

DETERMINANTS OF HOME BIAS AND FOREIGN
BIAS IN THE GLOBAL PORTFOLIO INVESTMENT OF
SELECTED OIC COUNTRIES

BY

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A thesis submitted in fulfilment of the requirement for the
degree of Doctor of Philosophy in Islamic Banking and
Finance

IIUM Institute of Islamic Banking and Finance
International Islamic University Malaysia

NOVEMBER 2021

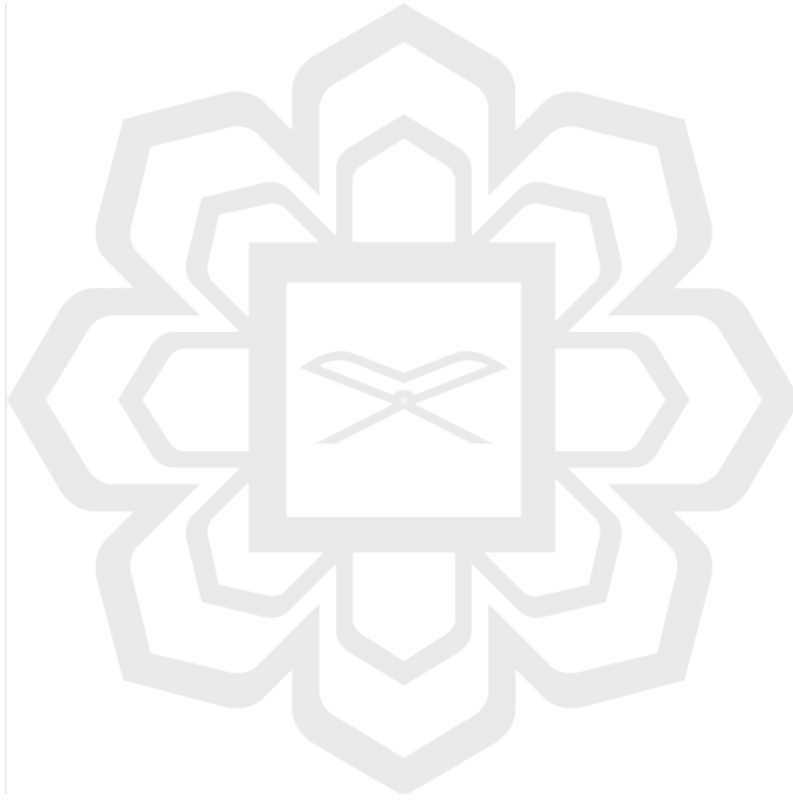
ABSTRACT

Home bias reflects the propensity of investors to invest substantially in domestic market. Whilst when investing abroad investors exhibit foreign bias, a tendency to overweight certain foreign market based on their preference. The existence of both home bias and foreign bias offers a discovery of new dimension that enables for a comprehensive and robust investigation of such phenomena. Therefore, the main agenda of this research is to examine the determinants of home bias and foreign bias in the global portfolio investment of selected OIC countries. In addition, this study also aims to evaluate the relationship between home bias and foreign bias. An unbalanced bilateral panel data of 12 OIC countries' outward equity investment in 74 host countries from year 2001 to 2016 is analysed. The samples observed are based on the composition of host countries that are represented by global, intra-OIC, and non-OIC samples. Cross-sectional analysis shows OIC countries display higher home bias towards non-OIC countries, although these countries are having higher level financial market openness, institutional qualities, economic development, market development, and higher access to information and communication channel, as compared to their OIC counterparts. Although the home bias occurrence is more prominent than foreign bias, the magnitude of foreign bias is more dominant than home bias. OIC countries exhibit higher foreign bias towards their OIC counterparts especially in MENA region. The results suggest, OIC countries not only exhibit foreign bias but also demonstrate regional bias. In the context of global portfolio investment of OIC countries, this geographical preference has resulted in foreign bias dominates home bias phenomena. System Generalized Method of Moments (GMM) estimator is employed to determine factors influencing home bias and foreign bias. The findings show home bias can be explained by factors related to institutional quality, familiarity, and global financial crisis. On the other hand, foreign bias can be explained by factors related to financial market openness, familiarity, information asymmetry, and global financial crisis. The relative factors introduced in the current study significantly explained the existence of home bias and foreign bias phenomena. Furthermore, a complementary relationship between home bias and foreign bias is also found. In addition, factors related to familiarity and global financial crisis support complementary relationship that exists between home bias and foreign bias. Summative findings indicate home bias may discourage global portfolio investment, while foreign bias may encourage the global portfolio investment of OIC countries. This study has a significant implication to the investors, fund managers and the regulators of the OIC countries. Investors and fund manager in OIC countries should be aware on the existence of home bias and foreign bias in their global portfolio investment that may potentially reduce the benefits of optimal diversification. It is a call for policy makers in the OIC countries to convince their local investors that international portfolio diversifications enable to minimize portfolio's risk and eventually increase the investment returns. In addition, policy makers in OIC countries need to design a comprehensive investment agreement to attract active participation and inter-regional investments among OIC countries.

