

# Community Effects and Externalities in Portfolio Choice\*

Peter M. DeMarzo  
*Stanford University*

Ron Kaniel  
*University of Texas, Austin*

and

Ilan Kremer  
*Stanford University*

## VERY PRELIMINARY

November 7, 2001

### Abstract

In this paper, we propose an explanation for biases in portfolio choice. We show that if individuals compete for local resources within their community, their utility depends on their own wealth as well as aggregate community wealth. This leads to an externality in portfolio choice. If investors are sufficiently risk averse, then individual investors will bias their portfolio choice in the direction of the aggregate portfolio choice of the community.

As a result, we show that even with complete financial markets and no aggregate risk, in all stable equilibria agents hold undiversified portfolios. Moreover, if a component of community income is tied to the output of local firms, the unique equilibrium is one in which portfolios are biased towards local firms as well. In addition, we show that equilibrium Sharpe ratios can be much higher than in standard models. We conclude with a number of policy implications.

---

\*We are grateful to ...

# 1 Introduction

Optimal portfolio choice is one of the most basic questions in financial economics. The way people allocate their wealth across risky assets has wide implications on asset pricing in particular and financial markets in general. In a standard model with a single consumption good, portfolio choice is determined solely by the risk and return characteristics of the individual assets. In this setting, rational, risk averse agents will not hold portfolios whose returns are stochastically dominated, and so should not hold diversifiable risk.<sup>1</sup> Moreover, when markets are complete, agents should only hold aggregate, market risk in their portfolios.<sup>2</sup>

Unfortunately, this simple model of portfolio choice does not fit observed behavior. There is a large body of empirical evidence demonstrating that individual investors do not adequately diversify their portfolios. For example, individual portfolios tend to be biased towards local firms, both at an international and a domestic level.<sup>3</sup> Moreover, locality has a broader interpretation than the geographical one – for example, individuals tend to invest in the industry, and even the company, in which they are employed.<sup>4</sup>

In this paper we develop a general equilibrium model in which agents are segmented into different communities. Our interpretation of a community is that of a group of people who share similar tastes. In a community there are some local resources that are valued only by its members. We show that competition for local resources leads agents to bias their portfolios in a way that is consistent with the empirical findings mentioned above. We also demonstrate that our model of local resources can be equivalently interpreted as a preference for “status.”. If status enters the utility function, agents care about their relative performance as compared to other agents in their community. The equivalence follows from the fact that status is also a finite resource that is local to a given community.

In the standard model of portfolio choice with a single consumption good, portfolios can be evaluated purely based on the distribution of their returns. Given a level of expected return, individuals should not choose portfolios with unnecessary risk. Given this view it is surprising to find that this principle appears to be systematically violated by individual investors. The most well-known evidence comes from looking at the international composition of investor portfolios. There exists an extensive literature on the locality of investment and the lack of international diversification by investors. In her recent survey, Lewis (1999) attributes the first finding of this phenomenon, known as the “home bias,” to Levy and Sarnat (1970). Since then there is a growing literature documenting this fact. A more recent finding is that the lack of diversification is not limited to the international arena. Investors choose local portfolios even within domestic markets. Huberman (1999) and Grinblatt and Keloharaju (1999) show that investors are more likely to invest in firms that are geographically close to them. Coval and Moskowitz (1999, 2001) show that also US mutual fund managers exhibit a preference for local companies. Further, “locality” is not limited to a geographic interpretation. Benartzi (2001) finds that employees tend to

---

<sup>1</sup>By diversifiable risk, we mean risk that can be eliminated without lowering the expected return.

<sup>2</sup>That is, portfolio returns should be measurable with respect to aggregate consumption. With stronger assumptions of HARA utility, agents hold the market portfolio.

<sup>3</sup>See, for example, the recent survey by Lewis (1999).

<sup>4</sup>See Benartzi (2001).

over-invest in their company's stock in the their retirement account. Since this choice is discretionary, it implies that investors knowingly choose undiversified portfolios.<sup>5</sup>

We formalize a two period general equilibrium model in which agents belong to one of two disjoint communities. These agents value two types of goods: local and global goods. While all agents value the global good only local agents value the community specific local good. We assume that there is a fixed supply of these local resources. These local resources represent local real estate, local labor and services, as well as community "status." If the supply of these resources does not increase with the wealth of the community, there will be competition for these goods which impacts relative prices. With standard assumptions on preferences, the price of the local resources will increase with the wealth of the community. The desire to hedge this price volatility then biases portfolio choice. This implies that individual investors will care about the correlation of their portfolio returns with the return of other investors in the community.

We examine a simple version of such an economy in which financial markets are complete. The model has two periods; in period one agents trade in financial assets, while in period two they trade goods in the spot market and consume. In section 2.1 we examine a benchmark for our analysis. There we get the standard result that the equilibrium is unique and agents hold the market portfolio. While agents want to hedge against local price uncertainty, the trades of those whose endowments are short the local good offset the trades of those whose endowments are long the local good.

In section 3 we modify this framework by assuming that there is a friction in the goods markets. Agents who are endowed with the local resources cannot sell them in advance using forward contracts. This is justified by the fact that local resources, such as labor, are subject to frictions such as moral hazard. Still, financial markets are complete in the sense that all state-contingent claims can be traded.<sup>6</sup> This constraint removes those traders whose endowments are long the local good from financial markets.

As a result of this participation constraint, financial markets are dominated by traders who wish to positively correlate their portfolio with the local good price. Since the local good price is increasing in the wealth of the community, this creates an externality in portfolio choice: if other investors hold portfolios with a high payoff in some state, then the local good price will be high in that state, and so each individual investor will also want their portfolio payoff to be high in that state. As a result when risk aversion is not too low multiple equilibria exist. While fully diversified portfolios can still exist in equilibrium, this equilibrium is not stable. The stable equilibria are ones in which investors in a given community tilt their portfolio in a given direction, taking on unnecessary risk.

We show that in these equilibria, agents are worse off than in a fully diversified equilibrium. The externality effect creates a kind of "prisoners dilemma": while we would all be better off if we all hold diversified portfolios, it is not in any single investors best interest to diversify on his or her own. This public goods aspect of portfolio diversification has

---

<sup>5</sup>Information advantages in investing in local firms may reconcile some of this evidence in the standard framework. However, only a small number of people have an exclusive access to such information. Moreover, informational asymmetries would be unlikely to generate the biases as systematic and persistent as those observed in the data.

<sup>6</sup>That is, while not all commodity-contingent claims are traded (agents cannot borrow against or sell forward their future labor income), there do exist "Arrow securities" for each state of the world.

important policy consequences.

We also explore a different interpretation of the local resource corresponds to a preference for community status, where status is defined as a measure of the wealth of an individual *relative to* the aggregate wealth in the community. Since status is not endowed ex-ante, it has a similar effect even without any trading frictions.

While the results thus far show the existence of equilibria in which agents choose undiversified portfolios, they are still inconclusive in that there exist multiple stable equilibrium. Stable equilibria require that investors in a given community tilt their portfolios in the same direction, but this direction is arbitrary. The reason for this is that the model thus far is perfectly symmetric in that there is no link between financial assets and the communities.

In section 5, we better relate our results to the empirical evidence by establishing such a link. In particular, we assume that some financial assets represent local companies. In addition, some investors are endowed with some income stream that is tied to the performance of the local firms. This income stream is not tradable. For example, agents receive wages that are directly tied to the performance of the local firms (options, bonuses, etc.). More generally, agents may hold skills or human capital whose value is positively correlated with the productivity of the local firms. If these agents are unable to trade against this income, they will be constrained in their portfolio choice. This has an effect on the equilibrium outcome. We examine the influence these agents have on unconstrained investors. We show that if there are enough such agents, the equilibrium is unique. In this unique equilibrium, unconstrained investors tilt their portfolios in the direction of these local employees. The magnitude of this bias is increasing in the number of the local employees and the volatility of their income.

In the last section, section 6, we describe a similar framework that has asset pricing implications. In the previous sections, price implications were avoided by having two symmetric communities whose portfolio biases offset each other in equilibrium. In this section we explore the consequences of having non-identical communities. We demonstrate that our model can increase equilibrium Sharpe ratios, and that this can be related to the equity premia puzzle and pricing “fads.”

## 1.1 Related Literature

Our paper is related to the theoretical literature on the “home bias” in international markets. More specifically, our paper is mostly related to papers that examine the effect of non-tradable assets. Some papers note the fact that some of the assets agents hold are non-tradable, such as human capital. Hence agents should hedge against fluctuation in human capital. However, as Lewis (1999) points out, using this view the puzzle is amplified. For example, Baxter and Jermann (1997) find that domestic human capital is highly correlated with domestic market returns. This implies an additional incentive for the local representative agent to invest in foreign stock and shy away from domestic ones. It is however consistent with our model. In the equilibrium we describe, agents invest in local stocks as it provides them with more wealth when the price of local resources rises. Other papers make the distinction between goods that can only be consumed locally and goods that are traded and can be consumed by all agents. While this is the basis for our analysis the approach taken by these papers is quite different. Unlike our model this leads to an equi-

librium which is pareto-optimal . This is a result of having each country be represented by a single representative agent. Also, in our framework the supply of local resources is fixed and there are no complementarities between the goods. Hence, the reasons for the bias are quite different from Tesar (1993). It is interesting to note that Stockman and Tesar(1995) and Lewis (1996) do not find the non-tradable goods volatility high enough to be able to explain the bias.

The utility function we use in this paper is similar to the catching up with the Joneses specification, first introduced in Abel (1990). However, it differs in two dimensions. First, similar to Gali (1994), who analyzes the potential impact of consumption externalities on the equity risk premium, our agents care about consumption relative to current aggregate consumption per capita; as apposed to consumption relative to lagged aggregate consumption per capita.<sup>7</sup> Second, and more important, our agents are heterogeneous. Specifically, an agent cares about her consumption relative to per capita consumption in her community, not relative to per capita consumption in the whole economy. A different dimension of heterogeneity is utilized in Chan and Kogan (2000); they use a catching up with the Joneses framework in order to characterize implications of cross-sectional heterogeneity in risk aversion on asset prices. While the agents in their paper have different risk aversion parameters, they still all use the same weighted average of past realizations of the aggregate consumption process as their benchmark (habit index).

Another related literature examines tournaments. In a tournament agents are rewarded for their relative standing, and in many cases only the winner is rewarded. Lazear and Rosen (1981) and Green and Stokey (1983) study the effects of laborers having tournament-based compensation. Chevalier and Ellison (1999) argue that mutual fund managers are subject to tournament based compensation and study the implications for their portfolio choice. Cole, Mailath and Postelwaite (2000) study saving and investment decisions in a matching game between men and women. This is a double-sided tournament in which, after investment returns are realized, men and women with equally ranked wealth are matched. Some of their conclusions are similar to ours. Our paper is different in that we develop a general equilibrium framework in which relative evaluation arises endogenously. Also, prices are endogenous in our model and are determined by aggregate demand.

