Wealth
Management

Economic View

Most investors have portfolios with greater allocations to their home market than would be the case if they invested according to that market's size relative to the rest of the world. This is referred to as the 'home bias puzzle'.

In this article, we discuss the history and current rationale of such a strategy, and explore whether it may be more appropriate for some investors to invest without a bias.

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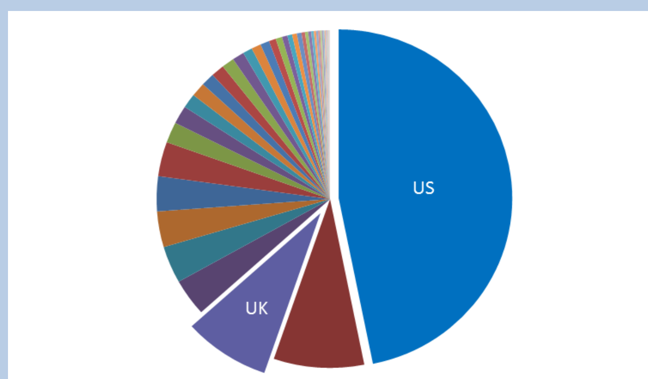
Home or away

Our world seems to be getting smaller. News from across the globe is available instantly. We make video calls to people halfway across the world as if they were in the next room. Retailers from countries previously considered remote now line the High Street next to established household names. We buy cars with a British badge, owned by a European corporation and manufactured in Asia. Yet, despite globalisation, most investors retain a disproportional allocation to assets in their home country.

There is much debate in the industry about whether this 'home bias' is the best approach, but we think a better question is not *if* but *when* a home bias is appropriate, and this really comes down to each investor's personal circumstances.

FTSE World Index country constituents by market capitalisation

The US dominates global equities in terms of market capitalisation, comprising some 47% of the overall market, with the UK edged into third by Japan. While UK equities account for just over 8% of the World Index, they comprise around half of the total equity exposure of many client portfolios.



Source: Bloomberg

It is a personal decision

A customer's longer-term, strategic asset allocation will be determined partially by their risk profile, but we believe it should also be influenced by the currencies in which they are earning and spending both now and in the future. We also take into account their investment time horizon and what plans, if any, they have for the eventual proceeds.

Take for example a customer who is living and working in the UK, spending pounds and has no plans to move abroad. A portfolio biased to the UK would match the currency of their inbound and outbound cashflows and minimise the risk of adverse currency movements.

An investor earning and spending in a variety of currencies, however, may need greater global allocations. They may be living in the UK but not domiciled here, and investing without a particular bias would open the door for a larger opportunity set. The more complex requirements and tax constraints of non-domiciled investors often make it difficult to incorporate a home bias of sufficiently good quality and a global approach is often more suitable.

If they are investing for a long period of time and have no specific plans for the investment proceeds, it could also be perfectly reasonable to invest more globally. In essence, the more that any of these factors can be relaxed, the more likely that global diversification may be appropriate.

It is also worth highlighting that a global approach is not reserved for higher risk investors only. If someone has a lower risk profile and the majority of their portfolio is sterling bonds, it may be beneficial to diversify their minority equity allocation more globally. Again, the decision comes down to what is best for the customer on a case-by-case basis.

The history of home bias

Home bias is not unique to the UK but occurs in other large developed markets. For instance, it is not uncommon for as much as 80% of the portfolio of an investor in America to be in US equities.

Home bias made perfect sense before the internet made information globally and instantly available. The argument that foreign transactions cost more is also moot, given the efficiency and competitiveness of today's markets. We do, however, acknowledge that it is difficult to invest in the companies of some developing countries, and that a weak regulatory framework probably makes investing in some markets too risky.

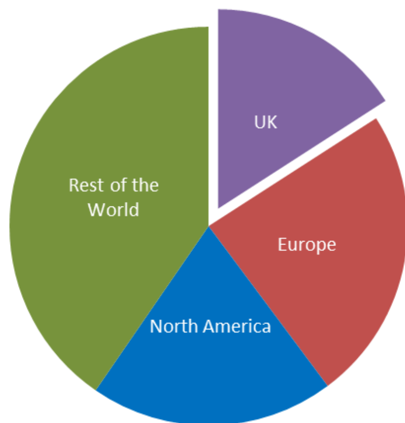
One reason that many investors retain a home bias is because they are simply not convinced that they will be better off by making such a significant shift from domestic to international equities. Indeed, this is a difficult task when these two asset classes are viewed by many people to be distinct but broadly interchangeable. There may also be capital gains tax issues. For these reasons, investors quite rationally tend to make small adjustments rather than wholesale changes.