ملخص البحث

يشير مصطلح التحيز للاستثمار المحلي (Home bias) إلى ميل المستثمرين إلى الاستثمار بشكل كبير في السوق المحلية. بينما عند الاستثمار في الخارج يظهر المستثمرون تحيزًا للاستثمار الأجنبي (Foreign bias)، وهو الميل إلى تفضيل بعض الأسواق الأجنبية على غيرها. يوفر وجود كل من التحيز للاستثمار المحلي والتحيز للاستثمار الأجنبي اكتشافًا لبعد جديد يتيح إجراء تحقيق شامل وقوي لهذه الظواهر. لذلك، فإن الغاية الرئيسية لهذا البحث هي دراسة محددات التحيز للاستثمار المحلي والتحيز للاستثمار الأجنبي في استثمارات المحافظة العالمية لبلدان منظمة التعاون الإسلامي المختارة. بالإضافة إلى ذلك، تهدف هذه الدراسة أيضًا إلى تقييم العلاقة بين التحيز للاستثمار المحلي والانبعاث الأجنبي. لتحقيق ذلك تم تحليل بيانات لوحة ثنائية غير متوازنة (unbalanced bilateral panel data) لاستثمارات الأسهم الخارجية لـ 12 دولة من دول منظمة التعاون الإسلامي في 74 دولة مضيضة من عام 2001 إلى عام 2016. تستند العينات التي تمت ملاحظتها إلى تكوين البلدان المضيفة والتي تمثلها عينات عالمية وداخلية وغير أعضاء في المنظمة. يُظهر التحليل المقطعي أن دول منظمة التعاون الإسلامي تُظهر تحيزًا للاستثمار المحلي أعلى من الدول غير الأعضاء في منظمة التعاون الإسلامي، على الرغم من أن هذه البلدان تتمتع بمستوى أعلى من الانفتاح في الأسواق المالية، والصفات المؤسسية، والتنمية الاقتصادية، وتطوير السوق، وزيادة الوصول إلى المعلومات وقنوات الاتصال، مقارنةً بنظيراتها في منظمة التعاون الإسلامي. على الرغم من أن حدوث التحيز للاستثمار المحلي أكثر بروزًا من التحيز للاستثمار الأجنبي، إلا أن حجم التحيز للاستثمار الأجنبي هو المسيطر أكثر من التحيز للاستثمار المحلي. تظهر دول منظمة التعاون الإسلامي تحيزًا للاستثمار الأجنبي أعلى تجاه نظيراتها في منظمة التعاون الإسلامي خاصة في منطقة الشرق الأوسط وشمال إفريقيا. تشير النتائج إلى أن دول منظمة التعاون الإسلامي لا تظهر فقط تحيزًا للاستثمار الأجنبي، ولكنها تظهر تحيزًا إقليميًا أيضًا. في سياق استثمارات المحافظة العالمية لدول منظمة التعاون الإسلامي، أدى هذا التفضيل الجغرافي إلى سيطرة التحيز للاستثمار الأجنبي على ظاهرة التحيز للاستثمار المحلي. تم استخدام طريقة اللحظات المعممة في النظام (GMM System) (Generalized Method of Moments) لتحديد العوامل التي تؤثر على التحيز للاستثمار المحلي والتحيز للاستثمار الأجنبي. تظهر النتائج أن التحيز للاستثمار المحلي يمكن تفسيره بالعوامل المتعلقة بالجوهر المؤسسية والألفة والأزمة المالية العالمية. من ناحية أخرى، يمكن تفسير التحيز للاستثمار الأجنبي من خلال العوامل المتعلقة بانفتاح الأسواق المالية، والألفة، وعدم تناسق المعلومات، والأزمة المالية العالمية. العوامل النسبية التي أدخلت في الدراسة الحالية أوضحت بشكل كبير وجود التحيز للاستثمار المحلي وظاهرة التحيز للاستثمار الأجنبي. علاوة على ذلك، تم العثور أيضًا على علاقة تكاملية بين التحيز للاستثمار المحلي والتحيز للاستثمار الأجنبي. بالإضافة إلى ذلك، فإن العوامل المتعلقة بالإمام والأزمة المالية العالمية تدعم العلاقة التكاملية الموجودة بين التحيز للاستثمار المحلي والتحيز للاستثمار الأجنبي. تشير النتائج النهائية إلى أن التحيز للاستثمار المحلي قد يثبط الاستثمار في المحافظة العالمية، في حين أن التحيز للاستثمار الأجنبي قد يشجع استثمار المحافظة العالمية لدول منظمة التعاون الإسلامي. هذه الدراسة لها تأثير كبير على المستثمرين ومديري الصناديق والمنظمين في دول منظمة التعاون الإسلامي. يجب أن يكون المستثمرون ومديرو الصناديق في دول منظمة التعاون الإسلامي على دراية بوجود تحيز للسوق المحلي وتحيز للسوق الأجنبي في استثماراتهم الاستثمارية العالمية مما قد يقلل من فوائد التنوع الأمثل. إنها دعوة لصانعي السياسات في دول منظمة التعاون الإسلامي لإقناع مستثمريهم المحليين

