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When Bonds Matter: Home Bias in Goods and Assets

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Abstract

This paper presents a model of international portfolios with real exchange rate and non financial risks that accounts for observed levels of equity home bias. Bonds matter: in equilibrium, investors structure their bond portfolio to hedge real exchange rate risks. Equity home bias arises when non-financial income risk is negatively correlated with equity returns, *after controlling for bond returns*. Our framework allows us to derive equilibrium bond and equity portfolios in terms of directly measurable hedge ratios. An empirical application to G-7 countries finds strong empirical support for the theory. We are able to account for a significant share of the equity home bias and obtain an aggregate currency exposure of bond portfolios comparable to the data.

JEL codes: F30, F41, G11

Keywords: International risk sharing, International portfolios, Equity home bias

1. Introduction

Despite an unprecedented increase in cross-border financial transactions over the last thirty years, international portfolios remain heavily tilted toward domestic assets. This is the well-known equity home bias (see French and Poterba (1991) and Coeurdacier and Rey (2011) for a recent survey). As of 2008, the share of U.S. stocks in U.S. investors' equity portfolios was 77.2%, despite the fact that U.S. equity markets account for only 32% of world

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