

Household Finance

Luigi Guiso

Axa Professor of Household Finance and Insurance

Einaudi Institute for Economics and Finance

February/March 2018

Course purpose and description

This course reviews retail investors financial decisions and the recent trend of literature on the determinants of investors' financial choices and the role of informal institutions – such as trust and social capital – in shaping the adoption of financial instruments and the working of retail financial markets.

The sequence is a 30-hour course based on lecture notes and the direct reading of a number of articles from the literature.

There is no reference textbook. Students will be required to read thoroughly the papers in the reading list. There is however one survey paper that touches upon most, but not all, the material covered in the course.

" Household Finance. An Emerging Field", (2012) Luigi Guiso and Paolo Sodini, in Handbook of the Economics of Finance, G. Constantinides, M. Harris and R. Stulz (eds), North Holland – is the main reference discussing several topics covered in the course. Denoted below HFEF

Grading policy

Grading is based on the preparation of the outline of a research project that is due two weeks after the end of course and on:

1. The class performance in the two recitations (20%).

2. A Research outline (80%)

Write an outline of a research project related to any one of the topics discussed in the course.

Research outlines should have :

1. A clear question and a motivation for asking it
2. How you are going to execute/test it
3. Should be up to four pages long (but 2 is fine)

Have to be handed in within 2 weeks after end of course

Topics and readings

Lecture 1

1.1 The rise of household finance. Why a new field? Why now?

Provides a definition of what household finances is about reasons for why a new field and why now. Discusses what is unique of households and how they relate to financial markets to achieve which objectives.

Material: slides and (*) reading

Readings

- (*) HFEF, Section 1
- (*) John Campbell, "Household Finance", Presidential Address to the American Finance Association, *Journal of Finance*. 61:1553-1604, August 2006.
- (*) Peter Tufano, 2009. "Consumer Finance", Annual Review of Financial Economics, 1: 227-47
- Stephanie Curcuru, John Heaton, Deborah Lucas and Damien Moor, "Heterogeneity and Portfolio Choice: Theory and Evidence", Handbook of Financial Econometrics, Yacine Ait-Sahalia and Lars Peter Hansen, (eds.).
- (*) Laurant Calvet, John Campbell and Paolo Sodini, "Measuring the Financial Sophistication of Households", *American Economic Review Papers and Proceedings*, 2010.

1.2. Facts about household assets and liabilities

Presents basic fact about households assets and liabilities and their components, shows who owns those asset and how much, shows how assets ownership and compositions varies according to wealth and age. Shows trends in ownership pattern , overall reliance on financial markets and discusses comparisons across countries

Material: slides, handouts and (*) reading

Readings:

- (*) HFEF, Section 1
- (*) John Campbell, "Household Finance", Presidential Address to the American Finance Association, *Journal of Finance*. 61:1553-1604, August 2006.
- Luigi Guiso, Michael Haliassos and Tullio Jappelli, Introduction to "Household Portfolios", in *Household Portfolios*, L. Guiso, T. Jappelli and M. Haliassos (eds.), MIT Press, Boston, December 2003.

Lecture 2

2.1 Household portfolio decisions: normative portfolio models to observed behavior: limited participation and under-diversification

Reviews Merton's portfolio model and shows how it predicts stock market participation and portfolio diversification.

Material: slides and starred readings.

Readings

- (*) HFEF, Sections 4.1 and 4.2
- (*) Calvet, Laurent E., John Y. Campbell, and Paolo Sodini. 2007a. "Down or Out: Assessing the Welfare Costs of Household Investment Mistakes." *Journal of Political Economy* 115, 707-747.
- (*) Polkovnichenko, Valery. 2005. "Household Portfolio Diversification: A Case for Rank Dependent Preferences." *The Review of Financial Studies*, 2005, 18(4): 1467-1501.
- (*) Goetzmann, William N., and Alok Kumar. 2008. "Equity Portfolio Diversification." *Review of Finance*, 12, 433-463.

Lecture 3

3.1 Households risk preferences. What do we know?

Discusses thoroughly how preferences for risk can be elicited at the level of the single investors and the pros and cons of various elicitation strategies. Discusses what drives heterogeneity in risk preferences across individuals, including variation in endowments, background risk, access to the credit market, demographics, IQ and genetics.

Material: slides and starred readings.