بأن تنويع المحفظة الدولية يساعد على تقليل أخطار المحفظة وزيادة عوائد الاستثمار في نهاية المطاف. بالإضافة إلى ذلك، يحتاج صانعو السياسات في دول منظمة المؤتمر الإسلامي إلى تصميم اتفاقية استثمار شاملة لجذب المشاركة النشطة والاستثمارات الأقاليمية بين دول منظمة التعاون الإسلامي.



APPROVAL PAGE

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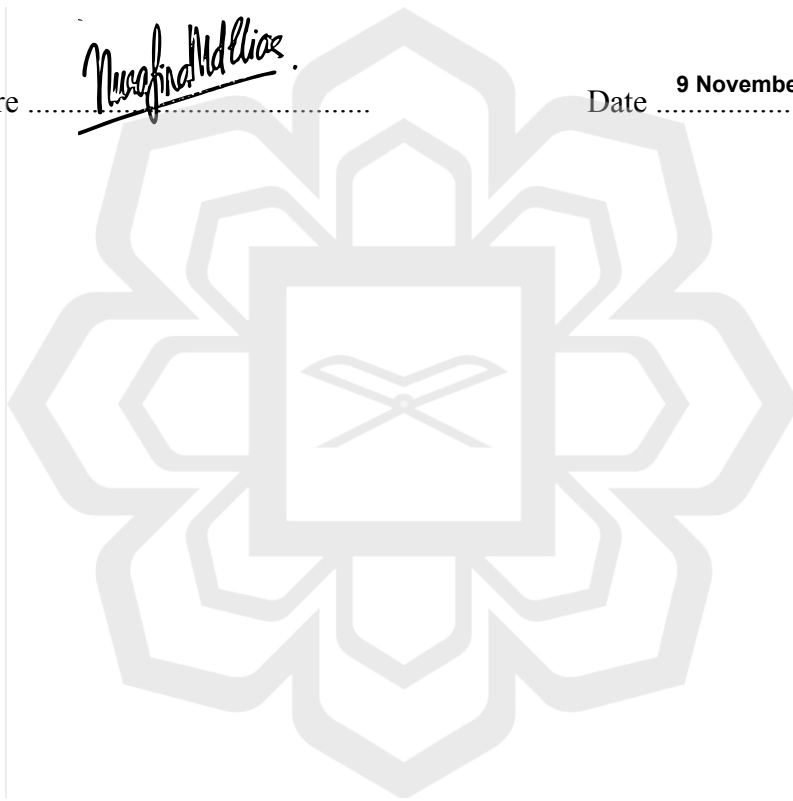
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DECLARATION

