



International asset allocation for incompletely-informed investors

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Available online 1 June 2010

Abstract

This study explains the home bias puzzle by examining the effect of information quality on the asset allocation decisions. Our calibration results based on MSCI data indicate that in order to hedge for the changing quality of the information, when updating their estimates of expected returns of foreign assets, those agents who are partially informed and relatively more conservative will tend to hold fewer foreign assets than completely-informed agents. Furthermore, the magnitude of home bias in the portfolio of partially-informed agents decreases with the precision of their estimates and the instantaneous correlation between the returns of the home and foreign assets.

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JEL classification: G11

Keywords: Asset allocation; Home bias; Incomplete information; Kalman-Bucy filter; Learning

1. Introduction

Portfolio theory suggests that in equilibrium, under the dual assumptions that all information is freely available to all market participants and that there are no other barriers to portfolio formation, all assets are held on the basis of their capitalization weights. Nevertheless, as Table 1 clearly shows, home bias is readily apparent in allocations to international equities, with investors tending to hold larger shares in home

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Table 1

International home bias in equity portfolios, December 2005.

Portfolio investment data come from the IMF's CPIS. The market capitalization data are from the World Federation of Exchange. The equity home bias can be calculated by deducting the ratio of total domestic market capitalization from the proportion of domestic equity in a country's portfolio.

Country	Market capitalization, percentage of total	Percentage of equity portfolio in domestic equities	Equity home bias
Argentina	0.11	82.64	82.53
Australia	1.83	83.57	81.74
Austria	0.29	57.79	57.51
Belgium	0.65	49.69	49.04
Brazil	1.08	99.26	98.18
Canada	3.37	75.59	72.22
Chile	0.31	84.97	84.66
Colombia	0.11	98.00	97.88
Czech Republic	0.12	88.75	88.62
Denmark	0.42	61.91	61.49
Egypt	0.18	98.81	98.63
Finland	0.54	65.87	65.32
France	3.99	68.53	64.53
Germany	2.77	57.41	54.64
Greece	0.33	93.35	93.02
Hong Kong	2.40	80.24	77.85
Hungary	0.07	90.59	90.51
India	2.43	100.00	97.57
Indonesia	0.18	99.85	99.67
Israel	0.28	91.34	91.06
Italy	1.81	57.22	55.41
Japan	17.13	94.16	77.04
Korea	1.63	97.39	95.76
Malaysia	0.41	99.02	98.61
Mexico	0.54	98.14	97.60
Netherlands	1.35	32.57	31.23
New Zealand	0.09	59.09	59.00
Norway	0.43	51.94	51.51
Philippines	0.09	99.65	99.56
Poland	0.21	97.90	97.69
Portugal	0.15	72.11	71.96
Russia	1.35	99.94	98.58
Singapore	0.58	70.68	70.09
South Africa	1.25	88.90	87.66
Spain	2.18	86.21	84.03
Sweden	1.00	60.82	59.82
Switzerland	2.12	59.67	57.54
Thailand	0.28	98.95	98.67
Turkey	0.37	99.93	99.57
United Kingdom	6.94	63.12	56.17
United States	38.60	82.17	43.57
Venezuela	0.02	94.29	94.27

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