## 2 Basic Model

Our model begins with a standard, 2-period stochastic exchange economy: There is a set of investors who live for 2 periods. In period one, these investors trade securities and choose portfolios. In period 2 the state of nature is realized, which determines investors' endowment income as well as their portfolio payoff. Agents then trade goods in the spot market, and consume. Investors act to maximize their utility over final consumption.

An important feature of our model is the notion of investor "communities," which we define below.

---

<sup>7</sup> Abel (1999) generalizes the structure in Abel (1990) to allow for dependence both on current and on lagged aggregate consumption.

**Communities and Consumption Goods:** There are two disjoint communities of investors. Community  $j \in \{1, 2\}$  has members  $I_j$ , so that  $I = I_1 \cup I_2$  is the set of all investors.

There are two types of consumption goods: (i) a global good that is consumed by all agents, labelled good 0, and (ii) local goods specific to each community, labelled as goods 1 and 2. Residents in community  $j$  consume both the global good 0 and their local good  $j$ .

This division into communities with distinct consumption sets is at the heart of our analysis. A natural interpretation is geographical communities (separate countries) with non-tradable goods such as local labor services, real estate, etc. More generally, communities can be thought of as social groups defined by their distinct tastes. For example, the communities of golfers versus skiers are defined by their consumption of country club memberships versus ski lift tickets. Finally, as we show in Section 3.2, the local goods may represent community “status.” In this case, the communities are defined as peer groups, whose members are concerned about their status relative to the rest of the group.

Formally, the local nature of the goods is modeled through agents’ preferences, as defined below.

**Preferences:** All agents maximize expected period 2 utility given a separable CRRA utility function:

$$u^i(x) = \frac{1}{1-\gamma} \sum_j \alpha_j^i x_j^{1-\gamma}$$

for some  $\gamma > 0$ . We use  $\{\alpha_j^i\}$  to represent the weight that agent  $i$  places on consumption of good  $j$ . Without loss of generality, we normalize  $\alpha_0^i = 1$  for all agents. To capture the notion of local goods, we let  $\alpha_j^i = 0$  for all agents  $i \notin I_j$ . Finally, we assume that all agents are symmetric in the importance they attach to the local good; that is, for  $j \in \{1, 2\}$ ,  $\alpha_j^i = \alpha$  for all  $i \in I_j$ .

To summarize, each agent in the economy has CRRA utility which is separable over the global good and the local good of their home community. The relative importance of the local good versus the global good is given by the parameter  $\alpha$ .

Note that our specification of agents’ preferences explicitly precludes any complementarity in consumption of the local and global good. This distinguishes our model from others in the literature on home bias and non-tradables.

**Assets and Uncertainty:** There are two firms (or “Lucas trees”) that produce output of the global good. The output of each firm is uncertain, and depends upon the state of nature,  $s$ , drawn from a finite set  $\{1, \dots, S\}$ . We denote by  $Y^1(s), Y^2(s)$  the output of the firms, and we assume they are not proportional (so that the assets are not redundant).

Note that at this point, beyond notation there is no formal association of firms with communities. However, we will later interpret firm  $j$  as being located in community  $j$ , and that this may be manifested as a bias in agents’ initial endowments (see Section 5).

There are also  $S - 2$  additional zero-net supply securities, with payoffs  $Y^l(s)$  of the global good for  $l = \{3, \dots, S\}$ . The role of these securities is to provide complete markets, which we shall assume throughout. We denote by  $Y(s) = (Y^1(s), \dots, Y^S(s))$  the vector of all security payoffs.

**Endowments:** Each agent  $i$  is initially endowed with a portfolio  $\bar{\theta}^i$ , so that  $\bar{\theta}_l^i$  is agent  $i$ 's initial endowment of shares of security  $l$ . We let  $\bar{\theta} = \sum_i \bar{\theta}^i$  be the aggregate endowment of shares, which we normalize so that  $\bar{\theta}_l = 1$  for  $l \in \{1, 2\}$  and  $\bar{\theta}_l = 0$  for  $l > 2$ .

Agents may also be endowed with goods. Let column vector  $\bar{x}^i(s)$  be the endowment of goods held by agent  $i$  in state  $s$ . We assume that for all  $s$ ,  $\bar{x}_j^i(s) = 0$  for  $i \notin I_j$ ; agents are not endowed with the local good of the other community.

We denote the aggregate endowment in the economy by  $\bar{X}(s)$ , which is given by,

$$\bar{X}_j(s) = \begin{cases} \sum_i \bar{x}_0^i(s) + Y^1(s) + Y^2(s) & \text{for } j = 0, \\ \sum_i \bar{x}_j^i(s) & \text{for } j \in \{1, 2\}. \end{cases}$$

That is, the aggregate endowment consists of the endowments of each agent, together with the good 0 output of the firms. We assume that  $\bar{X} > 0$ , there is a positive supply of all goods in each state.

**Timing and Trade:** Agents trade shares of the firms in period 1. We let  $q$  denote the vector of prices for shares, so that agent  $i$ 's budget constraint in period 1 is given by

$$q(\theta^i - \bar{\theta}^i) = 0. \quad (1)$$

After forming portfolios in period 1, the state of nature  $s$  is realized and agents trade goods in period 2. We let  $p(s) \in \mathbb{R}_+^3$  denote the vector of spot prices for goods. Without loss of generality, we let the global good be the numeraire so that  $p_0(s) = 1$  for all  $s$ . Agent  $i$ 's budget constraint in period 2 can therefore be written

$$p(s)(x^i(s) - \bar{x}^i(s)) \leq Y(s)\theta^i, \quad (2)$$

in each state  $s$ . That is, the agent's net expenditures cannot exceed his portfolio payoff.

**Equilibrium:** The standard notion of equilibrium in this setting is given by prices, portfolios and allocations  $(q, p, (\theta^i), (x^i))$  such that

1. for each agent  $i \in I$ ,  $(\theta^i, x^i)$  maximizes  $E[u^i(x^i)]$  subject to (1) and (2);
2. financial markets clear:  $\sum_i \theta^i = \bar{\theta}$ ;
3. spot markets clear: for  $s \in S$ ,  $\sum_i x^i(s) = \bar{X}(s)$ .

## 2.1 Aggregation and Diversification: The Benchmark Case

In this section we develop some standard results on aggregation and diversification for this economy. We show that equilibrium can be modeled as though there is a representative investor in each economy, and that these investors will hold the global market portfolio. These results will serve as a useful benchmark for our later analysis.

We begin by considering the spot market equilibrium in period 2. In this final period, the economy is a standard exchange economy, and we solve explicitly for equilibrium prices in terms of initial (start of period 2) endowments.

First, recall that at the start of period 2, agent  $i$  in community  $j$  has endowment  $\bar{x}_j^i$  of the local good, and

$$z^i \equiv \bar{x}_0^i + Y\theta^i$$

of the global good. Importantly, note that  $i$  has no endowment of the local good of the other community. This implies immediately that there is no trade between members of community 1 and 2 at this stage (both value the global good, but have nothing to exchange for it). Thus, we can solve for the exchange equilibrium within each community separately. In community  $j$ , there are two goods, 0 and  $j$ , which are traded. Recall that we let the global good be numeraire,  $p_0 = 1$ , so that  $p_j$  represents the relative price of the local good.

Given CRRA utility, it is easy to solve explicitly for the equilibrium price  $p_j$ . The necessary and sufficient first order condition for agent  $i$  is that the marginal rate of substitution equals the relative price:

$$p_j = \alpha(x_j^i/x_0^i)^{-\gamma}.$$

Equivalently,

$$x_j^i = (\alpha/p_j)^{1/\gamma} x_0^i, \quad (3)$$

which we can sum over  $i \in I_j$  and solve for  $p_j$  as

$$p_j = \alpha \left( \sum_{i \in I_j} x_0^i \right)^\gamma \left( \sum_{i \in I_j} x_j^i \right)^{-\gamma}$$

Using market clearing we have the following useful result:

**Lemma 1** *The equilibrium price of the local good is given by*

$$p_j = \alpha \left( Z^j / \bar{X}_j \right)^\gamma,$$

where  $Z^j \equiv \sum_{i \in I_j} z^i$  denotes the aggregate period 2 endowment of the global good in community  $j$ .

Given the equilibrium prices in period 2, we can now derive agents' indirect utility functions for numeraire wealth in period 2. This utility function can then be used to determine portfolio preferences in period 1.

**Lemma 2** *The indirect utility of agent  $i \in I_j$  with numeraire wealth  $w$  is given by*

$$v^i(w) = \frac{1}{1-\gamma} w^{1-\gamma} (W^j/Z^j)^\gamma,$$

where  $W^j = Z^j + p_j \bar{X}_j$ , the aggregate wealth of community  $j$ . The ratio of aggregate wealth to tradable wealth can also be written,  $(W^j/Z^j) = f(p_j) \equiv 1 + \alpha^{1/\gamma} p_j^{1-1/\gamma}$ , or alternatively as

$$(W^j/Z^j) = h(Z^j / \bar{X}_j), \quad (4)$$

where  $h(z) \equiv 1 + \alpha z^{\gamma-1}$ .

**Proof.** Recall that the agent consumes only the global good and the local good  $j$ . Using the budget constraint and (3), we have

$$y = x_0^i + p_j x_j^i = x_0^i + p_j (\alpha/p_j)^{1/\gamma} x_0^i = x_0^i f(p_j).$$

From the definition of  $u^i$  and (3),

$$u^i(x^i) = \frac{1}{1-\gamma} [x_0^{i,1-\gamma} + \alpha x_j^{i,1-\gamma}] = \frac{1}{1-\gamma} x_0^{i,1-\gamma} f(p_j).$$

Combining these yields the expression for  $v^i$  in terms of  $f$ . Finally, using Lemma 1,

$$f(p_j) = (1 + \alpha^{1/\gamma} p_j^{1-1/\gamma}) = (1 + p_j (\alpha/p_j)^{1/\gamma}) = (1 + p_j (\bar{X}_j/Z^j)) = (W^j/Z^j).$$

Similarly,  $h$  follows from  $f$  by substituting for  $p_j$  using Lemma 1. ■

Given this indirect utility function, we can restate the first period investment problem for each agent  $i \in I_j$  as follows:

$$\begin{aligned} \max_{\theta^i} \quad & E \left[ v^i(x_0^i + p_j x_j^i + Y \theta^i) \right] \\ \text{s.t.} \quad & q(\theta^i - \bar{\theta}^i) \leq 0. \end{aligned} \tag{5}$$

Thus, the first period problem looks like a standard, one-period, one-good investment problem with CRRA investors. There is one critical difference, however. The indirect utility function  $v^i$  depends upon the state variable  $f(p_j) = W^j/Z^j = h(Z^j/\bar{X}_j)$ . This “price dependence” of the utility function plays a key role in our analysis.