I hereby declare that this thesis is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

Nura Lina binti Md Elias

Signature *Nura Lina binti Md Elias* Date **9 November 2021**



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To my loved ones for their endless dua' and supports: -

My beloved husband:

Mohd Firdaus bin Abdul Latiff

My mother:

Salbiah binti Tahir

My Father:

Md Elias bin Othman

My childrens:

Nur Khairah Qaisara

Muhammad Aqil Elman

Nur Aisyah Qalesya

ACKNOWLEDGEMENTS

“In the name of Allah, the Most Gracious, the Most Merciful”

My pray and truthful thanks to Allah s.w.t who grant me strength and patience to complete this journey. The journey of searching His abundance of knowledge and wisdoms. The journey that teaches me that Ph.D is part of life process.

My utmost and sincere gratitude to my respected supervisors, Associate Professor Dr. Syed Musa Alhabshi and Associate Professor Dr. Razali Haron. I am indebted to their continuous guidance, support duas' and kindness throughout this journey. May Allah showered them and their beloved family with Rahmah and Barakah.

Special appreciation and dedication to my beloved husband, Mohd Firdaus, my beloved parents, and my lovely childrens for their endless duas', supports, and sacrifices during my study. To my only sister Nura Liza, my brother-in-law Mohd Yazid and my niece Adriana, thank you for the supports. May Allah blessed our family with a lot of love.

To my Ph.D mate Dr. Hasnida, Dr. Fariza, Dr. Zitah, Dr. Ezza, Dr. Syara, Dr. Min and Sr. Iffah, thank you for always there to guide when I am lost, pull me when I am falling, and motivate me when I lose hope. Thank you for the friendship and may Allah bless all you.

Indeed, this is a long journey for me. I endeavour all ups and downs to complete the journey that I've started. I am, therefore, thankful for all the experiences and lesson gained from this journey. It is not the end, rather a new beginning for me.

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LIST OF ABBREVIATIONS

IMF	International Monetary Fund
CAPM	Capital Asset Pricing Model
CML	Capital Market Line
CMT	Capital Market Theory
CPIS	Coordinated Portfolio Investment Survey
BOP	Balance of payment
GPI	Global Portfolio Investment
LOF	Liability of foreignness
OIC	Organization of Islamic Cooperation
OECD	Organization for Economic and Cooperation Development
U.S	United States of America
U.K	United Kingdom
NAFTA	North American Free Agreement
EU	European Union
ASEAN	Association of Southeast Asian Nations
EMU	Economic and Monetary Union
OECD	The Organisation for Economic Co-operation and Development
MNCs	Multinational Companies
SML	Security Market Line

CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF STUDY

Home bias phenomena was first documented in a seminal paper by French and Poterba (1991) when it was reported that domestic equity holding by investors in the United States, Japanese, and Britain were 98%, 94%, and 82% respectively. Their findings reveal that there is overinvestment in the domestic market beyond optimal benchmark as suggested by the international version of Capital Asset Pricing Model (CAPM).

In the international market, CAPM proposes that the world market portfolio is an efficient portfolio. The model suggests that the proportion of the wealth invested in a domestic equity market should be equal to its weight in the world market portfolio (Levy & Sarnat, 1970). Similarly, investors should hold securities from countries around the world in proportion to their weight in the world market capitalisation. The underlying assumptions includes that all investors have identical information and markets function perfectly.

Home bias reflects the propensity of investors to hold domestic securities rather than foreign assets in their portfolio. However, when investing abroad, investors tend to overweight or underweight certain foreign countries based on their preferences. This phenomenon is known as foreign bias, which was first explored by Chan, Covrig and Ng (2005). The authors claim that in comparison with home bias, foreign bias receives less attention. In similar vein, Beugelsdijk and Frijns (2010) and Imazeki and Gallimore (2009) claim that efforts are needed to find conclusive explanations for the existence of foreign bias, which is still lacking in the finance literature. Both of home bias and

foreign bias phenomenon reflect sub-optimal asset allocation of the global portfolio investment.

