

The Role of Human Capital in Imperfectly Informed International Financial Markets

Isaac Ehrlich

State University of New York at Buffalo
National Bureau of Economic Research
Hong Kong Institute for Monetary Research

and

Jong Kook Shin

State University of New York at Buffalo

April 2010

Summary

The paper's point of departure is that the information content of financial asset prices is formed partly through search for private information by individuals or investor groups, rather than gleaned exclusively from observed asset prices. Differences in the efficiency of search for information signals and in the opportunity costs involved lead to asymmetries in private information precision across investors and to variations in the price information content of traded assets. Our model links these variables to the level of prior knowledge, or "general human capital" investors possess concerning all traded assets, as well as idiosyncratic knowledge, or "specific human capital" associated with specific assets. In this context, the paper extends and generalizes the approach offered in Ehrlich, Hamlen and Yin (2008).¹

Pursuing a rational-expectations-equilibrium model of noisy prices with multiple assets and heterogeneous investors, we apply this model to explain the observed diversity in the degree of concentration of financial portfolios in domestic, relative to foreign assets across countries - what the literature has termed "home bias". Our model predicts that while conditional increments in general human capital, proxied by schooling, monotonically increase the expected absolute holdings of *both* home and foreign stocks, "home bias" at the market level is an inverted-U function of schooling. Symmetrically opposite results are predicted concerning the impact of variations in the opportunity costs of information production, proxied by individual labor market wages.

We test these predictions against aggregate market data concerning the compositions of aggregate portfolios across 23 countries over a 7-year period (2001-07). The results strongly support our discriminating hypotheses. A related, and more extensive, empirical investigation is contained in Ehrlich, Shin, and Yin (2010).²

¹ Isaac Ehrlich & William A. Hamlen Jr. & Yong Yin, 2008. "Asset Management, Human Capital and the Market for Risky Assets", *Journal of Human Capital*, University of Chicago Press, vol. 2(3), pages 217-262

² Isaac Ehrlich & Jong Kook Shin & Yong Yin, 2010. "Human Capital, Endogenous Information Acquisition, and Home Bias in Financial Markets", *NBER Working Paper Series 15668*, National Bureau of Economic Research, Inc