Estimating the Costs of International Equity Investments

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Abstract

In this paper we use and generalize the Cooper and Kaplanis (1994) methodology for estimating both the explicit and implicit costs that could reconcile international portfolio holdings with CAPM predictions. One advantage of our methodology is that we can simultaneously estimate costs of inward and outward investment and even interactions between home and host country. Second, the risk aversion parameter is estimated rather than postulated. Third, we do not need to assume that market capitalization equals wealth. Fourth, we can detect also information costs for domestic investments, not just differential costs. We find that the home bias in equity portfolios is related to a mixture of market frictions, such as information asymmetries, institutional factors, trading costs and controls on international capital flows. There is a large difference between average implicit investment costs for the developed and the emerging countries. Over the period 2001-2004, average implicit investment costs are estimated in the range of 0.26 percent per annum for the United States to 16 percent per annum for Turkey. There is also evidence of domestic information costs, which could explain part of the equity premium puzzle or the divergence between risk-aversion estimates from mean returns versus from intertemporal studies or inflation-hedging asset demand.

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