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INVESTOR RELUCTANCE TO INVEST IN FOREIGN EQUITIES

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Introduction

Historically, investors have preferred to hold domestic rather than foreign securities. This tendency, termed *home equity bias,* holds globally, not just in the US. While US equity markets constitute slightly less than 50% of world market capitalization, US investors hold less than 10% of their portfolios in foreign stock. Japanese investors prefer to invest only 3% of their portfolios outside Japan, while investors in the UK hold approximately 12% of their portfolios in foreign shares. Japan's share of global market capitalization is slightly more than 25% and Great Britain's share is about 13%. So, why are investors, worldwide, reluctant to invest globally and why does the strong home equity bias exist?

A behavioral rationale

Behavioral finance provides insights into "irrational" market behavior. Today, the role of investor behavior in moving financial markets is becoming widely acknowledged. Behavioral finance studies how investors actually behave, rather than how they are expected, rationally, to act. Behavioral finance looks at how psychology affects investor decision making, hence markets themselves. John Maynard Keynes, marquee economist, was wary of the animal spirits that affected markets, but saw those spirits as necessary to overcome inertia and move markets, creating investment opportunities. Today, emotions are viewed by scientists as indispensable to rational thought. Psychological factors are vetted as rational deviations from "efficient" market behavior.

A behavioral factor which helps to explain the home equity bias is the *status quo bias* or *endowment effect.* Studies indicate that individuals have real difficulty in adjusting to change. There is a cost, often monetary and economic, such as time spent, associated with change. Since international investment has become an option for the general public fairly recently, the status quo bias helps explain why investors opt to stick with their domestic holdings. The complexity of an item under consideration for change helps determine how strong the status quo bias will be. Studies have found that as investment decisions become more complex, as more portfolio choices are added, the tendency to maintain the status quo, in terms of holdings, also increases. For example, as the number of mutual funds now exceeds the number of exchange-listed stocks, the decision to switch among funds has become more complex and therefore less likely. With change less apt to occur, domestic holdings are less likely to be replaced by foreign investments.

Another behavioral aspect is the *illusion of truth* which proposes that investors are more apt to accept a statement as true, the more easy it is to process the statement. Generally, investment is regarded as a difficult process. Differences in foreign markets (accounting procedures, regulation, exchange rates) add new complexities to the investment decision – making it more difficult to process; which translates into investors avoiding foreign markets.

The standard argument

Foreign investment will entail greater transactions costs in terms of higher taxes, management fees, commissions, and an element of political risk. Also, to many investors, the uncertainties of foreign exchange fluctuations deter purchases of foreign stocks. And, some foreign markets are opaque, illiquid, subject to chicanery, and rife with misinformation and disinformation. Commonly, investors believe that returns in the domestic market will exceed those in the foreign market. Moreover, studies indicate that the pain of losing money in foreign markets exceeds the pain of losing equally in the domestic market.

Arguments supporting increased global investment

The primary rationale for investing in foreign equities is to improve the risk-return tradeoff. *Systematic risk* is risk which cannot be reduced by simply increasing the number of stocks in a portfolio. Enlarging the system to include foreign markets whose returns are not perfectly correlated with returns in the domestic market broadens the system and improves the risk-adjusted return. Essentially, international portfolio diversification implies lower risk for a given level of return.

The degree of coordinated movement between returns in two different markets is measured by the correlation coefficient. The lower the correlation coefficient, the better the returns from diversification. For example, if there is zero correlation between returns in two markets, investors can reduce risk by 33% by dividing the portfolio between the markets. Conversely, if there is a perfect correlation between returns in two markets, the correlation coefficient is +1.0 and there are no gains from diversification. Table 1 depicts the correlation coefficients of various stock markets over the last 15 years. As shown in Table 1, the correlation between the US and global financial markets is less than perfect, hence there are diversification benefits.

