J. of Multi. Fin. Manag. 19 (2009) 237–255

Contents lists available at ScienceDirect

Journal of Multinational Financial Management

journal homepage: www.elsevier.com/locate/econbase

The role of information asymmetries and inflation hedging in international equity portfolios

Maela Giofré[a,b,*]

[a] University of Torino, Corso Unione Sovietica 218/bis 10134 Torino, Italy
[b] Center for Research on Pensions and Welfare Policies (CeRP) and Collegio Carlo Alberto (CCA), Via Real Collegio 30 10024 Moncalieri (Torino), Italy

ARTICLE INFO

Article history:
Received 21 February 2008
Accepted 29 November 2008
Available online 22 January 2009

JEL classification:
F21
F30
F36
G11
G14
G15

Keywords:
Equity home bias
Portfolio choice
Inflation hedging
Information asymmetries

ABSTRACT

We investigate the role of information asymmetries and inflation hedging in shaping international equity portfolios. We confirm, in a multinational setting, Cooper and Kaplanis [Cooper, I.A., Kaplanis, E., 1994. Home bias in equity portfolios, inflation hedging and international capital market equilibrium. Review of Financial Studies 7 (1), 45–60] result of no inflation hedging motive driving investors' behavior and find evidence of a crucial role for financial market development and trade linkages.

1. Introduction

Against the predictions of the modern portfolio theory on potential benefits from international equity market diversification (Markowitz, 1952; Sharpe, 1964; Levy and Sarnat, 1970; Solnik, 1974), investors actually hold a disproportionately small amount of foreign equities. The evidence of lack of diversification, often referred to as "home equity bias", is documented by many authors (French and Poterba, 1991; Tesar and Werner, 1995, among others). Information asymmetry and investor hedging

* Tel.: +39 0116705052.
E-mail address: giofre@cerp.unito.it.

1042-444X/$ – see front matter
doi:10.1016/j.mulfin.2008.11.004

behavior have often been addressed by the literature as potential determinants of home bias. The informational motive is presumably the most appealing and intuitive explanation of the home bias puzzle: investors tend to allocate their funds towards assets they are more familiar with (Coval and Moskowitz, 1999; Grinblatt and Keloharju, 2001). The relevance of hedging uninsurable sources of risks, such as inflation risk, has also been widely investigated in the literature (Cooper and Kaplanis, 1994; Coën, 2001). In particular, when the Purchasing Power Parity does not hold, the investor–consumer wants to hedge the risk entailed by consuming a bundle of goods subject to a country-specific inflation risk. If there is a positive correlation between domestic inflation and domestic asset returns there is scope for hedging the inflation risk through an appropriate long position in domestic assets. The same reasoning applies to the possibility of exploiting inflation-return covariances in a multinational setting by choosing an optimal international portfolio allocation. A combination of these two factors, inflation hedging and information asymmetry, may potentially shed some light on the puzzling evidence of international portfolios. In this work we investigate how inflation hedging and informational factors influence not only the choice between home and foreign assets but also the fraction of the foreign portfolio invested in different countries. Considering bilateral portfolio holdings is indeed crucial when the objective is not justifying the home bias phenomenon but, more broadly, understanding the determinants of investor's portfolio choice. We claim that the hedging motive might actually drive investors' decisions but not be easily identifiable in a dichotomic home-foreign setting. In fact, many "familiarity" factors – hard to be captured – might induce to overinvest domestically so hiding other relevant factors. At the same time, eventual informational issues are more likely identifiable when splitting the foreign portfolio into its country components. We depart, on the one hand, from Cooper and Kaplanis (1994) approach in the sense that we test the inflation hedging motive on the overall international portfolio rather than on domestic investments only. On the other hand, we generalize the recent empirical work on international equity portfolios (Ahearne et al., 2004; Lane and Milesi-Ferretti, 2008) accounting also for the inflation risk. Our findings confirm, in a multinational setting, Cooper and Kaplanis (1994) result of no inflation hedging motive and evidence a crucial role for financial market development and trade linkages in driving international portfolio choice.

The paper is structured as follows. In Section 2 we briefly review the theoretical and empirical literature on home bias and equity portfolio investments. In Section 3 we build the theoretical framework. In Section 4 we describe the data. Section 5 defines the variables and concludes with some key descriptive statistics. In Section 6 we define the econometric setting. In Section 7 we show the empirical results. Section 8 finally concludes.

2. Literature review

Until very recently, the empirical work on international portfolio allocation has almost coincided, due to bilateral data limitations, with the research on home bias. Even though our paper does not deal explicitly with the home bias puzzle, it is worth summarizing here the major contributions to this literature. Since the seminal paper by French and Poterba (1991) much work has been done in order to explain the so-called "equity home bias" puzzle, that is the bias towards domestic assets observed in international stock portfolios. The candidate explanations proposed by the literature can be broadly grouped into those focusing on institutional factors and those focusing on investors' behavior.[1]

The strand of literature based on institutional factors is also the earliest (Black, 1974; Stulz, 1981; Tesar and Werner, 1995). It tries to explain the lack of portfolio diversification through the existence of barriers to international investment such as restrictions on international capital flows, withholding taxes and transaction costs. However, the relaxation of capital controls which occurred over the last decades has not significantly induced a parallel drop in home bias pointing to the inadequacy of the institutional explanation. Since then a new strand of literature centered on investors' behavior emerged, giving rise to three different approaches: the *sentiment*-based explanation, the risk hedging explanation and finally the information asymmetry explanation.

[1] See Lewis (1999) for a detailed survey on equity home bias.