ETF Specialist

Home Bias Blues: Investors Really Should Get Out More

By Ben Johnson, CFA | 06-21-17 | 06:00 AM | Email Article

A version of this article appeared in the May 2017 issue of Morningstar ETFInvestor*. Download a complimentary copy of* ETFInvestor *here.*

If diversification is the only free lunch in investing, investors are leaving a lot on the lunch table. Diversification is measured across a number of dimensions: individual stocks, industries, sectors, and so on. Most investors' portfolios are fairly well spread along these lines. However, when it comes to investing overseas, many decide to ditch diversification at the border.

"Home bias" is the term used to describe investors' tendency to tilt their portfolios in favor of domestic stocks (bonds, too, but I'm going to focus on stocks). Here, I'll discuss how home bias is measured, the factors that underpin this phenomenon, and why it's probably a good idea to expand your horizons a bit--especially given current valuations.

A Baseline for Bias

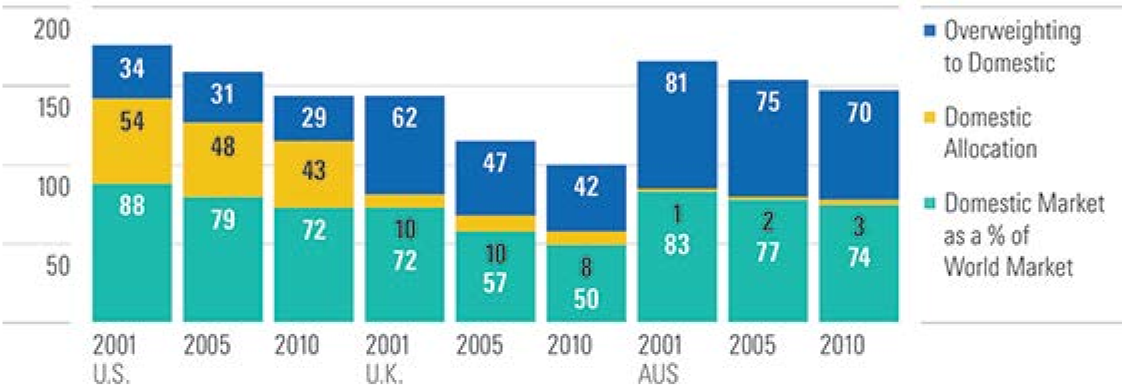
There are a number of measures of home bias that have been derived by academics through the years. But, for the sake of simplicity, I believe it's easiest to measure your home bias by comparing your current allocation to international equities with the portion of the market capitalization of global stock markets made up of stocks domiciled outside of the United States. Exhibit 1 provides a snapshot of the makeup of the global market as of the end of March. As you can see, U.S. stocks make up about 53% of the world's public equity market cap, with foreign stocks accounting for the remaining 47%. So, for example, using a market-cap-weighted portfolio of global stocks as our arbiter, any U.S. investor's stock portfolio that has an allocation of more than 53% to U.S. stocks is showing a home bias. Exhibit 2 shows the magnitude of home bias among investors in the U.S., United Kingdom, and Australia and how it has diminished (somewhat) over the years.

Exhibit 1 The Makeup of the Global Stock Market

	Total Value ($ Trillion)	Weight (%)	Weighted Avg Mkt Cap ($ Bil)	# of Securities
U.S.	23.9	53.2	136.1	3,503
Developed	16.2	36.0	47.5	5,442
Emerging	4.8	10.8	47.7	4,373
Global	45.0	100	94,654	13,318

Source: Dimensional Fund Advisors. Data as of March 2017.

Exhibit 2 Sizing Up Investors' Home Bias



Source: Vanguard, International Monetary Fund's Coordinated Portfolio Investment Survey (2011), Barclays Capital, and Thomson Reuters Datastream.

The Basis of Bias

There are a number of reasons investors might have overweightings in domestic stocks. Some are tangible, others intangible.

The Tangibles

There are many concrete, measurable explanations for why investors tend to favor local stocks.

Hedging

Most investors' liabilities are likely tied to domestic assets and denominated in their local currency. Local stocks are more likely to be correlated with these local liabilities, and therefore they will serve as a better hedge than an investment in foreign stocks.

Investment Costs

Investing in overseas markets can carry additional costs. Many foreign stock markets are less liquid than the U.S. market, and thus bid-offer spreads tend to be wider. Also, some foreign markets impose transaction taxes. The U.K. stamp duty is one such example, whereby investors buying U.K.-listed stocks will pay a tax equivalent to 0.5% of the transaction's value. These costs may deter investors from diversifying abroad.

Informational Asymmetries and Costs

Investors in foreign markets are likely to know more about their domestic enterprises and the environments they operate in than foreign investors. This creates potential informational asymmetries, whereby foreign investors risk being the patsy at the poker table. These asymmetries are not insurmountable, but leveling them comes at a cost. Portfolio managers investing in overseas markets must pay for recruiting and retaining local talent, for regular travel, and for other means of keeping up to speed in foreign markets.

Corporate Governance and Political Risk

Some overseas markets face substantial risk related to corporate governance and politics.

Misappropriation, asset seizure, and countless other nightmare scenarios are enough to scare many investors away from investing in certain countries' stock markets.

Multinationals
Many, including Vanguard founder and former CEO John Bogle, have argued that investing in domestic multinationals already results in significant exposure to overseas markets. According to S&P Dow Jones Global Indices, in 2015, 44.3% of the sales of constituents of the S&P 500 came from foreign countries. So the question becomes: If nearly half the sales of the companies in my U.S. stock portfolio are coming from outside the U.S., am I already sufficiently diversified?