(Source: 'Home Bias: The Private Investor Perspective', Geoff Warren, Russell Investments, 2009.)

Are there still benefits in diversifying?

Companies have become increasingly global. If we look at where the FTSE 100 companies generate their revenues, we see much more reliance on international markets (84% of revenue) than domestic ones (16%). Demand for the goods of a UK manufacturer is more likely to be driven by the economic conditions of foreign countries than what is happening here in the UK. Therefore, a home bias provides some global diversification in its own right.

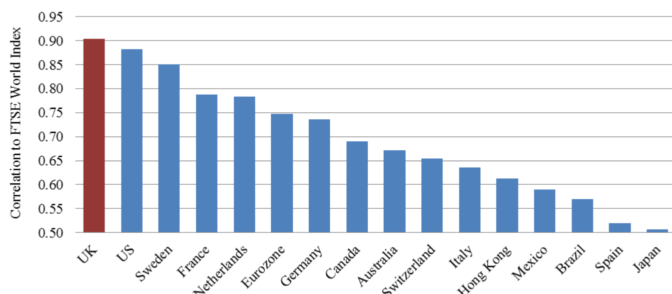
Source of revenues for FTSE 100 companies



Sources: Bloomberg using company accounts, for the financial year 2012

It is also true that returns from the UK stock market are more closely correlated with the global market than is evident in some other markets, which is shown clearly by the following chart. Again, this would add fuel to the argument that investors in highly correlated markets such as the UK do not gain as much benefit from diversifying globally.

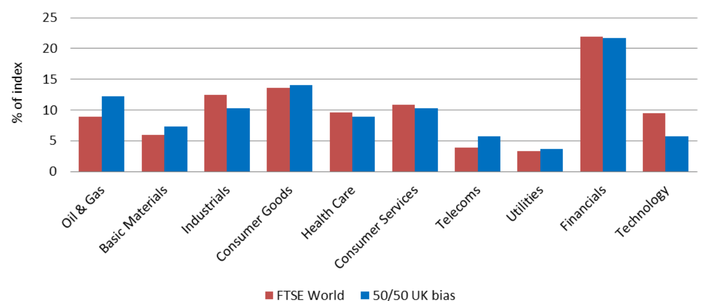
Home markets: correlation to world equities



Source: Bloomberg, to 31st October 2013. Monthly observed, three-year correlation of domestic market index returns to those of the FTSE World Index.

Look at it at the sector level, however, and it takes a twist. Compare a globally diversified portfolio with no country bias to one that is invested on a 50/50 (UK bias) basis. The home biased portfolio results in meaningful overweight exposures to the Oil & Gas, Basic Materials and Telecoms sectors, and underweights to Industrials and Technology. These positions are often unintentional and may or may not be desirable. Either way, they at least need to be understood.

Sector breakdown of the FTSE World index and a UK-biased allocation



Source: Bloomberg. UK bias is based on 50% FTSE World/50% FTSE 100 indices.

Deciding whether a home bias or no bias is most appropriate for a given customer is only the starting point. It gives us a framework for making tactical adjustments to the portfolio to reflect our shorter-term views. There are a number of options available to us to do this:

- We may increase allocation to those regions with larger exposures to our desired sectors.
- We may invest in funds with a particular style bias, which infers positioning towards certain sectors.
- We may also invest in thematic funds, or sector- or country-specific Exchange Traded Funds (ETFs).

Current examples of the latter are an actively managed global technology fund and a passive vehicle that provides exposure to European banks.

Conclusion

The debate over home bias versus global diversification does not have a simple yes or no answer. What is clear to us is that the investor's circumstances should drive which one is more appropriate, and to do this requires a flexible and customer-focused approach to portfolio construction. One size definitely does not fit all.

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