Equity Home Bias and Regret: An International Equilibrium Model

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Abstract

We develop an equilibrium international asset pricing model assuming that investors treat foreign assets as an asset class separate from domestic assets, their core portfolio. When the foreign portfolio underperforms the domestic portfolio, investors feel regret of having invested abroad. Such an attitude could be justified by numerous behavioral heuristics often mentioned in the home bias literature. Following regret theory, investors are assumed to construct their portfolios taking simultaneously into account their aversion to risk and to regret. In equilibrium, the expected return of foreign equity relative to domestic equity is equal to that dictated by the traditional CAPM plus a regret premium. This regret premium is a function of the difference of regret aversion across investors and net foreign positions. With similar regret aversion worldwide, the traditional CAPM pricing relation holds, even though investors exhibit home bias in their portfolio holdings. In equilibrium, it is sufficient to have regret aversion in a single country to observe home bias in portfolio holdings of investors from all countries. An implication of the model is that countries with larger home bias should have lower expected return on their equity markets. The article is theoretical, but provides some model calibration and a crude and simple test that lends support to this conclusion.

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