We begin with an aggregation result, which is standard given CRRA utility. Note, however, that we can only aggregate investors within a single community:

**Lemma 3** *If we replace a subset of investors of community  $j$ ,  $\hat{I}_j \subset I_j$ , with a single aggregate investor with endowment  $\sum_{i \in \hat{I}_j} \bar{x}^i$  and initial shareholdings  $\sum_{i \in \hat{I}_j} \bar{\theta}^i$ , then equilibrium prices and allocations (for the remaining agents) are unchanged.*

**Proof.** This is the standard aggregation result for CRRA utility functions. Here we have state dependent utility, but as the multiplicative factor is the same for all agents within community  $j$ , it can be treated as a change of measure, and the usual proof of aggregation applies. Note that one condition for aggregation is that endowments are traded. In our setting this is equivalent to

$$\bar{x}_0^i + p_j \bar{x}_j^i \in \text{span}(Y),$$

for all  $i \in I_j$ , for which complete markets is sufficient (though this can be weakened). ■

Thus, we can without loss of generality think of there being a single investor in each community. We will let investor  $i = 1$  (2) be the representative investor for community 1 (2).

Note that in equilibrium, representative investor  $j$  has second period wealth

$$W^j = Z^j + p_j \bar{X}_j.$$

Given the indirect utility function from Lemma 2, the marginal utility of income for  $j$  is

$$(W^j)^{-\gamma} (W^j/Z^j)^\gamma = (Z^j)^{-\gamma}. \quad (6)$$

That is, in equilibrium the representative investor behaves as though he has CRRA utility directly over consumption of the global good. This leads immediately to the following important benchmark result.

**Theorem 1** *In equilibrium, the consumption of the global good is perfectly correlated in the two economies ( $Z^1 = \lambda Z^2$ ). If the global good endowments are zero ( $\bar{x}_0^j = 0$ ), then each representative investor holds the market portfolio ( $\theta_1^j = \theta_2^j, \theta_l^j = 0$  for  $l > 2$ ).*

**Proof.** With complete markets, the marginal utility of income must be proportional for all investors. Thus,  $(Z^1)^{-\gamma} = \hat{\lambda}(Z^2)^{-\gamma}$ . The theorem then follows with  $\lambda = \hat{\lambda}^{-1/\gamma}$ . Since there are no redundant assets and  $Z^j = \bar{x}_0^j + Y\theta^j$ , if  $\bar{x}_0^j = 0$  then  $\theta^1 = \lambda\theta^2$ . This plus market clearing ( $\theta^1 + \theta^2 = \bar{\theta}$ ) implies the result. ■

The preceding result is not surprising, and confirms that absent market imperfections, we should not observe a “bias” in communities’ investment portfolios.<sup>8</sup> Note from the proof that what is critical for this result is that the aggregate wealth of each representative investor fluctuates in a way that offsets the price dependence of the indirect utility function. In particular, it is essential that aggregate investor wealth is equal to aggregate community wealth. When they are equated, we have a standard representative agent framework, and the equilibrium is Pareto optimal. In the next section, we introduce frictions that break the equality between investor and community wealth, and show that this leads to the possibility of suboptimal equilibria in which communities herd into undiversified portfolios.

### 3 Constrained Traders and Community Status

In this section we explore two different modifications to the economy which create a wedge between investor wealth and community wealth. The first approach assumes that certain members of the community are unable to participate in the asset market. The second modifies the utility function to reinterpret the local good as community status.

#### 3.1 Local Labor and Borrowing Constraints

A natural interpretation for the local good is local services, real estate and other local resources. To simplify the presentation, in this section we focus on local labor services, but discuss other possibilities in Section 7. A key feature of local labor services is that endowments consist of human capital. Due to moral hazard constraints, it is reasonable to assume that these agents cannot use this endowment as collateral for trading assets in the first period.

Formally, we assume that the community is composed of two distinct types of agents,  $I_j = I_j^I \cup I_j^L$ . Agents in  $I_j^I$  are **investors**; these agents are endowed with shares of firms

---

<sup>8</sup>It is not the case, however, that each individual agent will hold the market portfolio, since individual endowments of the local good will differ.

which they trade to construct portfolios in period 1. Specifically, for  $i \in I_j^I$ , the goods endowment is zero:  $\bar{x}_0^i = \bar{x}_j^i = 0$ . They are endowed with shares  $\bar{\theta}^i$ , and we assume that  $Y\bar{\theta}^i \geq 0$ .

The second group of agents,  $I_j^L$ , we refer to as **laborers**. These agents are only endowed with the human capital that produces units of the local good in period 2. That is, for  $i \in I_j^L$ , the global good and share endowment is zero,  $x_0^i = 0$  and  $\bar{\theta}^i = 0$ . Only the local good endowment  $x_j^i$  is non-zero.

In period 1, both groups of agents face the budget constraint,

$$q(\theta^i - \bar{\theta}^i) \leq 0.$$

In addition, we impose the “collateral constraint” that

$$Y\theta^i \geq 0. \quad (7)$$

That is, agents cannot borrow in the securities markets.

This collateral or borrowing constraint affects the two types of agents differently. Since investors have no endowment of goods, the constraint (7) is necessary in order to have positive consumption in all states. Thus, (7) does not bind for the investors, but is a natural consequence of their utility maximization.

On the other hand, (7) prevents laborers from using their endowment income in period 2 as collateral to trade securities in period 1. Since they also have no shares to trade, any non-trivial portfolio that satisfies the budget constraint and (7) represents an arbitrage opportunity, which cannot occur in equilibrium.

We summarize this below:

**Lemma 4** *In equilibrium, the constraint (7) does not bind for  $i \in I_j^I$ . For  $i \in I_j^L$ , constraint (7) implies that  $\theta^i = 0$ .*

**Proof.** If  $\gamma > 0$ , the marginal utility of consumption is infinite at zero. In equilibrium, agents consumption is therefore strictly positive. Thus, the constraint (7) does not bind for  $i \in I_j^I$ . For  $i \in I_j^L$ , the budget constraint implies  $q\theta^i \leq 0$ . This together with (7) implies an arbitrage opportunity unless  $Y\theta^i = 0$ . Given the non-degeneracy of the asset payoffs, this implies  $\theta^i = 0$ . ■

Thus, each community is composed of investors, who trade in period 1, and laborers, who are constrained from trading in period 1. Applying Lemma 3, we represent the set of investors  $I_j^I$  as a single aggregate investor in period 1. This aggregate investor has period 2 wealth,

$$Y\theta^j = Z^j.$$

This differs from the community wealth, which includes the endowment of the laborers,

$$W^j = Z^j + p_j \bar{X}_j.$$

This contrasts with the standard case consider previously in Section 2.1. Their, investor wealth and community wealth coincided. Here, investor wealth differs from community wealth ( $Z^j \neq W^j$ ), leading to the expression for marginal utility shown below:

**Theorem 2** *In equilibrium, the marginal utility of income for the representative investor of community  $j$  is given by*

$$(Z^j)^{-\gamma} (W^j/Z^j)^\gamma = (Z^j)^{-\gamma} h(Z^j/\bar{X}_j)^\gamma, \quad (8)$$

where  $h(z) \equiv 1 + \alpha z^{\gamma-1}$ .

**Proof.** Immediate from the discussion above and Lemma 2. ■

Relative to the standard case considered in Section 2.1, Theorem 2 reveals that when laborers are constrained from participating in the asset market, the marginal utility of community  $j$  investors is altered. Comparing (6) with (8), we see that the nature of the effect depends critically on the magnitude of the risk aversion parameter  $\gamma$ . When  $\gamma > 1$ , the functions  $f$  and  $h$  are increasing. Thus, the marginal utility of income is higher when the price  $p_j$  of the local good is higher, or equivalently when the global good is in relatively greater supply in the community. In this case, the agent has a desire to hedge and hold assets that payoff more when local prices are high. The effect is reversed if  $\gamma < 1$ . In that case, the agent exploits the price variability by holding assets that payoff when local prices are low. Finally, in the special case  $\gamma = 1$ , the effect disappears, and we have the following:

**Corollary 1** *If  $\gamma = 1$  (log utility), then the equilibrium coincides with that in Theorem 1.*

Before solving for the equilibrium for the case with  $\gamma \neq 1$ , we first introduce another specification of the model that leads to the same effect.

### 3.2 Relative Consumption and Community Status

In this section we alter the basic model by reinterpreting the utility function. Rather than two consumption goods in each community, suppose there is a single global good. Individuals have utility directly over the consumption of this global good, as before. In addition, however, agents also care about how their individual consumption compares to the aggregate level of consumption in the community as a whole. We can interpret this concern for relative consumption as a concern for community “status.” Each agent cares about his or her status, and so aggregate consumption appears directly in the utility function.

Specifically, we model the utility of agent  $i \in I_j$  as increasing in direct consumption  $x_0^i$  of the global good, and decreasing in  $Z^j = \sum_{i \in I_j} x_0^i$ , the aggregate consumption of the global good in the community. We restrict attention to functional forms of the following class,

$$u^i(x) = \frac{1}{1-\gamma} (x_0^i)^{1-\gamma} H(Z^j)^\gamma, \quad (9)$$

where  $H$  is positive and increasing (decreasing) if  $\gamma > (<)1$ . (Note that if  $\gamma > 1$ , utility is negative, and so  $H$  increasing implies  $u^i$  is decreasing in  $Z^j$ .)

This functional form captures the idea of agents concern for their community status, yet preserves aggregation and allows us to model the community as a single aggregate investor:

**Theorem 3** *If each agent  $i \in I_j$  has status-based utility 9, then equilibrium allocations for the community can be computed as if there is a representative investor of community  $j$  with marginal utility of income*

$$(Z^j)^{-\gamma} H(Z^j)^\gamma.$$

**Proof.** The proof of aggregation follows identically to the proof of Lemma 3. The remainder is straightforward. ■

This specification of the utility function is similar to Abel's (1990, 1999) notion of "catching up with Joneses." In that model (and similar models of habit formation), utility depends not only on direct consumption, but is also decreasing in some sufficient statistic of the level of aggregate consumption.<sup>9</sup>

Note also that in this setting, the notion of community is different than before. Rather than being distinguished by the consumption of a particular good, the communities are defined via social networks or peer groups. Individuals in each community care about their consumption relative to those with whom they socialize or otherwise identify with. This distinction will become important when we discuss applications in Section 7.

Finally, note that our model of local labor in the previous section is isomorphic to a particular model of community status with  $h = H$ . That is, when individuals must compete for scarce local resources, relative wealth matters.

## 4 Equilibrium with Local Labor / Status

In this section we analyze equilibrium portfolio choices in the presence of the frictions introduced in the previous section. Of interest is whether agents may choose to hold under-diversified portfolios in equilibrium.

To simplify the analysis we make the following two assumptions:

1. initially endowments of the global good are only through shareholdings,  $\bar{x}_0^i = 0$ ;
2. there is no aggregate risk,  $\bar{X}_1 = \bar{X}_2 = 1$  and  $\bar{X}_0 = 2$ .

