

Discussion of
“Hedging Recessions”
by Branger, Larsen, and Munk

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- Great paper!
 - lots of details
 - careful calibration

- Difficult to discuss
 - lots of results
 - related to large literature
 - I only have 10 minutes!
 - ...

What is the paper about?

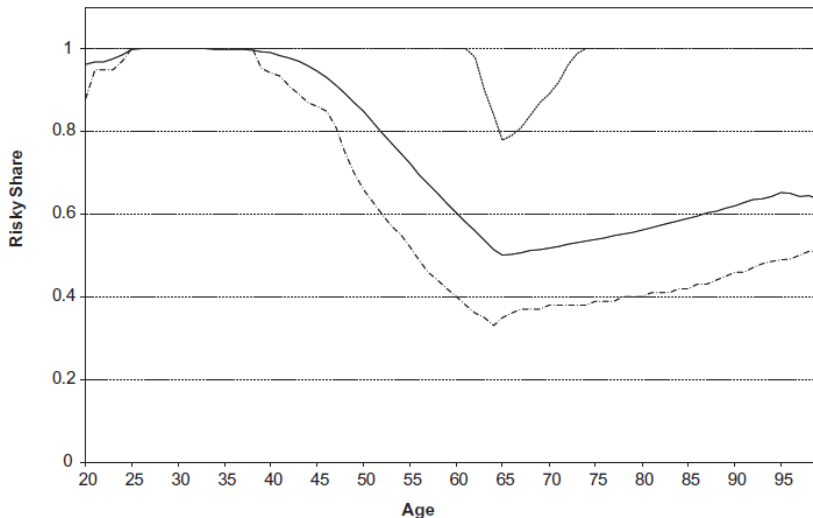
Difficult to match observed life-cycle of risky portfolio share

- participation puzzle
- slope: many models predict decline with age
- level: many models predict very high share
- model predictions often at odds with common financial advice

Focus of this paper:

share of risky assets when young

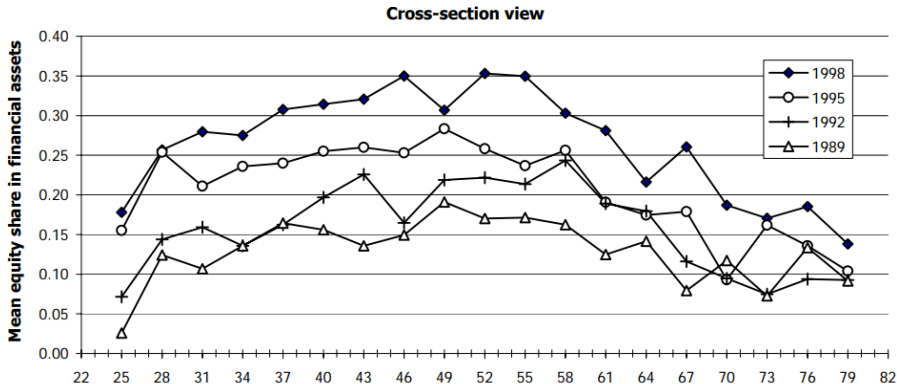
Standard Model: Risky asset share over the life-cycle



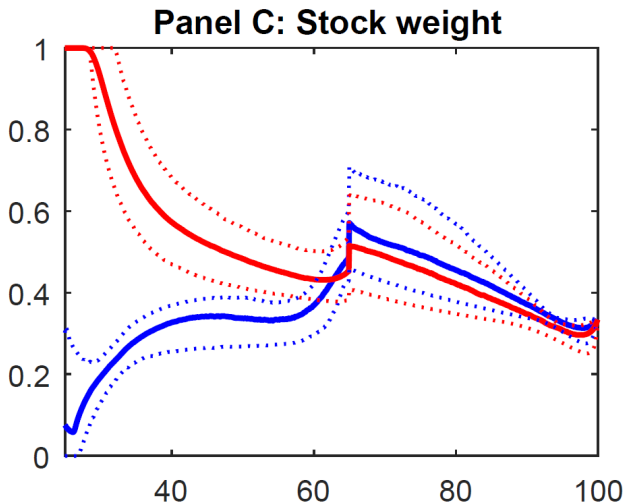
Cocco, Gomes, and Maenhout (2005) [CGM]

Data: Risky asset share over the life-cycle

Equity Shares in Financial Assets, SCF data, 1989-1998



Ameriks and Zeldes (2004). Similar patterns in other countries.



