**How do you factor human behaviour into investment decisions?**

Even in today’s globalised world there’s evidence of what Professor Ian Cooper and Honorary Senior Research Fellow Evi Kaplanis termed ‘home bias’ some twenty-five years ago. Investors – from individuals to finance professionals – like to hold shares in their home country, even if there’s an economic cost in doing so.

Various theories have been put forward to try to explain why people do this, including inflation risks, taxes, foreign exchange exposure and transaction costs. But in their groundbreaking paper of 1986, Cooper and Kaplanis showed that this is hard to explain by rational decision-making; it looks more like something to do with human behaviour – people prefer to hold investments that are familiar and close to them. And because modern capital market theory is based on the idea that investors diversify efficiently, that tendency has important implications for financial decisions to this day.

**Human behaviour rules OK**

Over the years home bias has decreased. American funds held 97 per cent of their equities in the US in 1987-89, compared with 90 per cent in 2010. But that is still high, and it’s a significant percentage in other countries too – 71 per cent in Canada, 79 per cent in Australia. Emerging markets such as Egypt, Venezuela, the Philippines, Turkey and Russia show even more defined home bias, although part of this can be explained by their capital export restrictions.

Hundreds of papers have now been written on the subject, and the equity home bias puzzle goes to the heart of debates about behavioural versus rational finance and international versus domestic finance. The practical implications are enormous, raising questions such as whether pension funds should hold globally diversified portfolios and whether relatively unsophisticated investors should be encouraged to use a rational diversification strategy. “There’s no question that the idea of home bias has had a large impact on both research and practice,” says Cooper. “We’re proud to have made an early contribution to this extremely important idea.”

**International finance takes off**

It was in 1974 that Bruno Solnik and Fischer Black both released key papers on international finance. Solnik’s was called *Why not Diversify Internationally rather than Domestically?* and it was evident that there was a disconnect between the theory of finance that said people should diversify as much as possible, around the world, and the reality of the stocks people were actually holding.

Investors gave various reasons for this. They said they had to hedge against unexpected rises in inflation, for example, or they might pay more tax on overseas holdings. So in the early 1980s Cooper and Kaplanis started on empirical research at London Business School to investigate possible explanations, even though back then it was hard to get hold of data. “Just to find out the returns on each stock market you had to go to the microfiche copy of the Financial Times and pull them out month by month,” says Kaplanis, who was a PhD student at the time. “Finding data on portfolio holdings was our biggest obstacle. We had to get hard copies from different sources.”

**Why there’s a puzzle**

Cooper and Kaplanis’ approach was to examine each of the things that people suggested could be obstacles to investing abroad and see if they represented big enough costs to justify not holding foreign shares. Their first paper was published in 1986, and showed that these costs and disadvantages were not large enough to explain this behaviour. In a second paper they first used the phrase ‘home bias’, and in a third, published in 1994, they developed the technology needed to make a model to investigate the full range of these issues.

“We systematically went through them – tax, foreign exchange exposure, different transaction costs, inflation – and showed that they were not of large enough size,” says Cooper. “It’s now generally accepted that these are not the explanation.”

Subsequently, other important London Business School research by Professor Richard Portes and Professor Hélène Rey has shown that ‘closeness’ is indeed the main influence on investors’ choices of foreign investments, and began the process of linking this to possible differences in the information investors have about other countries.

**What it means for investors**

But it’s the nature of finance research that these results raise as many questions as they answer, as Cooper describes: “In our field you reach a point where you have something that you think is an accurate description of what you’re dealing with, but it’s always incomplete. Business is not science. Finance is not science. So it’s not like physics where you get a result and it’s clear that it is the correct solution.”

And since that 1994 paper, *The Implications of the Home Bias in Equity Portfolios*, Cooper and Kaplanis have been exploring the practical implications of their findings for practitioners.

© 2014 London Business School
For example, there’s a problem for responsible employers who want to offer their employees a range of possible pension funds to choose from for their defined contribution plan. Do they offer the choice of a largely domestic fund as well as a global fund even though they know that people are biased towards choosing the domestic one that may not be in their best interests?

**Real world relevance**

Then there’s a problem for a corporation that wants to buy a company in another country. They need to value that company, but what cost of capital do they use to come up with the valuation? The valuation will be influenced by whether that country’s investors hold domestic or diversified portfolios.

It’s a question that Kaplanis would get calls about from past MBA students who took her international finance course: “They’d say, ‘Evi we remember you were saying about home bias and how it affects the cost of capital, well I’m here now trying to work it out for my job.’”

Kaplanis and Cooper are both sympathetic to the students-turned-practitioners as they say there’s no standard answer to the question and it is a matter of judgement. “What we can do is give them some boundaries that they can put to this cost of capital depending on what they think about it,” says Kaplanis. “So they have upper bounds and lower bounds to their evaluations and it gives them a framework to exercise judgement.”

**The mysteries of finance**

In addition to the practical puzzles, academically there is still an open question around home bias that no one knows the answer to: just why do people favour assets they’re familiar with, even though they pay a cost for it?