Note that for item (2), we normalize the aggregate supply of each good to one per community. This normalization is without loss of generality.

Given the assumption of no aggregate risk, the Pareto Optimal allocation is obvious – each investor should hold a fully diversified riskless portfolio. This is the unique equilibrium that corresponds to the conclusion of Theorem 1. Under what conditions does this conclusion remain valid? The following result is a partial answer.

**Theorem 4** *Full diversification ( $\theta_1^i = \theta_2^i$ ) is always a competitive equilibrium. Moreover, if the marginal utility of income of the aggregate investor in each community is decreasing, this equilibrium is unique.*

**Proof.** With complete markets, the equilibrium condition is that agents' marginal utilities of income are proportional. If agents fully diversify, then  $Z^j$  is constant for each community  $j$ . Thus, the marginal utility of income is constant, and this is supported as an equilibrium. In this equilibrium, the price of each asset is equal to its expected payoff.

The equilibrium condition that marginal utilities are proportional implies that the marginal utility of income in community 1 is increasing with the marginal utility of income in community 2. If the marginal utility of income is decreasing in income, this implies

---

<sup>9</sup>Indeed, in Abel (1990), agents care about relative consumption  $x^i/Z^j$ . This corresponds to  $H(z) = z^{1-1/\gamma}$ . Of course, in Abel's setting it is lagged rather than current aggregate consumption which is used.

that  $Z^1$  is increasing in  $Z^2$ . Since  $Z^1 + Z^2 = \bar{X}_0$  a constant, this implies that  $Z^1$  and  $Z^2$  are constant as well. Thus, both communities must fully diversify. ■

This theorem has as an immediate consequence,

**Corollary 2** *Full diversification is the unique equilibrium outcome if*

- *Agents care about status and  $\gamma < 1$ ,*
- *Local laborers are collateral constrained and  $\gamma \leq 2$ .*

**Proof.** Using Theorem 3, the first result follows since for  $\gamma < 1$ , the definition of status requires that  $H$  is decreasing. Using Theorem 2, the second claim follows since the marginal utility of income is monotone in  $h(z)/z = 1/z + \alpha z^{\gamma-2}$ , which is decreasing for  $\gamma \leq 2$ . ■

Thus, if agents are not particularly risk averse, full diversification is the unique equilibrium even with the frictions we have introduced. However, when agents are sufficiently risk averse, this is no longer the case. In the remainder of this section, we identify conditions such that equilibria exist in which agents fail to diversify completely. Since our model of local labor can be nested as a particular case of status, we focus our attention on that interpretation of the model.

We begin by introducing the following further simplifying assumptions:

1. There are two equally likely states,  $s \in \{1, 2\}$ ,
2. Each firm pays

$$Y^j(s) = \begin{cases} 1 + d & \text{if } s = j \\ 1 - d & \text{if } s \neq j, \end{cases}$$

for some  $d \in (0, 1]$ ,

3. Communities are symmetrically endowed,  $\bar{\theta}_1^1 = \bar{\theta}_2^2$ .

Given two states, markets are complete with trading in only the shares of the two firms. The two firms have identically distributed payoffs, but are perfectly negatively correlated. Given symmetrically endowed communities, it is natural to consider a symmetric equilibrium in which the two securities have equal prices,  $q_1 = q_2$ .

To solve for such an equilibrium, note first that if communities are symmetrically endowed and the securities are equally priced, then the budget constraint for each community is simply

$$E[Z^j] = 1.$$

Thus, we can represent the consumption of community 1 by its “volatility”  $\sigma$ . That is, if community 1 consumes  $1 + \sigma$  in state 1, it must consume  $1 - \sigma$  in state 2, where  $\sigma \in [-1, 1]$ . By market clearing, community 2 therefore consumes  $1 - \sigma$  and  $1 + \sigma$  in states 1 and 2, respectively.

Finally,  $q_1 = q_2$  implies that the marginal utility of income for each investor is equated across the two states. Since the consumption of the two communities is symmetric, using Theorem 2 we have the following, single equilibrium condition:

$$\frac{h(1 + \sigma)}{1 + \sigma} = \frac{h(1 - \sigma)}{1 - \sigma}. \quad (10)$$

Note that  $\sigma = 0$ , full diversification, trivially satisfies (10) and therefore is always an equilibrium. We now show that when investors are sufficiently risk averse, equilibria with less than full diversification are also possible.

**Theorem 5** *For  $\gamma > 2$ , there exists an equilibrium with income volatility  $\sigma > 0$  if the importance  $\alpha$  of the local good (status) satisfies*

$$\alpha = \frac{2\sigma}{(1 - \sigma^2)[(1 + \sigma)^{\gamma-2} - (1 - \sigma)^{\gamma-2}]} \quad (11)$$

**Proof.** Using the definition,  $h(z) = 1 + \alpha z^{\gamma-1}$ , and cross-multiplying, (10) can be rewritten,

$$(1 - \sigma)(1 + \alpha(1 + \sigma)^{\gamma-1}) = (1 + \sigma)(1 + \alpha(1 - \sigma)^{\gamma-1}),$$

and the result follows by solving for  $\alpha$ . ■

This result demonstrates that for sufficiently risk averse agents, any level of income volatility can be supported as an equilibrium given appropriate importance of the local good. The intuition for this result is the following. Recall that the price of the local good (or the price of obtaining status) is increasing in community income. Thus, when community income is volatile, so is the cost of the local good. Each agent in the economy therefore wants to hold a portfolio that is positively correlated with community income in order to hedge this price uncertainty.

Equation (11) gives  $\alpha$  as a function of  $\sigma$ . Of course, it would be more natural to solve for  $\sigma$  a function of  $\alpha$ , but an analytic solution is not possible in general. Certain cases can be explicitly solved, however, as shown below.

**Corollary 3** *A sufficient condition for the existence of an equilibrium with  $\sigma > 0$  is  $\gamma > 2 + 1/\alpha$ . Also, we have the following explicit solutions:*

$$\begin{aligned} \gamma = 3: \quad \sigma &= \sqrt{1 - 1/\alpha}, & \gamma = 5: \quad \sigma &= \sqrt{\sqrt{4 - 1/\alpha} - 1}, \\ \gamma = 4: \quad \sigma &= \sqrt{1 - 1/(2\alpha)}, & \gamma = 6: \quad \sigma &= \sqrt[4]{1 - 1/(4\alpha)}. \end{aligned}$$

**Proof.** Define  $\alpha(\sigma)$  by (11). Note that  $\alpha$  is continuous in  $\sigma \in (0, 1)$  and as  $\sigma \rightarrow 1$ ,  $\alpha \rightarrow \infty$ , while as  $\sigma \rightarrow 0$ ,  $\alpha \rightarrow 1/(\gamma - 2)$ . This establishes the first result. The rest follow from algebraic manipulation. ■

Below we plot the equilibrium income volatility  $\sigma$  as a function of both  $\alpha$  and  $\gamma$ . Note that  $\sigma$  is increasing in both risk aversion as well as the importance of local (relative) consumption. Note also that the sufficient condition  $\gamma > 2 + 1/\alpha$ , while not strictly necessary, is nearly so. The exceptions occur for  $\gamma > 6$  and  $\alpha < .25$ .

## 4.1 Investor Reaction Functions

The results of the previous section demonstrate the possibility of under-diversified equilibria. In this section, we develop a further understanding of these equilibria by examining the best response of an individual investor to the aggregate portfolio choice of his community.

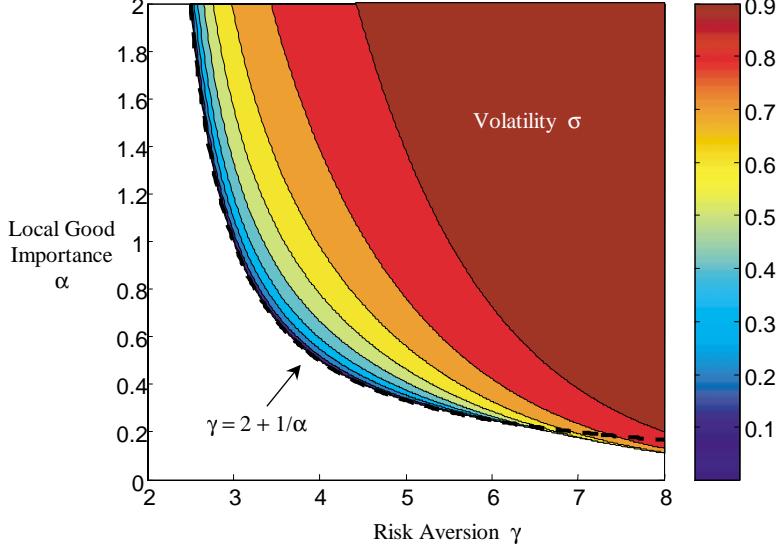


Figure 1: Equilibrium Volatility  $\sigma$  Given Risk Aversion  $\gamma$  and Importance of Local Good  $\alpha$

Consider the portfolio choice for an investor  $i$  in community  $j$ . The payoff of this portfolio can be decomposed as

$$z^i = \begin{cases} \bar{z}^i(1 + \sigma^i) & \text{if } s = 1 \\ \bar{z}^i(1 - \sigma^i) & \text{if } s = 2, \end{cases} \quad (12)$$

where  $\bar{z}^i$  is the mean and  $\sigma^i$  is the volatility of  $i$ 's portfolio choice. Recall also that with equally priced securities, the aggregate investment payoff  $Z^j$  of community  $j$  can be similarly written as  $Z^j = 1 \pm \sigma$ . We now address how the optimal volatility choice for agent  $i$  relates to the choice of his community.

Taking  $Z^j$ , or equivalently the community volatility  $\sigma$ , as given,<sup>10</sup> investor  $i$  chooses a portfolio to equate his marginal utility of income across states. Using Lemma 2, this implies that

$$\frac{h(1 + \sigma)}{1 + \sigma^i} = \frac{h(1 - \sigma)}{1 - \sigma^i}.$$

Solving for  $\sigma^i$ , we find that investor  $i$ 's best response volatility choice is given by

$$\sigma^i = m(\sigma) \equiv \frac{h(1 + \sigma) - h(1 - \sigma)}{h(1 + \sigma) + h(1 - \sigma)}. \quad (13)$$

The best response function is illustrated for  $\alpha = 1$  and  $\gamma \in \{1/2, 1, 2, 3, 4\}$  in Figure 2 below. Since community volatility is the aggregate volatility of investors portfolios, an equilibrium is a fixed point  $m(\sigma) = \sigma$ ; in the figure, this is where  $m$  crosses the  $45^\circ$  line. Thus,  $\sigma = 0$  for all choices of  $\gamma$ , whereas  $\sigma > 0$  is an equilibrium only for the case  $\gamma = 4 > 3 = 2 + 1/\alpha$ . Below we establish a number of properties of  $m$  which are evident from the figure.

<sup>10</sup>Since  $Z^j$  maps to  $p_j$ , this is equivalent to taking the distribution of the local good price as given, as is standard in general equilibrium.

