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journal homepage: www.elsevier.com/locate/jbfEast or west, home is best: The birthplace bias of individual investors[☆]Ted Lindblom, Taylan Mavruk^{*}, Stefan Sjögren

University of Gothenburg, Vasagatan 1, Box 100, Gothenburg 405 30, Sweden

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ABSTRACT

We examine whether there is birthplace bias in addition to local bias in the portfolio choice of individual investors. We find that, on average, individual investors who live in their birthplace invest almost three times more of their portfolio capital in local firms than other locals. A bias toward birthplace firms persists for a long time after moving elsewhere and increases significantly for “homecomers.” Our detailed analysis suggests that individual investors’ proximity bias is largely an urban phenomenon, which is explained neither by the information hypothesis nor by the familiarity hypothesis. We find that more sophisticated investors, in terms of portfolio diversification, earn, on average, abnormal portfolio returns, but they do this regardless of their portfolio distortion. Thus, attention ought to be directed toward whether individual investors are financially sophisticated rather than whether they are proximity biased.

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1. Introduction

This paper addresses the question of why investors, despite the emergence of globalized financial markets and new information

technology, invest a disproportionate amount of their capital in firms headquartered close to their homes. The paper contributes to the contemporary literature by examining whether birthplace bias, in addition to local bias, explains investors’ portfolio choice and portfolio returns by applying new concepts and measurement methods. The analysis is based on detailed data on individual investors’ portfolios of stocks, including information on the location of firms, where investors were born, and where they are living and/or moving.

Previous studies on investor preferences for proximate firms are consistent in documenting a significant distortion of the average portfolio of both professional investors (French and Poterba, 1991; Tesar and Werner, 1995; Kang and Stulz, 1997; Coval and Moskowitz, 1999; Lewis, 1999; Hau, 2001; Baik et al., 2010; Hamberg et al., 2013; Cooper et al., 2013) and individual investors (Grinblatt and Keloharju, 2001a; Zhu, 2002; Massa and Simonov, 2006; Bodnaruk, 2009; Seasholes and Zhu, 2010). There is far less consensus about the reasons for the observed biases of investors. This is particularly true for the geographical proximity bias phenomenon, commonly referred to as the “local bias” displayed in the average investor’s domestic portfolio. Empirical findings are mixed and support either of two contrasting explanations: the information hypothesis or the familiarity hypothesis.¹

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^{*} Corresponding author.

E-mail addresses: ted.lindblom@handels.gu.se (T. Lindblom), taylan.mavruk@handels.gu.se (T. Mavruk), stefan.sjogren@handels.gu.se (S. Sjögren).

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¹ In particular, the home bias literature also puts forward hedging as a potential rational explanation for investors’ portfolio distortion toward stocks of firms

The information hypothesis, as suggested, for example, by Coval and Moskowitz (2001), presumes a case of information asymmetry in which local investors receive value-relevant (negative or positive) information about firms in their vicinity before non-local investors. Accordingly, the authors find that locally biased investors earn positive abnormal returns.² Value-relevant information may be obtained through social networks, information leakage, or insider information (see, e.g., Seyhun 1986, and Korniotis and Kumar, 2013a). Alternatively, local investors may have a comparative advantage in interpreting information about local firms (see, e.g., Grinblatt et al., 2011a,b). In a Merton (1987)-like bounded-rationality setting, these firms are likely to form a subset of firms that local investors will follow and develop knowledge about over time.³

The familiarity hypothesis assumes that investors' preferences are driven by psychological, cultural, and/or emotional factors such as investor hubris, common language, feelings of belonging, overconfidence (Odean, 1998; Barber and Odean, 2000; Grinblatt and Keloharju, 2001b; Huberman, 2001; Bailey et al., 2008, 2011; Korniotis and Kumar, 2013a), and a strong connection to the local area (Baltzer et al., 2015).⁴ Investors are thus expected to be familiar with the firms in their vicinity in terms of "knowing of" rather than having true "knowledge about" these firms. In this framework, the proximity bias observed in an investor's portfolio is driven by the "heart" rather than by the "brain."⁵

Recent literature suggests that the proximity bias phenomenon goes beyond tilted portfolios toward geographically close stocks. Pool et al. (2012) observe that professional investors managing mutual funds are, on average, overweighting stocks of firms headquartered in their "home state" even when living elsewhere.⁶ The traditional local bias measure does not capture such portfolio distortion. The authors hypothesize and find that the professional investor who has moved to another state is unlikely to possess any informational advantage *ex ante* about home-state firms. In a working paper, Seasholes et al. (2011) report that individual investors in China perceived firms located in the province in which they were assumed to be born as more familiar.⁷ Using our detailed data on individual Swedish investors, we are able to distinguish between the place in which individual investors are currently living and the place in which they were born.⁸ Hence, we adopt the concept of "birthplace bias" to examine the proximity-bias phenomenon in more depth.⁹

We define birthplace bias as the extent to which native investors tilt their portfolios toward the stocks of firms headquartered in their area of birth, i.e., the individual's birth district. For native investors who are residents of the district in which they were born (referred to as "native locals"), the local and birthplace biases coincide. However, these biases become differentiated for native investors who live elsewhere (referred to as "native non-locals").