Table 1. Correlation of Annual Stock Market Returns (15-Years Ending December 2004)

	U.S.	Emerging Markets	World	World ex U.S.	EAFE
U.S.	1.00	0.31	0.85	0.63	0.66
Emerging Markets	0.31	1.00	0.62	0.74	0.68
World	0.85	0.62	1.00	0.94	0.95
World ex U.S.	0.63	0.74	0.94	1.00	0.99
EAFE	0.66	0.68	0.95	0.99	1.00

Source: MCSI Equity Indices, Morgan Stanley Capital International, 2005.

In Table 1, the emerging markets category is defined as the MSCI Emerging Markets Index, while the world category consists of the MSCI World Index. The world without the US category is defined as the MSCI World Index excluding the US Index, and the EAFA category includes Europe, Australia, and the Far East.

Another argument for foreign investment is that foreign stocks may offer higher rates of return than US stocks. Economies with faster growing GDP will tend to reflect this advantage in higher market returns. Thus, one might both reduce risk and increase returns with an inclusion of foreign equities. The US is a mature economy with an average growth rate of about 3.5% per year. Contrast that with China's economy, currently growing at approximately 9% per year. Rightfully, one would expect China's young stock market, and other emerging country stock markets to grow at a faster rate than the US market. Table 2 shows the mean returns of the US stock market (S&P 500 index) over three five-year periods, from 1990-2004, compared to that of other markets.

Table 2. Five-Year Average Returns for Global Markets (in % per year)

5-Year Period	U.S.	Emerging Markets	World	World ex U.S.	EAFE
1990-1994	9.28	25.66	5.82	4.36	3.69
1995-1999	28.70	6.06	19.29	12.80	13.52
2000-2004	(0.71)	8.65	0.31	2.70	1.81

Source: MCSI Equity Indices, Morgan Stanley Capital International, 2005.

Moreover, added return in foreign markets will be realized if the domestic currency weakens against foreign currencies. Simply, if a European investment is purchased and sold for the same amount of euros, but the US dollar weakens by 10% against the euro during the holding period, US investors earn a 10% return. A depreciating dollar can turn a modest capital gain into a substantial one. Given the huge US trade deficit ($700 billion)and a world awash in dollars, the dollar may depreciate more over the next three to five years.

Convergence theory

Convergence holds that market returns in global economies will approach a global mean over time. The world-wide technology revolution, improved investor communications, greater transparency, and freer trade have helped increase the correlation of market returns. Which begs the question, does greater convergence of global returns eliminate the benefits of international portfolio diversification?

The simple answer is no. First, return correlations fall when markets do well, in particular, the still-dominant US market. Moreover, there is no certainty that correlations will continue to strengthen. To assume the global economy operates in well-oiled synchronization requires a real stretch of the imagination. Consider the Asian contagion of 1997-2000 which plunged a good portion of Asia into recession. Concurrently, the US economy was experiencing a historically low unemployment rate of less than 4%. Economies and business cycles are not always well-coordinated. Global economic shocks are more apt to affect markets in a lagged rather than a simultaneous manner.

Conclusions

We perceive the argument for portfolio diversification into foreign equities as compelling, from the basis of reducing risk and increasing return. While the correlation coefficient between returns in the UK and Canada and US markets approaches 0.8 (+1.0 is perfect correlation), it is considerably lower for other developed nations and lower yet for emerging country financial markets.

There are behavioral factors that resist the logic of asset diversification abroad. While not readily quantifiable, behavioral characteristics profoundly affect the decision to invest in foreign securities.

With time, investor behavior is gradually being modified, encouraging a larger foreign security presence in investor portfolios. Summarily, we offer four reasons to diversify abroad.

(1) If they overlook foreign markets, US investors ignore 50% of global market capitalization and restrict their risk-return choices.

(2) Some emerging nation economies are growing at higher rates than the US. Higher GDP growth is often reflected in higher market returns.

(3) Investors can lower risk by investing abroad. So long as two economies do not move in lockstep, risk can be lowered through diversification.

(4) Firms in virtually every industry increasingly compete in a global, rather than national, market. Therefore, when considering an industry, the US investor cannot ignore foreign producers.

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