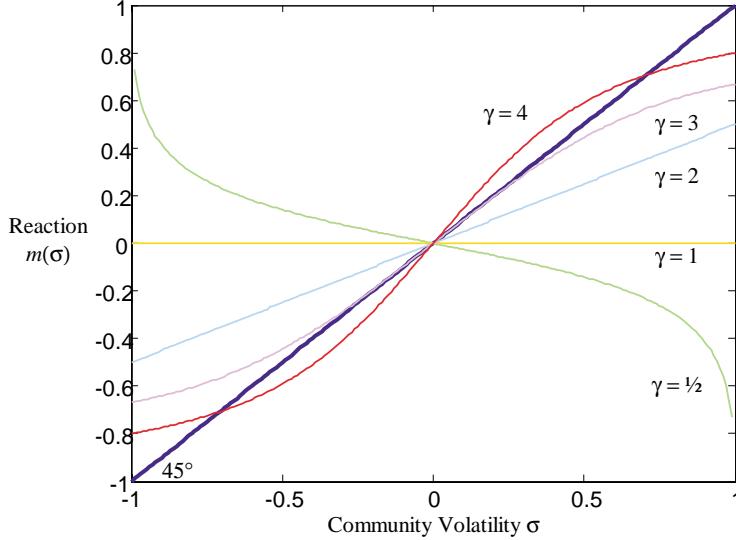


Figure 2: Optimal Portfolio Choice  $\sigma^i$  given Community Volatility  $\sigma$

**Lemma 5** *The best response function  $m$  satisfies*

1.  $m$  is continuous in  $\sigma$ ,
2.  $m(0) = 0$ ,
3.  $m(-\sigma) = m(\sigma)$ ,
4.  $m$  is increasing (decreasing) for  $\gamma > (<)1$ ,
5.  $m(1) < 1$ ,
6.  $m'(0) > 1$  if and only if  $\gamma > 2 + 1/\alpha$ ,

**Proof.** Property 1 follows since  $h$  is continuous and  $h(z) > 1$ . Properties 2 and 3 follow immediately from the definition of  $m$ . Property 4 follows from the monotonicity of  $h$ . Property 5 follows since  $h(0) = 1$ . For 6,

$$m'(\sigma) = 2 \frac{h'(1+\sigma)h(1-\sigma) + h'(1-\sigma)h(1+\sigma)}{(h(1+\sigma) + h(1-\sigma))^2},$$

and so

$$m'(0) = \frac{2\alpha(\gamma-1)(2+2\alpha)}{(2+2\alpha)^2} = \frac{\alpha(\gamma-1)}{1+\alpha}$$

which implies that  $m'(0) > 1$  if and only if  $\gamma > 2 + \frac{1}{\alpha}$ . ■

Property 2 above verifies our earlier result of Theorem 4 that full diversification ( $\sigma = 0$ ) is always an equilibrium. That is, if the community portfolio is unbiased, it is optimal for each individual investor to fully diversify as well. Property 4 demonstrates the tendency to

“herd” and choose a portfolio close to one’s community when agents are more risk averse than log-utility. Property 3 implies that this tendency is symmetric across securities 1 and 2, as should be expected given the symmetry of the model.

For  $\gamma > 2 + 1/\alpha$ , properties 1, 5 and 6 establish the existence of undiversified equilibrium, consistent with Corollary 3. That is, since  $m'(0) > 1$ , for  $\sigma$  sufficiently close to zero,  $m(\sigma) > \sigma$ . But then  $m(1) < 1$  and continuity implies that  $m$  must cross the  $45^\circ$  line for some  $\sigma > 0$ . The next result establishes that this is a complete characterization of the set of equilibria.

**Theorem 6** *If  $\gamma > 2 + 1/\alpha$ , there exists a unique  $\sigma^* \in (0, 1)$  such that  $m(\sigma^*) = \sigma^*$ . Thus, the set of equilibria is given by  $\{-\sigma^*, 0, \sigma^*\}$ .*

**Proof.** Existence follows from the argument in the text. For uniqueness, ... TBA ■

Figure 2 also provides further intuition for these undiversified equilibria. For  $\gamma > 1$ , investors hedge by choosing portfolios that payoff more when the price of the local good is high. That is, investors respond to a bias in the community portfolio by choosing a portfolio that is similarly biased (property 4). When investors are sufficiently risk averse, this effect is self-sustaining: in equilibrium, agents do not diversify because the rest of their community is not diversified.

This result highlights the fact that our model generates *portfolio externalities*. That is, the optimal portfolio choice of an investor depends upon the portfolio choices of his neighbors. When agents are sufficiently risk averse, this creates a “herding” effect: agents within a community choose portfolios that are highly correlated.

## 4.2 Equilibrium Stability

Of course, one caveat to our analysis thus far is that there are multiple equilibria. While undiversified equilibria exist, it is not clear that they are necessarily natural or plausible relative to the fully diversified one. One refinement criteria that has been used in the literature is that of dynamic stability. The definition of stability relies on an iterative procedure in which agents react to the last period’s outcome. A stable equilibrium can be thought as a limiting outcome of such a process. Hence this refinement has the view that an equilibrium is an outcome of a gradual process in which agents converge to an equilibrium strategy. Formally,

**Definition 1** *An equilibrium  $\sigma$  is **locally stable** if for every  $\sigma'$  in a neighborhood of  $\sigma$ , the sequence  $\{\sigma_n\}_{n=0}^\infty$  defined by  $\sigma_0 = \sigma'$  and  $\sigma_{i+1} = m(\sigma_i)$  converges to  $\sigma$ . An equilibrium  $\sigma$  is **globally unstable** if any sequence  $\{\sigma_n\}_{n=0}^\infty$  for which  $\sigma_{i+1} = m(\sigma_i)$  and  $\sigma_0 \neq \sigma$  does not converge to  $\sigma$ .*

The next result shows that it is the undiversified equilibria which are stable.

**Theorem 7** *If  $\gamma > 2 + \frac{1}{\alpha}$  then:*

- the full diversification equilibrium,  $\sigma = 0$ , is globally unstable,
- the undiversified equilibrium  $\sigma^* > 0$  is a locally stable in the neighborhood  $(0, 1]$  (as is  $-\sigma^*$  in  $[-1, 0)$ ).

**Proof.** We first observe the fact that  $m'(\sigma) > 1$  implies that  $\sigma$  is unstable. Hence, (i) follows from property 6 of  $m$ . Note that from property 6 that  $\sigma^*$  is the unique point in  $(0, 1)$  such that  $m(\sigma) = \sigma$ . Then given properties 1, 5, 6, and 4, it must be that  $m(\sigma) \in (\sigma^*, \sigma)$  for all  $\sigma \in (\sigma^*, 1]$ , and  $m(\sigma) \in (\sigma, \sigma^*)$  for all  $\sigma \in (0, \sigma^*)$ . Thus, starting from any point in  $(0, 1]$ , the sequence converges monotonically to  $\sigma^*$ . The case of  $-\sigma^*$  is symmetric. ■

The result of the theorem can be seen in Figure 2. For  $\gamma = 4$ , starting from  $\sigma$  arbitrarily close to but not equal to zero, investors choose progressively less diversified portfolios until the undiversified equilibrium is reached.

### 4.3 Welfare Analysis

We have seen that when risk aversion and the importance of the local good is sufficiently large, there exist multiple equilibria, and that in the stable equilibria investors hold undiversified portfolios. In this section we consider the efficiency properties of these equilibria. In doing so, we consider the welfare of both investors and of laborers.

Given that there is no aggregate risk in the economy, it is immediate that the fully diversified equilibrium is Pareto optimal, whereas an undiversified equilibrium cannot be (giving each agent the average consumption bundle that he consumes would make him better off). What is less clear is the welfare comparison of the two types of equilibria. While some agents must be worse off in an undiversified equilibrium relative to the fully diversified one, other agents might be better off (that is, the equilibria may be Pareto incomparable). The following result shows that this is not the case, and that in fact the full diversification equilibrium Pareto dominates the undiversified equilibria.

**Theorem 8** *Every investor is worse off in the undiversified equilibrium than in the full diversification equilibrium. The same is true for every laborer as long as their endowments of the local good are uncorrelated with the payoffs of the firms.*

**Proof.** From Lemma 2, the indirect utility for any agent in community  $j$  is given by

$$v(w) = \frac{1}{1-\gamma} w^{1-\gamma} h(Z^j)^\gamma$$

where  $w$  is the agent's numeraire wealth. First consider the investors. From 12 and the budget constraint, in equilibrium the wealth of investor  $i$  is given by

$$w^i = \bar{z}^i Z^j,$$

where  $\bar{z}^i = \bar{\theta}_1^i + \bar{\theta}_2^i$ . In the fully diversified equilibrium,  $Z^j = 1$ . Thus, since the existence of an undiversified equilibrium implies  $\gamma > 2$  (by Corollary 2) and hence that utility is negative, investor  $i$  is worse off in the undiversified equilibrium if and only if

$$E \left[ (Z^j)^{1-\gamma} h(Z^j)^\gamma \right] > h(1)^\gamma. \quad (14)$$

Now, the equilibrium condition for the undiversified equilibrium is that the investor's marginal utility of income is equated across states, or equivalently,  $h(Z^j)/Z^j = c$ , for some constant  $c$ . Using this plus the fact that  $E[Z^j] = 1$ , (14) is equivalent to

$$h(Z^j)/Z^j = c > h(1).$$

Suppose  $c < h(1)$ . Then multiplying by  $Z^j$  and taking expectations yields

$$E[h(Z^j)] < h(1),$$

which contradicts the convexity of  $h$  for  $\gamma > 2$ . Thus,  $c > 1$ , and every investor is worse off in the undiversified equilibrium.

Next consider the laborers. For  $i \in I_j^L$ , using Lemma 1,

$$w^i = p_j \bar{x}_j^i = \alpha \bar{x}_j^i (Z^j)^\gamma.$$

Thus, given  $\bar{x}_j^i$  and  $Z^j$  are uncorrelated, laborer  $i$  is worse off in the undiversified equilibrium if and only if

$$E \left[ (Z^j)^{\gamma(1-\gamma)} h(Z^j)^\gamma \right] > h(1)^\gamma.$$

Because  $\gamma > 1$ , a sufficient condition is

$$E \left[ (Z^j)^{(1-\gamma)} h(Z^j) \right] > h(1),$$

which follows immediately since  $z^{1-\gamma} h(z) = z^{1-\gamma} + \alpha$  is convex in  $z$  for  $\gamma > 1$ . ■

## 5 Constrained Investors

Thus far, we have established that, when they exist, the undiversified equilibria are the stable equilibria in this economy. However, there are two symmetric unstable equilibria, given by  $\sigma^*$  and  $-\sigma^*$ . In other words, investors in each community hold biased portfolios, but the bias can be towards either asset. This is natural since until now, there is no formal link between the assets and the communities. In this section, we consider one natural link and explore the consequences for equilibrium selection.