Currency Risk
Buying foreign stocks can expose investors to currency risk. In some cases, assuming this risk can add substantial volatility. Given that the long-run expected return for any currency is zero, many see this as a risk that is not worth taking.

The Intangibles
There are also some behavioral explanations as to why investors tend to prefer local stocks over foreign ones.

Familiarity
Famed investor Peter Lynch is known for his "invest in what you know" ideology. Home bias reflects investors' preference for the familiar. They feel--either rightly or wrongly--that they know their local markets and local firms better than those overseas. In some cases, this preference for the familiar can be even more extreme and manifest itself in a bias toward the hyperlocal. After all, there is such a thing as the LocalShares Nashville Area ETF (NASH).

Pride
Home bias could also simply be a reflection of investors' pride in their nation and its champions of industry.

The World Is Getting Flatter
There are plenty of legitimate reasons--tangible and intangible--that explain why investors might choose to favor their domestic equity market. But I would argue that some of these have grown flimsier with time. Furthermore, in my opinion, even when considering them all together, they don't warrant the degree of home bias that exists in many investors' portfolios today.

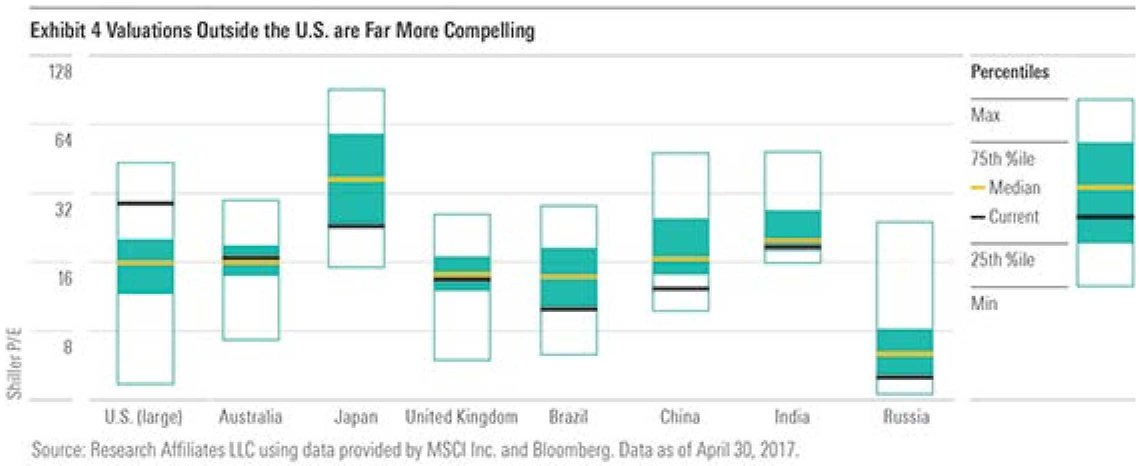
Among the concrete explanations behind home bias, I believe those relating to investment and informational costs and currency risks have become less convincing with time and will likely weaken further in the future. The world is increasingly flat, and barriers to the movement of information and capital continue to come down. The cost of investing in overseas markets has declined with time, and new markets will continue to open to new investors. One of the most telling examples of this trend is Vanguard Emerging Markets

Stock Index (VEIEX). This fund was the first emerging-markets index fund when its Investor share class launched in May 1994. At the time, the fund's fee was 0.60% and it tracked the MSCI Select Emerging Markets Index--a narrow representation of emerging-markets stocks that was designed for investability as opposed to representativeness. Fast forward to 2017, and the fund has sprouted new share classes, including an exchange-traded fund share class (Vanguard FTSE Emerging Markets (VWO)). The fund's fee (for the Admiral and ETF share classes) is less than a fourth of what it was more than two decades ago (0.14%). And it now tracks the FTSE Emerging Markets All Cap China A Inclusion Index, which includes China A-shares, a market that has only recently opened to foreign investors. Costs have and will continue to come down, as will barriers to the flow of information and capital. These are no longer good excuses to favor domestic stocks.

Avoiding currency risk is another justification that no longer holds water. In recent years, we have seen a variety of ETFs offering exposure to various foreign stock markets that manage currency risk on investors' behalf. Some hedge this risk outright; others hedge away a portion of the risk, while the newest additions manage it dynamically. The growth in the number and variety of these convenient and cost-effective tools that allow investors to take currency risk out of the equation mean that currency risk is no longer a good excuse for home bias.

Exhibit 3 It's Not Always Like This

Source: Morningstar Direct. Relative wealth chart plotting MSCI USA GR Index versus MSCI ACWI ex-USA GR Index. Data from Dec. 1987 to Apr. 2017.



Back to Diversification

Ultimately, making the case for greater exposure to international stocks is somewhat easier and more compelling than knocking down the pillars of home bias. In my mind, it boils down to this:

1) U.S. stocks and foreign stocks have not and will not ever move in unison (see Exhibit 3).

2) Pairing assets that zig and zag at different times in response to different fundamental drivers (changes in rates, inflation, differences in fiscal and monetary policies, and so on) is generally a good way to reduce portfolio risk and thus (in theory) boost your odds of sticking to your plan.

3) Perhaps most fundamentally, there will be times when valuations across global markets are out of sync (see Exhibit 4). It is at these moments when taking from your leaders (U.S. stocks of late) to add to your laggards (developed ex-U.S. stocks of late) can make the most meaningful contributions to your long-term returns.

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