In the academic literature, the existence of home bias and foreign bias has raised the question of the degree of capital market imperfection, optimality of portfolio, as well as reasons for such phenomena. The central argument of the phenomena is the issue of optimal portfolio. Both biases signal the existence of sub-optimal portfolios that will jeopardize the risk-adjusted return of a portfolio. Home bias reflects that investor seems like to ignore the benefits of international portfolio diversification. Moreover, when investing internationally, investors tend to prefer certain foreign markets based on their preferences; a situation known as foreign bias. Home bias and foreign bias phenomena are considered as barriers for diversification benefits and optimal portfolio investment.

Home bias is identified as one of the major puzzles in the financial economics since investors do not allocate their funds optimally across international markets, but systematically overweigh the securities of their home country. Over the last decades, the global financial landscape has dynamically shifted into financial integration phase across global financial markets. From economic point of view, financial integration contributes to higher economic growth by removing barriers to international trade and helping to allocate capital efficiently. Market integration also fosters dramatic increase in cross-border equity transactions because of free flow of information. Intuitively, home bias is expected to be non-exist.

In contrast, finance point of view suggests that market integration may bring adverse implications towards international equity transactions. This is because when market is integrated, the potential benefits of diversifications are reduced. Greater market integration will result in higher correlation between market returns, thus

reducing the potential of diversification benefits. Although removal of formal barriers promotes international investment, less diversification benefits resulting from market integration may hinder potential gains from international investments. Thus, home bias exists.

Despite voluminous empirical research on home bias phenomena, majority of scholars have agreed that home bias research is rather inconclusive. Mukherjee et al. (2018) argue that equity home bias is still one of the most pervasive and unresolved empirical puzzles in financial economics. Similarly, Vanpée and De Moor, (2012) and Lütje and Menkhoff (2012) concede that the equity home bias puzzle is still something not completely understood.

Some researchers opined that foreign bias is another manifestation of home bias. For instance, Dodd and Frijns (2015) claim that foreign bias is related to familiarity bias where investors perceive assets from certain countries as riskier than others because they are less familiar with them. Furthermore, Bergin and Pyun (2012) claimed that investors are trapped in two anomalies in international investment; namely home bias and foreign bias. They prefer to hold substantial domestic assets, at the expense of international diversifications benefits. When investing abroad, investors prefer countries with high correlation with their home country. This will result in reduced benefits of global portfolio diversification. The researcher termed this as correlation puzzle or also known as a preference for familiarity. Niszczoła (2014) posits as home bias is attributed to divergence of rational behaviour, overweight in domestic assets means that investors sub-optimally invest in foreign markets, thus foreign bias exists.

Discussions in Chapter 2 and Chapter 3 indicate prevailing discussion on the existence of home bias and foreign bias phenomenon. Despite the global trend towards greater international financial integration and globalization, the existence of home bias

and foreign bias signal sub-optimality in global portfolio diversification and hitherto remains elusive. Home bias puzzles have fostered the need to investigate the theoretical reasoning. An eagle eyes is needed to observe this phenomenon from the practical point of view. In addition, far too little attention has been given to investigate the existence of foreign bias. A clear understanding of foreign bias is still needed for better understanding of global portfolio diversification. Hence, the existence of both phenomena signals urgent need for a systematic investigation.

In the literature, it has been highlighted that home bias phenomenon is severe and may have an adverse impact on the international risk sharing (Maier and Scholz, 2018). Several empirical studies have provided compelling evidence that home bias (foreign bias) has a negative (positive) impact on cost of capital, stock market development, investor protection, and economic growth (Kwabi, 2015). The findings suggest that the government needs to revise the policy by encouraging outward investment by domestic investors, while attracting inward investment from foreign investors.

Conversely, few studies have argued that home bias is not as critical as reported in previous research. The evidence suggests that international investments are so costly, making it unattractive. They contend that investors may enjoy the benefits of international diversification through investment in the Multinational Companies (MNCs) of the domestic market (Hagan-luff and Berrill, 2015; Cai and Warnock, 2012; Salehizadeh, 2003) . These contentions provide an indication that investment in home markets is attractive as compared to the foreign markets, thus home bias exist.

There is nowadays a substantial body of research on home bias. However, little attention has been paid to the phenomenon of foreign bias. Furthermore, there has been yet a systematic examination of the relationship between home bias and foreign bias,

and their influence towards global portfolio investment. To some researchers, home bias may be similar to foreign bias. While other researchers argue that both biases are different. Moreover, most of the researchers believed that the difference between home bias and foreign bias are based on predetermined factors without any proper reasoning. In sum, there is inconclusive evidence on the relationship between home bias and foreign bias. Therefore, current study contends that it is essential to study the relationship between home bias and foreign bias. As suggested by Lütje and Menkhoff (2012), a study on foreign bias may generate new ideas from which understanding the home bias may be beneficial. Furthermore, it may provide thorough understanding of the influence of both biases in the global portfolio investment.

