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Human Capital, Asset Allocation, and Life Insurance

Peng Chen , CFA, Roger G. Ibbotson, Moshe A. Milevsky & Kevin X. Zhu

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event of the wage earner's death. Life insurance has long been used to hedge against

mortality risk. Typically, the greater the value of human capital, the more life insurance the family needs.

Intuitively, human capital affects not only optimal life insurance demand but also optimal asset allocation. However, these two important financial decisions—how much life insurance to buy and what the optimal asset allocation is—have consistently been analyzed separately in theory and practice. Popular investment and financial planning advice regarding how much life insurance one should acquire is seldom framed in terms of the riskiness of one's human capital. And conversely, optimal asset allocation has only lately been framed in terms of the risk characteristics of human capital. Rarely is this decision integrated with the life insurance decision.

We argue that these two decisions must be determined jointly because they serve as risk substitutes when viewed from the perspective of an individual investor's portfolio. Life insurance is a perfect hedge for human capital in the event of the wage earner's death; that is, term life insurance and human capital have a negative 100 percent correlation with each other in the "alive" (consumption) state versus the "dead" (bequest) state. If life insurance pays off at the end of the year, human capital does not, and vice versa. Thus, the combination of the two provides great diversification to an investor's total portfolio.

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- Bequest preferences and a person's subjective survival probability have significant effects on the person's demand for insurance but little influence on the person's optimal asset allocation.
- Conservative investors should invest relatively more in risk-free assets and buy more life insurance.

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