Human Capital and International Portfolio Diversification: A Reappraisal

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Equity Home Bias Puzzle

- If markets are complete, agents should short-sell assets to the state-by-state value of their endowment income risk and purchase a portfolio of assets that corresponds to a constant fraction of the aggregate endowment or income
- In an open economy, this implies that it is optimal to hold a portfolio dominated by the world stock market
- Empirically, people hold mostly domestic securities

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Approach of the Paper: The Ingredients

Empirical Facts:

- Labour income less correlated with domestic market income than foreign
- Large proportion of total wealth in the form of labour income
- Foreign assets increases on financial wealth to labour income ratio

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Approach of the Paper: The Recipe

Empirical Facts:

- Labour income less correlated with domestic market income than foreign: **Take correlation from data**
- Large proportion of total wealth in the form of labour income: **Short-selling constraints**
- Foreign assets increases on financial wealth to labour income ratio: **Incomplete Markets**

Results of the Paper: The Borch

Paper concerned with quantitative results for an economy calibrated to US data

- As liquid wealth (bond holdings and labour income) rises, households start purchasing domestic assets
- Further increases in wealth result in international diversification
- Using the distribution of income, the implied aggregate portfolio corresponds with the stylized fact of the equity home bias puzzle when there is idiosyncratic income risk
- robust to imperfectly correlated aggregate income across countries

Possible Extensions

- The equity home bias puzzle is (potentially) about risk and the Feldstein-Horioka puzzle is about returns, but there could be an intersection in the results somewhere
- If Idiosyncratic risk and borrowing constraints are both countercyclical, then dynamically there should be changes in the portfolio composition. “Cyclical Dynamics in Idiosyncratic Labor Market Risk” Storesletten, Telmer, Yaron (2004), “Incomplete Markets and Aggregate Demand” Werning (2015)

Possible Extensions

- How does collateralized borrowing fit into this story? "Productivity Losses from Financial Frictions: Can Self-Financing Undo Capital Misallocation?" Moll (2014)
- Fluctuations in capital account could potentially be explained by changes in either idiosyncratic risk or borrowing constraints. policy too? "Dilemma not Trilemma: The Global Financial Cycle and Monetary Policy Independence" Rey (2013)