Rather than engaging in the current debate on the existence of home bias, the current research takes initiatives to provide a systematic investigation on the determinants of home bias and foreign bias. This research contributes to the literature on the determinants of home bias and foreign bias from the perspective of relative factors. The study also extends to ascertain the relationship between home and foreign bias in the scope of global portfolio investment.

1.2 PROBLEM STATEMENT

The existences of home bias and foreign bias signals miss-allocation of portfolio as well as inefficiency in the investment allocation. The biases may lead to suboptimal in assets allocation. As suggested by portfolio theory, diversification is the ultimate task of any investment that may benefit investor in term of risk reduction. Thus, sub-optimal portfolio due to under-diversification may lead to lower portfolio performance.

Basu and Huang-jones (2015) provide empirical evidence on under-performing globally diversified equity funds in the emerging markets. Majority of the funds show

poor performance relative to the market benchmark, even before the transaction costs. The empirical findings show that the systematic risk of most of the funds is parallel to market benchmark portfolio. This suggests that the funds are aiming for diversification benefits rather than seeking higher risk-adjusted returns through active management. Similarly, Busse, Goyal and Wahal (2014) offer evidence that both retail mutual funds and institutional products with global investment mandate show little evidence for superior performance. In addition, several empirical investigations have proven that home bias may result in reduced risk sharing, and higher cost of capital slow market development as well as weak investor protection (Kwabi, 2015; Kwabi, Faff, Marshall, and Thapa, 2016; Lau et al., 2010).

Despite the voluminous empirical studies that provide reasons behind the home bias phenomenon, researchers have nearly agreed that the findings are rather inadequate. This situation has called for further investigation into the possible factors that may explain the phenomenon. To the best of the author's knowledge, previous studies on home bias have only focused on the host countries' factors. There is yet to see an attempt to explore the potential explanation of the home bias and foreign bias based on relative factors. In other words, the effect of relative factors between home and host countries' factors remains unexplored. Therefore, current study undertakes a novelty approach to fill this gap by engaging on relative factors between home and host countries.

While the world is becoming more globalised and capital markets are becoming more liberalised, in-depth investigation of the barriers in the international portfolio investment is significantly important. Most of the previous studies have concentrated on home bias research, but less attention was given to research on foreign bias (Beugelsdijk and Frijns, 2010). In fact, the relationship between home bias and foreign

bias is so far inconclusive. Therefore, there is limited evidence on how home bias and foreign bias phenomena are related. Furthermore, the influence of both home bias and foreign bias in the global portfolio investment remains unexplored.

Karolyi (2016) claims that foreign bias is a “close cousin” of home bias, implying that both biases may be the same. Similarly, Dodd and Frijns, (2015) suggest that both home bias and foreign bias may in fact only be one puzzle. In contrast, several authors have noted that there is statistical difference between home bias and foreign bias (Chan et al., 2005; Bekaert and Wang, 2009; Imazeki and Gallimore, 2009; Holinski, Kool, and Muysken, 2012; Elona, 2014). In sum, there has been confusion in the literature about the relationship between both puzzles. Thus, comprehensive research is important to understand both puzzles that may explain the investors’ behaviour in the global investment landscape.

A thorough review of literature reveals that home bias and foreign bias have not been thoroughly investigated in the emerging countries. Nevertheless, no attempt has been made to investigate these phenomena in the context of OIC countries. Consequently, this offers a new opportunity for research agenda in the area of global portfolio investment. Therefore, the current study attempts to fill this gap by providing systematic investigation of these phenomena in the context of OIC countries.

In summary, there is an urgent need for a systematic investigation of these phenomena in emerging countries. Based on the global investment mandate, current research is proposing models that may capture the reason behind these phenomena. In addition, the influence of home bias and foreign bias on global portfolio investment provides important evidence to the finance literature. Moreover, this study extends the discussion in this area by examining possible relationship between home bias and foreign bias.