Readings

- (*) HFEF, Section 3
- (*) Charles Holt and Susan Laury, "Risk aversion and incentive effects", *American Economic Review*, 92, 5 (Dec., 2002), 1644-1655.
- (*) Dohmen, Thomas J., Armin Falk, David Huffman, Uwe Sunde, Jürgen Schupp, and Gert G. Wagner. 2011. "Individual Risk Attitudes: New Evidence from a Large, Representative Experimentally validated Survey" *Journal of the European Economic Association*.

- Dohmen, Thomas J., Armin Falk, David Huffman, and Uwe Sunde. 2010. "Are Risk Aversion and Impatience Related to Cognitive Ability?" *American Economic Review*, 100(3): 1238–1260.
- (*) Frederick, Shane. 2006. "Cognitive Reflection and Decision-Making." *Journal of Economic Perspectives*, 19(4): 24-42.
- Luigi Guiso and Monica Paiella, "Risk aversion, wealth and background risk", *Journal of the European Economic Association*, December 2008, 6, 6, 1109-1150.
- Beauchamp, Jonathan, David Cesarini, Magnus Johannesson, 2011, "The Psychometric Properties of Measures of Economic Risk Preferences", New York University working paper.
- (*) Cesarini, David, Magnus Johannesson, Paul Lichtenstein, Örjan Sandewall, and Björn Wallace. 2010. "Genetic Variation in Financial Decision-Making." *Journal of Finance*, 65(5): 1725-1754.

Lecture 4

2.1 Household portfolio decisions: from normative portfolio models to observed behavior: limited participation and under-diversification

Show how Merton's portfolio model departs from observed behavior. Discusses the stock market participation and diversification "puzzles" and their explanations (including fixed participation costs, non-standard preferences and beliefs). Discusses limited participation in financial instruments other than stocks.

Material: slides and starred readings.

Readings

- (*) HFEF, Sections 4.1 and 4.2
- (*) Michael Haliassos and Carol Bertaut, "Why So Few Hold Stocks?", *The Economic Journal*, 105, September 1995, 1110-1129.
- (*) Annete Vissing Jorgerson and Orazio Attanasio (2003), "Stock-Market Participation, Intertemporal Substitution and Risk Aversion", *American Economic Review*, pp. 383-391.
- (*) Grinblatt, Mark, Matti Keloharju, and Juhani Linnainmaa. 2011. "IQ and Stock Market Participation." *Journal of Finance*, 66, 2121-2164.
- (*) Barberis, Nicholas, and Ming Huang, and Richard Thaler. 2006. "Individual Preferences, Monetary Gambles and Stock Market Participation: A Case for Narrow Framing (2006), *American Economic Review*, 96 (4), 1069-1090.
- Luigi Guiso and Tullio Jappelli, "Awareness and Stock Market Participation", *Review of Finance*, 2005, 9, 537-567. R
- Shawn Cole and G.K. Shastry "Smart Money: The Effect of Education, Cognitive Ability, and Financial Literacy on Financial Market Participation", 2009, mimeo.

Lecture 5

Discusses three topics and introduces basic behavioral tools

Material: slides and starred readings.

5.1 The portfolio of the rich

* Carroll, Christopher D. 2002. "Portfolios of the Rich." In Luigi Guiso, Michael Haliassos and Tullio Jappelli (Eds) *Household Portfolios*, Cambridge, MA: MIT Press.

5.3. Information and portfolio choices

* Peress, Joel. 2004. "Wealth, Information Acquisition and Portfolio Choice." *The Review of Financial Studies*, 17(3): 879-914.

* Guiso, Luigi and Tullio Jappelli. 2006. "Information Acquisition and Portfolio Performance", CSEF Working Paper No. 167

Marcin Kacperczyk, Jaromir Nosal and Luminita Stevens, (2017) "Investor Sophistication and Capital Income Inequality : *February 2017*."

5.3. Some behavioral tools

Readings

- (*) HFEF, Section 3
- *Kahneman, Daniel, and Amos Tversky. 1979. "Prospect Theory: An Analysis of Choice Under Risk." *Econometrica*, 47(2): 263-291.
- Epstein, Larry G., and Martin Schneider. 2010. "Ambiguity and Asset Markets." NBER, Working Paper 16181
- Gollier, Christian. 2006. "Does Ambiguity Aversion Reinforce Risk Aversion? Applications to Portfolio Choices and Asset Prices." University of Toulouse, mimeo.
- Prachi Deuskar, Pan Deng and Scott J. Weisbenner, 2013, "The Effect of Regret", WP. University of Illinois
- Dimmock Stephen, G. Nanyang, Roy Kouwenberg, Olivia S. Mitchell and Kim Peijnenburg. 2013 "Ambiguity Aversion and Household Portfolio Choice: Empirical Evidence". Bocconi University WP
- Dominitz, Jeff, and Charles F. Manski. 2012. "Measuring and Interpreting Expectations of Equity Returns." *Journal of Applied Econometrics*.

