other variables do not significantly affect home bias.

6. Conclusion

In HB studies, we compare actual portfolio weights with benchmarks. There are various approaches to compare these two, but they give almost the same results. Therefore, we adopted the most commonly used approach, i.e., CAPM, and found a strong presence of HB among the investors of China, Greece, India, Indonesia, and the Philippines for 2005-2019. Investors from Argentina, Mexico, Peru, and Poland were least home-biased. Hungry exhibits a negative home bias, suggesting the advantageous divestment of overseas shares. This bias denies investors the advantages of international diversity, enabling them to achieve superior returns with reduced risks. Solnik (1974) states that the stock price movements of various countries are mostly unrelated or significantly less correlated; therefore, if the stocks of one country do not do well, we can take advantage of other country's stocks, and risk reduces substantially. In examining the factors influencing home bias, we observe a notable negative impact of trade on home bias. We observe a notable positive impact of lagged home bias. However, we do not find a significant effect of other variables, such as global financial crisis, inflation, institutional quality, and rent. Mishra (2015) also finds no significant effect of natural resources rent on home bias. So, our results partly support and partly contradict earlier findings.

7. Limitation of Study

We have used data from 2005 to 2019 due to the absence of updated information regarding global market capitalization on the World Federation of Exchanges (WFE) website for the periods following 2019. This limitation prevents us from accessing the most current and comprehensive financial metrics necessary for our analysis.

Competing Interests Disclaimer:

We declare that they have no known competing financial interests, non-financial interests, or personal relationships that could have appeared to influence the work reported in this paper.

Disclaimer (Artificial Intelligence)

We hereby declare that NO generative AI technologies such as Large Language Models (ChatGPT, COPILOT, etc.) and text-to-image generators have been used during the writing or editing of this manuscript.

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