Discussion on: Do Disaster Expectations Explain Household Portfolios? by Sule Alan

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SUMMARY

- Objective: explain portfolio facts
  - Low stock market participation.
  - Moderate conditional equity holdings (even early in life).
- Method:
  - Hhold; life cycle; uninsurable risk; stocks and bonds
  - Candidate factors: discount rates; participation costs; and ...
  - ... expected disasters: rare but big (ok with equity premium)
  - These factors are estimated, including beliefs about disasters.
- Findings:
  - Including more moments (disasters) helps (like it does in asset pricing context)
  - Disasters are essential to produce: (1) low stocks for young; (2) low conditional stock holdings.
- Contribution:
  - brings disasters in portfolio analysis (they have already been used extensively in asset pricing)
  - solves the young portfolio puzzle
  - ingenious pseudo-data and MDS estimation approach.

MAIN COMMENTS

This is a thought-provoking paper. Makes an important point within the portfolio literature.

Questions/remarks:

- The nature of disaster expectations.
- Estimates.
- Assumptions and over-identifying observations.
- Beyond this paper.

DISASTER EXPECTATIONS

- The paper departs from observed equity premium as a proxy to expected returns. This could be done in two ways:
  - A Use subjective beliefs
  - B Use further moments from long historical/cross-section data

  The paper follows route A.
- Under option A:
  - Having found sharp differences across groups, heterogenous subjective beliefs seem to be at work. But we would need a good story to tell.
  - Otherwise, one might want to impose invariant beliefs about p and ϕ (heterogeneous π is more plausible). Would the story still work?
- Why option B?
  - Direct evidence exists on GDP disasters (e.g., Barro) and flat-tailed S&P500 stock returns 1900-2004.
  - More congruent with standard RE
  - End result should be pretty much the same (?)

ESTIMATES

- The sharp differences in disaster beliefs is surprising, specially between cohorts which are quite close. But for younger cohorts and the more educated estimates are less reliable (i.e, too heterogeneous). Thus differences between point estimates may be meaningless. Why not report just the more reliable cohort 1 as benchmark?
- Estimated disaster expectations about 4% per year. This looks too big compared with Barro's direct evidence of about 2% (although the scale of the loss may be comparable). What if we were to use the latter?

FURTHER POINTS

- Two assumptions that might not be innocuous:
  - Borrowing limits
  - Asymmetry: only disasters, no windfalls
- That conditional portfolio shares are 100% without disasters (i.e., Model 3) seems to be at odds with results from previous literature (with "reasonable" risk aversion).
  - That risk-aversion estimated here is too small seems critical. It is then important to know how precisely it is estimated.
  - Also are there other implications to help judge different approaches further?
- Overidentifying implications:
  - Distribution of consumption
  - Wealth distribution in the cross section

WHERE FROM HERE?

What is the point of explaining portfolio composition?

- Comparative statics: the link between stabilization in "normal" times and portfolio composition across countries (or over time). Is it of any consequence for welfare?
- A macro question: the cost of business cycles and disasters. Do portfolios matter? Need an equilibrium model.

THOUGHTS

- Main point: including more moments away from Normal helps (as it does in asset pricing context)
- The point seems to be that disasters have a larger significance at young ages. If this is so, the paper should try to provide the intuition?
- Although portfolio may be the flip side of equity premium, note that the life cycle pattern (small savers) which is the main point does not bear direct connection with asset pricing. Also the two issues, pricing and portfolio, have been addressed in different types of models. Integrating within incomplete-markets setting?