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Brian Hill, Tomasz Michalski

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RISK VERSUS AMBIGUITY AND INTERNATIONAL SECURITY DESIGN

Brian Hill
GREGHEC, HEC Paris & CNRS
Jouy-en-Josas, France
hill@hec.fr

Tomasz Michalski
HEC Paris
Jouy-en-Josas, France
michalski@hec.fr

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Abstract

We study portfolio allocation and characterize contracts issued by firms in the international financial market when investors exhibit ambiguity aversion and perceive ambiguity in assets issued in foreign locations. Increases in the variance of their risky production process cause firms to issue assets with a higher variable payment (equity). Hikes in investors' perceived ambiguity have the opposite effect, and lead to less risk-sharing. Entrepreneurs from capital-scarce countries finance themselves relatively more through debt than equity. They are thus exposed to higher volatility per unit of consumption. The expected returns on capital invested in capital-scarce countries may also be lower. Such results do not hold in the absence of ambiguity, that is, when investors only perceive risk. New facts uncovered from cross-country firm-level data are consistent with our model.

JEL codes: F21, F34, G11, G15, D81

Keywords: ambiguity aversion, risk aversion, debt/equity choice, international capital flows, international insurance, home bias

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