Recall that investors in our model hold initial endowments of the global good in terms of shares of the two firms. They then trade these shares in the first period asset market. Suppose, however, that some investors hold endowments of the global good that are correlated with the performance of the local firm but are not tradable. For example, agents may receive compensation that is directly tied to the performance of the local firms (options, bonuses, etc.). More generally, agents may hold skills or human capital whose value is positively correlated with the productivity of the local firms. If these agents are unable to trade against this income, they will be constrained in their portfolio choice, affecting the equilibrium outcome.

In particular, for investor  $i \in I_j^I$ , we assume that some part of the initial endowment  $\bar{\theta}^i$  is not tradable. We denote this component by  $\hat{\theta}^i$ . Given this, the collateral constraint (7) becomes

$$Y\theta^i \geq Y\hat{\theta}^i. \tag{15}$$

That is, the tradable portion of the portfolio does not entail borrowing,  $Y(\theta^i - \hat{\theta}^i) \geq 0$ . This constraint limits the portfolios that investors can hold. For example, in the case  $\hat{\theta}^i = \bar{\theta}^i$ , then (15) together with the budget constraint implies that  $\theta^i = \hat{\theta}^i$  in equilibrium.

To simplify this setting, we assume that there are two types of investors in each community,  $I_j^I = I_j^U \cup I_j^C$ . Investors  $i \in I_j^U$  are unconstrained, so that  $\hat{\theta}^i = 0$ . Investors  $i \in I_j^C$  are completely constrained with  $\hat{\theta}^i = \bar{\theta}^i$ . The payoff of the aggregate portfolio of the constrained traders in community 1 can be described in terms of its expected wealth  $\omega$  and volatility  $\hat{\sigma}$  as follows:

$$Y \sum_{i \in I_1^C} \hat{\theta}^i \equiv \omega \begin{bmatrix} 1 + \hat{\sigma} \\ 1 - \hat{\sigma} \end{bmatrix}.$$

Recall that the payoff of firm 1 in state  $s = 1$  is  $Y^1(s) = 1 + d > 1$ . Thus, the notion that constrained traders endowments are correlated with the local industry is captured by assuming  $\hat{\sigma} > 0$ . Finally, to preserve symmetry, we assume that the same decomposition applies to community 2, with  $\hat{\sigma}$  replaced by  $-\hat{\sigma}$ .

What effect does the presence of constrained investors have on the equilibrium portfolios of unconstrained investors? Assuming securities are equally priced, given an aggregate (constrained and unconstrained) community volatility of  $\sigma$ , recall that the reaction function  $m(\sigma)$  gives the optimal portfolio volatility of the unconstrained investors. Since with equally priced securities  $EZ^j = 1$ , the unconstrained investors have aggregate expected wealth  $1 - \omega$ . This yields the equilibrium condition:

$$(1 - \omega)m(\sigma) + \omega\hat{\sigma} = \sigma,$$

which can be rewritten as

$$m(\sigma) = \frac{\sigma - \omega\hat{\sigma}}{1 - \omega} \equiv f(\sigma|\omega, \hat{\sigma}).$$

This equilibrium condition is illustrated in Figure 3 with  $\alpha = 1$  and  $\gamma = 4$ . Rather than an equilibrium being defined as the intersection of  $m$  with the  $45^\circ$  line, it is now the intersection of  $m$  with the line defined by  $f$ . The line  $f$  can be thought of as a rotation of the  $45^\circ$  line around the point  $\sigma = \hat{\sigma}$  until it has slope  $1/(1 - \omega)$ . This is illustrated with  $\hat{\sigma} = 50\%$  and  $\omega = 20\%$ .

The following results can be seen easily from the figure:

**Theorem 9** *Suppose  $\gamma > 2$ . For any  $\omega > 0$ ,  $\hat{\sigma} > 0$ , full diversification is no longer an equilibrium. For any  $\hat{\sigma} > 0$ , there exists large enough  $\omega$  such that there is a unique equilibrium. This equilibrium is stable and has  $\sigma^* > 0$ .*

**Proof.** The first statement follows immediately since  $m(0) = 0$  and  $f(0|\omega, \hat{\sigma}) < 0$ . For the second result, we first observe that there exists a finite  $M$  such that  $m'(\sigma) < M$ . This follows from the definition of  $m$  plus the fact that  $h(z) > 1$  and  $h'(z)$  bounded for  $z \in [0, 2]$ . Since  $m(0) > 0 > f(0|\omega, \hat{\sigma})$  and  $m(1) < 1 \leq f(1|\omega, \sigma)$ , there is at least one equilibrium with  $\sigma > 0$ . If  $1/(1 - \omega) > M$ , then this equilibrium must be unique. ■

The figure also makes clear the following comparative statics properties of  $\sigma^*$ , which both follow from the fact that  $m$  is increasing:

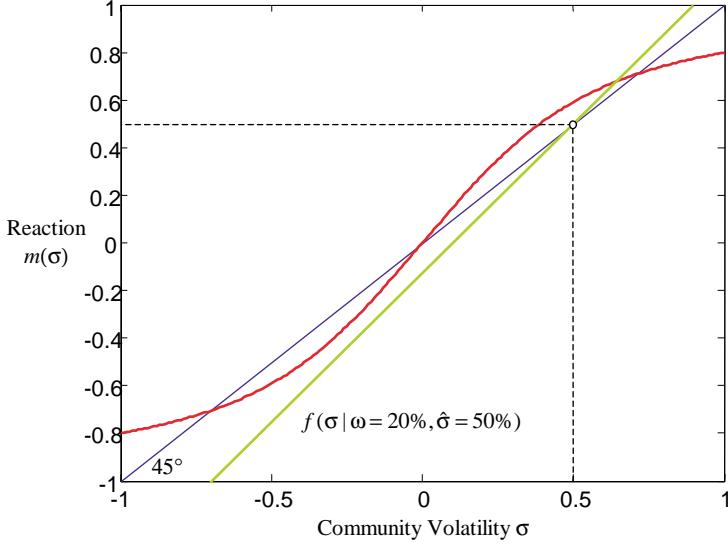


Figure 3: Equilibrium with Constrained Investors

1. As the wealth of the constrained investors increases so does their influence on the unconstrained investors. That is,  $|m(\sigma^*) - \hat{\sigma}|$  is decreasing in  $\omega$ , and  $\sigma^*$  converges monotonically to  $\hat{\sigma}$  as  $\omega \rightarrow 1$ .
2. The more volatile the constrained investors income is, the more volatile the portfolio of the unconstrained investors. That is,  $\sigma^*$  and  $m(\sigma^*)$  are increasing in  $\hat{\sigma}$ .

Thus, the existence of constrained investors breaks the symmetry of the model and biases the equilibrium portfolio choice of the community in the direction of the local firms. This is consistent with the “home bias” literature and related literature on the locality effect in portfolio choice.

Note also that even if local investors are currently unconstrained, the fact that they may have been constrained in the past can serve as an equilibrium selection device. For example, prior to the opening of international financial markets, investors were constrained to choose “home-biased” portfolios. Once markets were opened, however, the stability arguments of the previous section suggest that rather than move to the fully-diversified equilibrium, the economy would instead move to the nearby stable equilibrium and the home bias would persist. In this view, the home bias of investors today is a by-product of historical initial conditions together with a coordination problem induced by the portfolio externality effects that we have documented.

## 6 Price Effects

Thus far, we have considered economies in which the communities are symmetric and all securities have equal expected returns. In this section, we keep the same basic structure as before but make the model asymmetric. We then examine the potential distortions of prices and expected returns introduced by the effects that we have outlined.

In particular, we consider the case in which a small subset of the global population is subject to the local labor / status effects. The remaining population cares only about the global good. If the small community “herds” into asset 1 and chooses an undiversified portfolio, then by market clearing, the remaining population will also be undiversified and hold a relatively higher share of asset 2. For this to occur in equilibrium, the return of asset 2 must exceed that of asset 1.

Formally, consider two communities as before, but now of uneven size. Let community 1 have share  $w$  of the aggregate global wealth; that is,  $\bar{\theta}^1 = w\bar{\theta}$ . This community also has an equivalent endowment of the local good  $\bar{X}_1 = w$ . We assume the local good has importance given by  $\alpha$ , as before.

Community 2 has aggregate portfolio endowment  $\bar{\theta}_2 = (1 - w)\bar{\theta}$  and local good endowment  $\bar{X}_2 = 1 - w$ . However, we assume that this community is not subject to local labor / status effects. One way to achieve this is to assume that  $\alpha_2^i = 0$  for  $i \in I_2$ ; that is, the local good is unimportant in this community. Alternatively, we can leave preferences unchanged but remove the collateral constraint for community 2.

Given this specification, investors in community 1 are subject to the portfolio bias introduced by local labor / status effects, while those in community 2 are not. Thus, an undiversified equilibrium will affect equilibrium prices. Since markets are complete, we can describe asset prices in terms of state prices. Let  $\pi$  be the relative price of consumption in state  $s = 1$  relative to consumption in state  $s = 2$ . Then the equilibrium condition for investors in community 2 is given by

$$\left( \frac{1/(1 + \sigma_2)}{1/(1 - \sigma_2)} \right)^\gamma = \pi. \quad (16)$$

Since community 1 investors are subject to local labor / status effects, their optimal portfolio choice satisfies

$$\left( \frac{h(1 + \sigma_1)/(1 + \sigma_1)}{h(1 - \sigma_1)/(1 - \sigma_1)} \right)^\gamma = \pi. \quad (17)$$

Finally, given that there is no aggregate risk, market clearing requires

$$w\sigma_1 + (1 - w)\sigma_2 = 0. \quad (18)$$

Together, equations (16), (17) and (18) provide the 3 equilibrium conditions determining the variables  $\pi$ ,  $\sigma_1$  and  $\sigma_2$ . To facilitate comparisons with our earlier results, we solve for the equilibrium as follows. First, we can use (18) to solve for  $\sigma_2$  in terms of  $\sigma_1$ . Then from (16) we can solve for  $\pi$  in terms of  $\sigma_2$ , and hence, from the previous result, in terms of  $\sigma_1$ . This gives

$$\pi = \left( \frac{1 - w(1 - \sigma_1)}{1 - w(1 + \sigma_1)} \right)^\gamma. \quad (19)$$

We can interpret this the supply function of community 2. That is, given community 1's demand  $\sigma_1$ , (19) gives the marginal price at which investors in community 2 are willing to supply it. Given this supply function, we can determine the reaction function of a community 1 investor. That is, given aggregate holdings  $\sigma_1$  in the community, and given state prices according to (19), what is the optimal risk choice  $\sigma^i$  for an individual investor

$i$  in community 1? Using (19), investor  $i$ 's first order condition is given by

$$\frac{h(1 + \sigma_1)/(1 + \sigma^i)}{h(1 - \sigma_1)/(1 - \sigma^i)} = \frac{1 - w(1 - \sigma_1)}{1 - w(1 + \sigma_1)},$$

and solving for  $\sigma^i$  yields the reaction function,

$$m_1(\sigma_1) = \frac{h_1(1 + \sigma_1) - h_1(1 - \sigma_1)}{h_1(1 + \sigma_1) + h_1(1 - \sigma_1)}. \quad (20)$$

where  $h_1(z) = h(z)(1 - wz)$ . Thus, an equilibrium corresponds to a fixed point,  $m_1(\sigma_1) = \sigma_1$  (which implies (17)).