LECTURE 6

Trust and household financial choices

Discusses the importance of trust (and culture) in affecting individual financial decisions and introduces financial advice

Material: slides and starred readings.

Readings:

- (*) Guiso, Luigi, Paola Sapienza, and Luigi Zingales. 2008. "Trusting the Stock Market." *The Journal of Finance*, 63(6): 2557-2600.
- (*) Grinblatt, Mark, and Matti Keloharju. 2001a. "How Distance, Language, and Culture Influence Stockholdings and Trades." *Journal of Finance*, 56, 1053-1073.
- (*) Guiso, Luigi, Paola Sapienza, and Luigi Zingales. 2004. "The Role of Social Capital in Financial Development." *American Economic Review*, 94(3): 526-556.
- (*) Nicola Gennaioli, Andrei Shleifer, Robert W. Vishny, 2013 "Money Doctors", NBER WP 18174
- Harrison Hong, Jeffrey D. Kubik and Jeremy Stein, "Social Interaction and Stock market Participation", *Journal of Finance*, 59, 2004, 137-163.
- (*) Ernst Fehr, "On the Economics and Biology of Trust", Presidential Address, European Economic Association 2008,
- Paola Sapienza, Anna Toldra and Luigi Zingales, "Understanding Trust", *Economic journal*, 2013.
- Luigi Guiso, Paola Sapienza and Luigi Zingales (2011) "Is Civic Capital the Missing Link", in "Handbook of Social Economics", J. Benhabib, A. Bisin and M., North Holland - is a useful reference for some of the classes. Denoted below as CK

LECTURE 7

Portfolio allocation over the life-cycle

Reviews the debate on the saving and portfolio allocation over the life cycle when in realistic contexts featuring uncertain labor income, borrowing constraints, costly participation and disaster events in either the labor market or over assets returns.

Material: slides and starred readings.

Readings

- (*) HFEF, Sections 4.4
- (*) Jagannathan, Ravi, and Narayana R. Kocherlakota. 1996. "Why Should Older People Invest Less in Stocks Than Younger People?" *Quarterly Review*, Minneapolis Federal Reserve Bank, Summer, 11-23.
- Merton, Robert C. 1971. "Optimum Consumption and Portfolio Rules in a Continuous-Time Model." *Journal of Economic Theory*, 3, 373-413.
- (*) Cocco Joao, Francisco Gomes, and Pascal Maenhout. 2005. "Consumption and Portfolio Choice over the Life-cycle." *Review of Financial Studies*, 18(2): 491-533.
- (*) Malkiel, Burton G. 1996. *A Random Walk Down Wall Street: Including a Life-Cycle Guide to Personal Investing*. 6th edition New York: Norton.

- (*) Gomes, Francisco J., Laurnence Kotlikoff, and Luis Viceira. 2008. "Optimal Life-Cycle Investing with Flexible Labor Supply: A Welfare Analysis of Life-Cycle Funds Puzzle." *American Economic Review*, 98(2): 297-303.
- (*) Ameriks, John, and Stephen Zeldes. 2004. "How Do Household Portfolio Shares Vary with Age?" Columbia University, Working Paper.
- (*) Fagereng, Andreas, Charles Gottlieb and Luigi Guiso. 2013. "Asset Market Participation and Portfolio Choice over the Life-Cycle." CEPR WP

LECTURE 8

Frequency and profitability of trading

Discusses trading motives according to normative models and to observed behavior and shows whether individual investors gain or lose from trading.

Material: slides and starred readings.

Readings

- (*) HFEF, Sections 4.3
- (*) Calvet, Laurent E., John Y. Campbell, and Paolo Sodini. 2009. "Fight or Flight? Portfolio Rebalancing by Individual Investors." *Quarterly Journal of Economics*, 124(1): 301-348.
- Grinblatt, Mark, and Matti Keloharju. 2001. "What Makes Investors Trade?" *Journal of Finance*, 56, 589-606.
- (*) Alvarez, Fernando, Luigi Guiso and Francesco Lippi "Durable Consumption and Asset Management with Transaction and Observation Costs", *American Economic Review* 2012, 102 (5) 2272-2300.
- (*) Mark, Matti Keloharju, and Juhani Linnainmaa. 2012. "IQ, Trading Behavior, and Performance", *Journal of Financial Economics*, 104, 339-362