Intuition: Start with known model solutions

Merton-Mossin-Samuelson benchmark model (MMS)

- risky share in total wealth, $\frac{x_s}{A} = \frac{1}{\gamma} \frac{EER_s}{Var_s}$ (constant)
- in financial wealth, $\pi = \frac{x_s}{W} \equiv \pi_{MMS}$ (if no labor income)
- if tradable risk-free labor income: $\pi = (1 + \frac{H}{W})\pi_{MMS}$

→ π is high when young and then declines

“H is bond-like”

(also robust feature of new “standard models” with risky labor income)

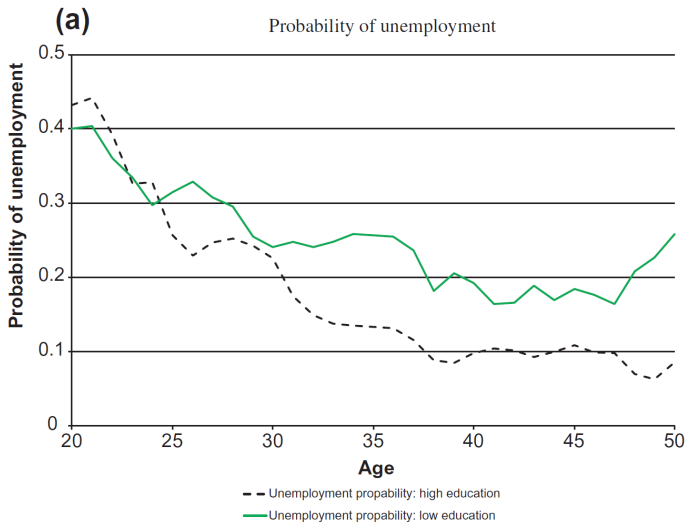
Implications

- consistent with financial advice (eg 100-age rule)
- not consistent with observed choices of young ← **THIS PAPER**

Extensions: New “standard” model (e.g. CGM 2005)

- idiosyncratic, persistent income risk (incl. unempl. & disasters)
 - BTW: also age-dependent unemployment risk (eg Guiso Jappelli Pistaferri, 2002)

Age-dependent unemployment risk



Guiso, Jappelli, and Pistaferri (2002)

Extensions: New “standard” model (e.g. CGM 2005)

- idiosyncratic but persistent income risk (incl. unempl. & disasters)
 - BTW: also age-dependent unemployment risk (eg Guiso Jappelli Pistaferri, 2002)
- labor income correlated with stocks (eg co-integration)
 “H is stock-like”
- incomplete markets (eg short selling & borrowing constraints)
- return predictability
- non-standard preferences, beliefs, trust
- ...

This paper

My intuition based on Campbell Viceira (2002) with risky labor income

$$\pi = \underbrace{\frac{1}{\rho} \pi_{MMS}}_{\text{"H as bonds"}} - \underbrace{\left(\frac{1}{\rho} - 1\right) \frac{Cov(s, y)}{Var_s}}_{\text{hedging motive}}$$

- ρ is the elasticity of consumption wrt financial wealth
- $\frac{1}{\rho} > 1$ is approximately $(1 + \frac{H}{W})$, hence $\frac{1}{\rho} \rightarrow 1$ as age $\rightarrow T$
- **H as bond**: idiosyncratic income risk gives declining CGM profile
- **H as stock**: persistence and correlation introduces hedging motive
 - **persistence**: unempl. has persistent effect on y and hence H
 - **correlation**: stocks and unempl. risk are correlated
 - declining unemployment risk amplifies hedging lifecycle

→ combining both motives gives hump-shaped π -profile

Question: Benzoni, Collin-Dufresne, Goldstein (2007) get hump shape just from labor/equity co-integration.

- Is the correlation too low in your model?
- Does age-specific unemployment amplify this role?

Main suggestion: Simplify! For example, do you really need

- health shocks in retirement,
- complicated retirement income,
- signal extraction problem of state variables,

to model the risky share of the young?

If so, tell the reader what would happen if the model didn't have these features.

Could also relate paper to recent work by Guvenen et al about excess skewness and kurtosis of lifetime incomes in recessions.

Great paper - thanks!!