A novelty in relation to prior studies is that we analyze and compare the average proximity (local and/or birthplace) biases of individual investors with respect to whether they are native locals, native non-locals, or other locals.¹⁰ In addition, we conduct a counterfactual analysis to compare the proximity bias of individual investors before and after they move to another district.¹¹ Consequently, we disclose what we denote as the individual investors' "counterfactual bias," defined as the extent to which the portfolios of moving investors are distorted toward their new location before they move there. Finally, we develop a value-weighted proximity bias measure by which we assess the average portfolio distortion of the total amount of capital invested.¹² Previous studies have generally only measured and reported on the unweighted local bias of the average individual investor. No study has compared individual local investors according to birthplace.

Our findings lend support to the fact that there is birthplace bias in addition to local bias.¹³ First, the value-weighted proximity bias measure discloses that native locals are on average almost three times more locally biased than other locals in terms of capital invested. This divergence is not captured by the traditional unweighted measure, and is particularly evident in urban areas.¹⁴ Second, both measures display a bias for birthplace firms in the average portfolio of native non-locals.¹⁵ Finally, the counterfactual analysis suggests that the birthplace bias of individual investors persists for a long time after they have moved to another place. Our analysis also shows that individual investors who move back to the district in which they were born (referred to as "homecomers") are on average becoming more locally biased over time than other movers. Hence, birthplace bias adds to our understanding of findings in prior studies documenting growth in the local bias of movers over time.¹⁶

The birthplace bias of the average individual investor appears to be neither informationally nor behaviorally driven. We find that birthplace bias does not cause abnormal portfolio returns

headquartered in their respective home countries. Investors may hedge against inflation risk and, with possible implications for the geographical proximity bias phenomenon, price uncertainty in nontradable goods (Cooper and Kaplanis, 1994). Testing hedging against uncertainty in nontradables, Pesenti and van Wincoop (2002) find that a small fraction of home bias can be explained by such hedging. However, Massa and Simonov (2006) find no evidence supporting hedging as an explanation of local bias in individual investors' domestic portfolios.

² Positive abnormal returns are also reported by, e.g., Feng and Seasholes (2004), Ivković and Weisbenner (2005), and Ivković et al. (2008).

³ After moving to a new location, the average investor's local bias is reported to increase over time (e.g., Bodnaruk, 2009).

⁴ Among others, Seasholes and Zhu (2010) and Nofsinger and Varma (2012) do not find that locally biased portfolios generate significant positive abnormal returns.

⁵ In this respect the behaviorally rooted familiarity hypothesis is consistent with the theory of "affect heuristic," which predicts feelings-based investment decisions (cf. Alhakami and Slovic, 1994).

⁶ The authors identify the investor's home state as the state in which the investor received a social security number for the first time—usually when obtaining a driving license or their first job. Hence, the investor may have been born elsewhere.

⁷ The authors use the Chinese identity number ("hukou") system to define each individual's birthplace. In the original hukou system, individuals are registered as being born in the province where they first applied for an ID card.

⁸ We have access to the actual birth district of each individual investor born in Sweden, as well as the local district in which the investor currently lives.

⁹ More than one-third of individual investors (42%) have moved from their birth district (see Table 2).

¹⁰ Other locals are defined as local investors who live in the local district, but were born elsewhere.

¹¹ A counterfactual analysis aims to determine the effect a change in an independent variable of interest, the antecedent, has on the dependent variable, the consequent (see Klotz, 2008). It is used, for example, in treatment assessments to compare and assess the effect on the consequent before and after the treatment (see, e.g., Angrist and Pischke, 2009). In our counterfactual analysis, we evaluate the impact on portfolio distortion (the consequent) of a change in location (the antecedent) when moving to a new location (the treatment).

¹² This is the weighted average portfolio distortion based on the actual market value of each individual investor's portfolio.

¹³ Consistent with previous studies, we also find that the average individual investor is locally biased. Both native and other local investors tilt their portfolios by 4.6% towards stocks of firms located in the district in which they live. This is in line with the findings of studies focusing on other concentrated markets, such as those in Finland (see Grinblatt and Keloharju, 2001b) and Norway (see Døskeland and Hvide, 2011), as well as on large continental markets, such as mainland China (see Feng and Seasholes, 2004) and the U.S. (see Seasholes and Zhu, 2010). The average individual investor seems to be proximity biased irrespective of market structure.

¹⁴ In rural districts, the value-weighted and unweighted average local biases of both native locals and other locals are significantly lower, and barely differ.

¹⁵ The birthplace bias is on average greater among native locals than among native non-locals, which implies that time spent in the home area matters.

¹⁶ See, e.g., Bodnaruk (2009).

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