Globalization increases the access to financial markets and provides expanding opportunities for investors to diversify internationally. As suggested by the Modern Portfolio Theory (Markowitz, 1952), rational investors should use one of the following two strategies to achieve portfolio diversification: (1) Investing in asset classes thought to have low correlations or (2) increasing the sizes of portfolio in multiple markets. In the early 1970s, diversification was referred to as the “free lunch” in investment. However, French and Poterba (1991) show that investors still tend to hold a disproportionate part of domestic equities in their portfolios. This phenomenon is called “the equity home bias,” which is still puzzling in the international finance literature. These essays investigate what drives individuals to hold inefficient portfolios and forgo the benefits of international diversification.

The first chapter of this study explains the equity home bias among international portfolios by analyzing the relationship between the sizes of portfolio required and the investor’s perception about risk. A flexible three-parameter distribution developed by Hueng and Yau (2006) to model the measures of risk for stock returns is extended here. Conclusions reveal that there is a trade-off between the desirable reduction of variance and the undesirable increase of negative skewness of diversifying international portfolios.
This trade-off relationship may give an explanation to the equity home bias phenomenon in reality.

The second chapter further examines the same question from the correlation perspective. Through numerical analysis, this chapter presents the evolution of U.S. equity home bias in the context of dynamic correlations between developed and emerging markets. The results imply that the persistent high correlations between the developed European and North American markets induced a high U.S. home bias; while on the other hand, the developed Pacific Asian and emerging markets have been relatively less correlated with that of the North American market and has led to a lower U.S. home bias. As future correlations are steadily increasing, investors may seek newly open markets for diversification benefits in the present. Yet over the long run, the benefits of international diversification can be very few. The home bias in the future will be rationalized by the equilibrium correlations between international markets.

The third chapter uses micro data to analyze the portfolio choices in risky assets over the working-age of the single individual and the retired segments that are exposed to health and medical expense risk. Single retirees respond to changes in medical expense by altering their portfolio toward risky assets, while no evidence is found in the changes of single working people’s portfolios. This result is in contrast to theoretical prediction, which assumes that the elders tend to hold riskless assets.