Comparing (20) with (13), we note that the two coincide for  $w = 0$ . That is, if community 1 is negligible and has no price impact, then the reaction function is exactly the one we derived in the symmetric case. A straightforward calculation shows that  $m_1(\sigma_1)$  is decreasing in  $w$ ; as the community becomes larger, so does its price impact, leading investors in the community to reduce the scale of their positions.

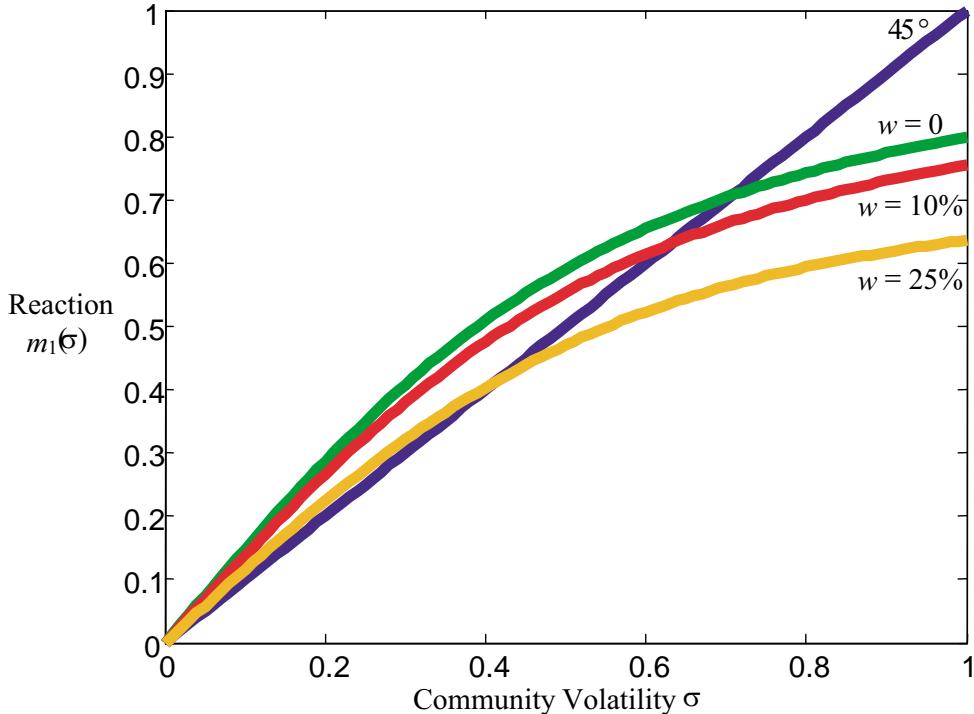


Figure 4: Equilibrium with Price Impact

Figure 4 illustrates the reaction function for  $\alpha = 1$ ,  $\gamma = 4$  and  $\omega \in \{0, 10\%, 25\%\}$ . We have the following result regarding the existence of an undiversified equilibrium:

**Theorem 10** For  $w < 1/2$ , there exists an undiversified equilibrium if

$$\gamma > 1 + \frac{1 + 1/\alpha}{1 - w}.$$

The largest undiversified equilibrium,  $\sigma_1^*$ , is decreasing in  $w$ .

In the undiversified equilibrium,  $\sigma_1^*$ , investors in community 2 hold risky portfolios. Thus, expected asset returns will no longer be equated and will contain risk premia. The importance of these risk premia can be measured by computing the maximal Sharpe ratio of the assets:

$$\rho = \max_R \left| \frac{E[R] - r_f}{\sigma(R)} \right| = \left| \frac{\pi - 1}{\pi + 1} \right|.$$

Figure 5 illustrates both  $\sigma_1^*$  and  $\rho$  for varying sizes  $w$  of the community, given  $\gamma = 4$  and  $\alpha = 1$ . Note that for this economy we can observe large Sharpe ratios  $\rho$  even though aggregate consumption is *riskless*. Thus, our model produces an “equity premium puzzle.” The resolution of the puzzle in the context of our model is that while aggregate consumption is smooth, individual consumption is very volatile due to the “herding” of community 1 investors.

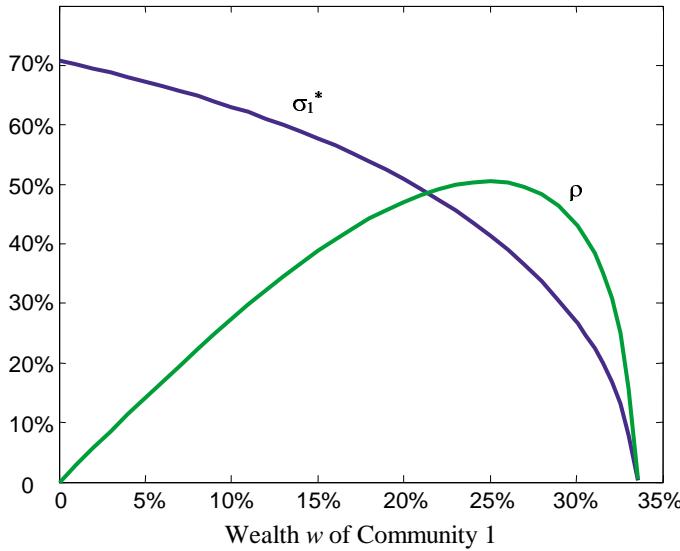


Figure 5: Equilibrium Volatility and Sharpe Ratio vs. Community Size

## 7 The Importance of Local Goods

The analysis thus far has depended on two critical assumptions. First, we have assumed that local goods account for a large enough component  $\alpha$  of utility. Second, we have assumed that agents endowed with the local good are constrained from participating in financial markets. In this section we evaluate the reasonableness of both of these assumptions.

## 7.1 Empirical Evidence for Local Goods

The effects described in this paper depend upon the existence of goods that are consumed locally and are not traded across communities. To what extent is the existence of such goods justified empirically? At the international level, Stockman and Tesar (1995) and Kravis, Heston and Summers (1982) estimate that non-traded goods account for close to 50% of a country's output. Traditionally, these estimates include housing, health, education, construction, local transportation, electricity, etc. Taking this estimate as given suggest (using the full diversification benchmark) that  $\alpha$  is close to 1.

However, it is important to note that the value of goods that are traditionally considered as tradable, such as manufactured retail goods, also include a significant non-tradable component. This is because their prices reflect the cost of labor, local transportation and real estate related costs related to their distribution. Burstein, Neves and Rebelo (2001) estimate that these (non-tradable) distribution costs represent close to 50% of the final price of (tradable) consumer goods. Taking this into account in our two good model would suggest  $\alpha \approx 3$ .

Alternatively, one can also interpret this data as a sign of complementarities. In particular, it suggests that individuals consume goods which are themselves "bundles" of both tradable and non-tradable goods. We can incorporate this in our current model by introducing a 3rd good,  $x_{0j}$ , in the utility function of agent's in community  $j$ , which is produced by combining  $g$  units of the global good and  $1 - g$  units of the local good. The figure below illustrates the effect on the reaction function when  $g = 50\%$ ,  $\gamma = 3$ , and the weights for each good in the utility function are given by  $\alpha_0 = \alpha_j = 1$ ,  $\alpha_{0j} \in \{0, 1, 10\}$ . Note that the production complementarity enhances the the effects described in this paper.<sup>11</sup>

The discussion above has focused on the interpretation of local goods from an international perspective. In our model, however, local goods are defined in terms of tastes. Thus, "communities" in our sense may be "taste-based" rather than geographic. Given this interpretation, the community effects we describe depend on the existence of heterogeneous tastes across different groups of consumers. For example, retired consumers consume a distinct set of goods (e.g., retirement homes). As long as the distinguishing tastes are for goods in relatively inelastic supply, community effects in portfolio choice will emerge. This suggests interesting avenues for future empirical work.

## 7.2 Participation Constraints

In the model we assumed that agents endowed with the local good are completely constrained from participating in the financial market. Given that participation rates in the stock market in the U.S. are still below 50% (and as recently as 1989 were close to 30%), and that participation is strongly correlate with wealth, it seems reasonable to assume that

---

<sup>11</sup>Note also that this experiment only measures the importance of the production complementarity. It still leaves equal weight on the pure global and pure local goods. To be most consistent with the Burstein, et al. (2001) data, we should reduce the weight on the pure global good to close to zero. This would further enhance our results.

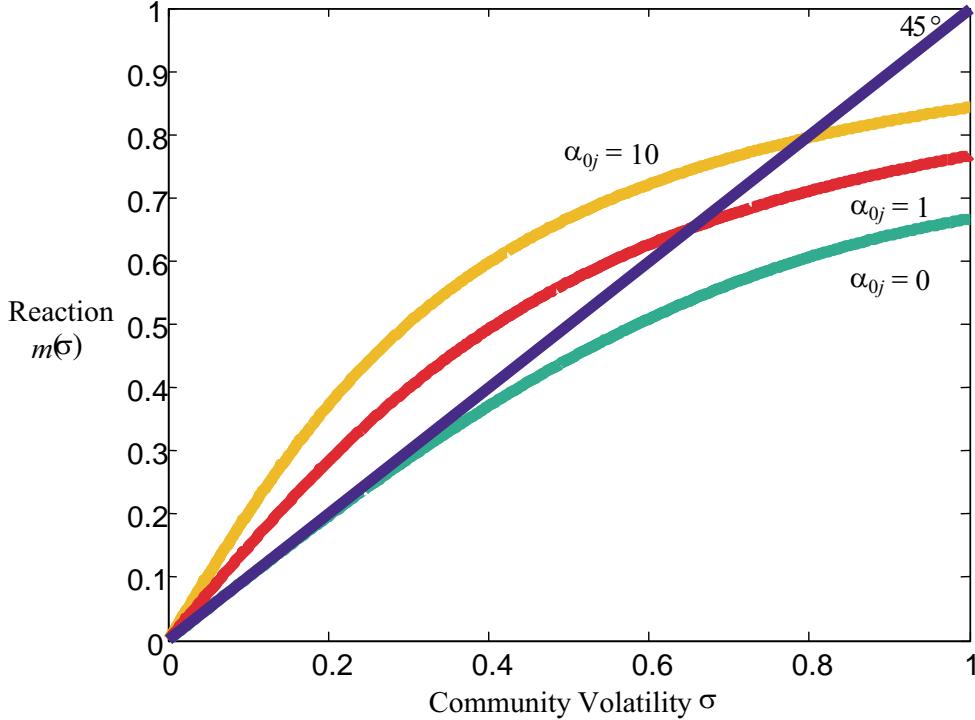


Figure 6: Equilibrium with Production Complementarities

participation rates are relatively low for individuals in the local labor market. In addition, even if individuals endowed with local goods do participate in the financial market, it is likely that they are unable to fully collateralize the value of their future endowment – brokers typically do not accept future labor income, real estate, etc., as collateral for margin accounts.

