

## What Fund Boards Should Know About “Home Bias”

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Many academics and researchers suggest investors include foreign equities in their portfolios to increase diversification. Yet, until recently, investors highly favored equities of their home country. This preference is called “home bias.” In a 2003 speech, Alan Greenspan noted:

*Researchers have consistently found that, in general, investors direct too much of their savings domestically. Owing to risk aversion, they tend, to their own detriment, to over-discount foreign returns.*

Although foreign equities (developed and emerging) in 2003 were half of the world’s capitalization, their portion of U.S. mutual funds was only 12%. Since then, however, investors have switched to favor foreign equities, thereby reducing this home bias. But, increased investment in foreign equities also changes a fund’s risk profile. Peter Ciampi, analyst with Interactive Data Pricing and Reference Data, who was granted a patent for Fair-Value Pricing of a Financial Asset, spoke with Fund Directions last month about these changes in investment and what fund boards should keep on their radar.

### The Data:

Summaries based on Morningstar® data show that during the last four years U.S. equities in U.S. mutual funds increased from \$2.45 trillion to \$5.14 trillion – an increase of 110%. During the same time, foreign equities increased almost 4 times as much - from \$38 billion to \$1.85 trillion – nearly 408%.

Between 2003 and 2007, foreign equities rose by 197% while U.S. equities rose by only 78%. Therefore, pure asset growth partially explains the increase, but a significant portion came from investor flows. Data from January 2007 through August 2008 provide a dramatic example. Flows into U.S. equities decreased by \$93 billion while flows into foreign funds increased by \$127 billion; so, net flows into foreign funds exceeded U.S. funds by \$220 billion (although it’s worth noting that August 2008 was the first time in the 20 month period when U.S. fund flows exceeded foreign flows).

But, higher expected return comes with higher risk. Between 2003 and 2007, annualized volatility (volatility is a formal measure of risk) of the S&P 500® was 12%, while that of foreign markets was 17%. Higher volatility means wider price swings in both directions and this is clear in the table below. When the markets rose, foreign assets outperformed U.S. assets, but in the last nine unpleasant months the S&P 500 dropped 19%, while foreign markets dropped 27%.

	S&P 500 return	Non-US return	S&P 500 Volatility	Non-US Volatility
2003-2007 (5 years)	78%	197%	0.12	0.17
2008 Jan.-Sep.	-19%	-27%	0.23	0.29

### **Why Fund Boards Should Care**

Boards should be paying close attention to this move away from U.S. assets for a few reasons:

- As asset allocation changes, through the inclusion of more foreign assets, the risk profile of the fund changes. A fund invested exclusively in foreign securities may have higher volatility, as described above. A fund with only a portion of its holdings in foreign securities may have only some percentage of this volatility. Boards should monitor changes in allocation to insure the fund stays within its risk/return objectives.
- The fund board is responsible for determining fair values of foreign securities if market quotations are not readily available.

### **Will This Trend Continue?**

It's difficult to say whether this trend toward investing in foreign assets will continue given current market conditions. As mentioned, in 2003 the foreign asset percentage of U.S. mutual funds was only 12% - today it's 27%. One could predict that the trend will continue until all home bias is eliminated and the U.S. mutual fund percentage increases to 55%, since foreign assets now comprise approximately 55% of world capitalization.

An alternate speculation is that the "credit crisis" could make investors again favor home markets - a return of home bias (as mentioned above, in August U.S. fund flows exceeded foreign fund flows). No one can predict the future, but this potential asset reallocation is certainly noteworthy and warrants the attention of funds and their boards.

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