

Asymmetric Information and Equity Home Bias Puzzle: Theory and Evidence

John M. Barron; Jinlan Ni¹

Department of Economics
Krannert School of Management
Purdue University
ni1@mgmt.purdue.edu

Abstract

Equity home bias, the observation that holdings of foreign assets are substantially below that predicted by standard portfolio choice models, is one of the major puzzles in international finance. This paper investigates the impact of asymmetric information on the equity home bias. The model explicitly introduces information costs in a rational expectation model where investors differ in their levels of initial wealth. The two-stage game of information acquisition results in two types of investors in the domestic market; the investors with larger wealth acquire information about the foreign asset and information is conveyed to the uninformed investors through the price. The uninformed investors only receive partial information and thus their demand for the foreign asset is relatively low. The model differs from the existing literature on home bias in that it explains not only the aggregate home bias but also different degrees of home bias across the investors. A unique pension fund data set and the extensive Morningstar mutual fund data both provide support for the implications of the model.

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