(UBS Pensions series 24) A Human Capital Explanation for an Asset Allocation Puzzle

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Abstract

We show that a life-cycle asset allocation model with liquidity constraints and realistically calibrated uninsurable labor income risk rationalizes the asset allocation puzzle of Canner, Mankiw and Weil (1997). Based on empirical estimates of the correlation between stock returns and individual earnings, labor income is a closer substitute to long-term bonds than to stocks. As a result, more risk averse investors hold a smaller proportion of their risky portfolio in equities. Moreover, this explanation is consistent with the recommendation that younger households should be more heavily invested in stocks than older households.

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