Thus, it seems natural to assume that there are constraints that inhibit hedging the local price risk for owners of the local good. However, these constraints are unlikely to be as extreme as those imposed in the model. Here we show that we can relax these constraints somewhat without undermining the main results.

Suppose an agent endowed with 1 unit of the local good is permitted to participate in the financial market. Then, given community risk  $\sigma$  his optimal trade will be to adjust his portfolio risk to the optimal risk given by the reaction function  $m(\sigma)$ . That is, he will choose a portfolio that pays  $\{-b, b\}$ , where  $b$  satisfies:<sup>12</sup>

$$\frac{P(1 + \sigma) - b}{P(1 - \sigma) + b} = \frac{1 + m(\sigma)}{1 - m(\sigma)},$$

where  $P(z)$  is the price of the local good given global community income  $z$ . Using Lemma 1 to compute  $P$  with  $\bar{X}_j = 1$ , solving for  $b$  yields:

$$b(\sigma) = .5\alpha[(1 - m(\sigma))(1 + \sigma)^\gamma - (1 + m(\sigma))(1 - \sigma)^\gamma].$$

---

<sup>12</sup>Note that the trade  $\{-b, b\}$  has cost zero (with symmetric prices) and so satisfies the budget constraint.

Thus, if a fraction  $l$  of the endowment of local good is held by agents who are unconstrained, then we get the aggregate reaction function

$$m_l(\sigma) = m(\sigma) - lb(\sigma).$$

The figure below illustrates this reaction function for the case  $\gamma = 4$ ,  $\alpha = 2$  and  $l \in \{0, 10\%, 25\%\}$ .

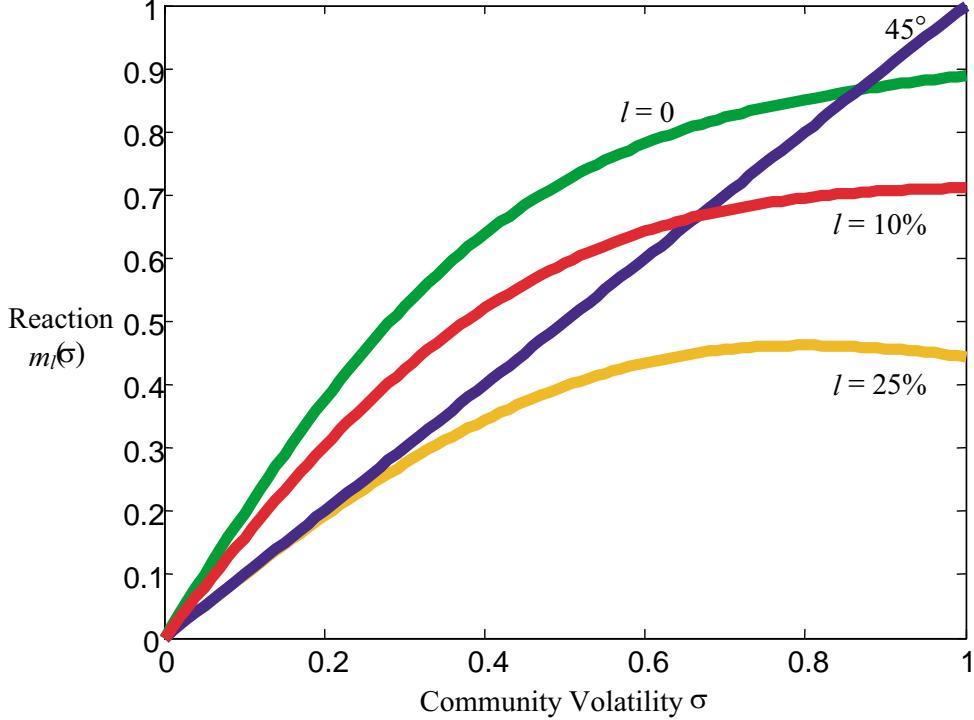


Figure 7: Equilibrium with Unconstrained Holders of the Local Good

Increasing  $l$  diminishes the equilibrium bias since the tendency of investors to herd is offset somewhat by the hedging of the holders of the local good.<sup>13</sup> However, in the example above as long as  $l < 25\%$ , undiversified equilibria still persist. Indeed, we have the following general result, which shows that our results do not depend on the extreme assumption that  $l = 0$ .

**Theorem 11** *There exists an undiversified equilibrium as long as*

$$l < \frac{\gamma - (2 + 1/\alpha)}{\gamma + \alpha}.$$

<sup>13</sup>In this framework we assumed that a fraction  $l$  is unconstrained and the remainder are fully constrained. However, one can also allow for partially constrained agents. A natural constraint, for example, is that the position is “capped” by some amount  $\bar{b}$  which may depend on the equilibrium  $\sigma$ . In this case,  $m_l(\sigma) = m(\sigma) - \min(b(\sigma), \bar{b}(\sigma))$ . It is easy to show that the undiversified equilibrium persists in this alternative specification as well, as long as  $\bar{b}(\sigma)$  is not too large. One possible choice is that  $\bar{b} = P(1 - \sigma)$ , the amount of riskless borrowing a laborer can conduct.

**Proof.** TBA ■

## 8 Conclusion

Our paper provides an explanation for biases in portfolio choice. Indeed, we demonstrate that individuals may choose undiversified portfolios even in an environment with complete financial markets and no aggregate risk. Our starting point is the notion that competition for local resources creates an externality so that individuals care about their relative wealth in the community. These local resources may represent local real estate, local labor and services, as well as community “status.” If the local resources cannot be fully collateralized, and if investors are sufficiently risk averse, then individual investors will bias their portfolio choice in the direction of the aggregate portfolio choice of the community.

Absent aggregate risk, there always exists an equilibrium in which all investors are fully diversified. While this equilibrium is Pareto optimal, we show that when agents are sufficiently risk averse, this equilibrium is not stable. In all stable equilibria, investors in a given community tilt their portfolio in the same direction, taking unnecessary risk. Each agent does not diversify because the rest of her community is not diversified. That is, each investor wants to hedge by choosing portfolios that yield a higher payoff when the price of local resources is high, and the price of the local resource is increasing in community wealth. As a result of this “herding” effect, agents are worse off than in a fully diversified equilibrium.

In order to predict the direction in which the aggregate portfolio of a community will be biased, we consider the possibility that some portion of community income is tied to the productivity of the local firms. This creates a bias towards local firms, selecting a “home bias” as the unique equilibrium.

Finally, we also consider the implications of our model for asset returns. We show that the presence of a small subset of agents in the economy that are subject to community effects is sufficient to significantly impact returns. Specifically, equilibrium Sharpe ratios can be high, even though aggregate consumption is riskless. The intuition for this result is that propensity for individual communities to “herd” in their investment decisions implies that community consumption is much more variable than aggregate consumption.

Within our model, diversification is a public good. Any individual investor’s failure to diversify will induce other investors in the same community to tilt their portfolios in the same direction, ultimately making the entire community worse off. One implication for this is a history dependence in portfolio choice. Prior to the development of financial markets, communities were likely unable to diversify many “local” risks. As markets have become more complete, one would expect investors to diversify their portfolios away from such risks. Our results make clear, however, that there is a coordination aspect to such diversification. As a result, the community is likely to remain in a stable equilibrium in which the local risk is still held.

This has obvious policy implications. For example, there is a role for social policies which subsidize investor diversification. There can be welfare gains from restricting investor portfolio choice in retirement accounts in a way that prevents them from holding undiversified positions. Indeed, our results imply that much of the policy implications related to public goods may also apply to investor diversification.

## 9 References

Abel A.(1990):“Asset Prices under Habit Formation and Catching up with the Joneses,” *American Economics Review* 80:38-42.

Abel A.(1999):“Risk premia and term premia in general equilibrium,” *Journal of Monetary Economics* 43:3-33.

Baxter M. and U. Jermann(1997):“The International Diversification Puzzle Is Worse Than You Think,” *American Economic Review* 87:170-180.

Benartzi B.(2001):“Excessive Extrapolation and the Allocation of 401(k) Accounts to Company Stock,” *Journal of Finance*.

Burstein A., J. Neves and S. Rebelo (2001):“Distribution Costs and Real Exchange Rate Dynamics During Exchange-Rate-Based-Stabilizations,” *Kellogg working paper*.

Chan Y., and L. Kogan(2000):“Catching Up with the Jonses: Hetrogeneous Preferences and Dynamics of Asset Prices,” University of Pennsylvania working paper.

Chevalier J. and G. Ellison(1997):“Risk Taking by Mutual Funds as a Response to Incentives,” *Journal of Political Economy* 105:1167-1200

Cole H., G. Mailath, and A. Postlewaite(2001):“Investment and Concern for Relative Position,” *Review of Economic Design*, forthcoming.

Coval J. and T. Moskowitz(1999):“Home Bias at Home: Local Equity Preference in Domestic Portfolios,” *Journal of Finance*.

Coval J. and T. Moskowitz(2001):“The Geography of Investment: Informed Trading and Asset Prices,” *Journal of Political Economy*, forthcoming.

Gali, J.(1994):“Keeping up with the Jonses: Consumption externalities, portfolio choice, and asset prices,” *Journal of Money credit and Banking* 26:1-8

Green J. and N. Stokey(1983):“A Comparison of Tournaments and Contracts,” *Journal of Political Economy* 91:349-364.

Grinblatt M. and M. Keloharju(1999):“Distance Bias, Language Bias, and Investor Sophistication: Results from Finland” Working Paper.

Huberman G.(1998):“Familiarity Breeds Investment,” Working Paper.

Lazear E. and P. Rosen(1981):“Rank-Order Tournaments as Optimum Labor Contracts,” *Journal of Political Economy* 89:841-864.

Levy H. and M. Sarnat(1970):“International Diversification of Investment Portfolios,” *American Economic Review* 60:668-675.

Lewis K.(1996):“What Can Explain the Apparent Lack of International Consumption Risk Sharing?,” *Journal of Political Economy* 104:267-297.

Lewis K. (1998):“International Home Bias in International Finance and Business Cycles,” *NBER working paper*.

Lewis K. (1999):“Trying to Explain Home Bias in Equities and Consumption,” *Journal of Economic Literature*37:571-608.

Stockman Alan C. and L. Tesar(1995):“Tastes and Technology in a Two-Country Model of the Business Cycle: Explaining International Comovements,” *American Economic Review* 85:168-185.

Tesar L.(1993):“International Risk-sharing and Non-traded Goods,” *Journal of International Economics* 35:69-89.