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Home Bias in Financial Markets: Robust Satisficing with Info Gaps

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Abstract


The observed patterns of equity portfolio allocation around the world are at odds with predictions from a capital asset pricing model (CAPM). What has come to be called the "home-bias" phenomenon is that investors tend to hold a disproportionately large share of their equity portfolio in home country stocks as compared with predictions of the CAPM. This paper provides an explanation of the home-bias phenomenon based on information-gap decision theory. The decision concept that is used here is that profit is satisfied and robustness to uncertainty is maximized rather than expected profit being maximized. Furthermore, uncertainty is modeled nonprobabilistically with info-gap models of uncertainty, which can be viewed as a possible quantification of Knightian uncertainty.

Keywords: Equity home bias, Knightian uncertainty

JEL Classification: D81, F30, G11, G15

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