

Suboptimal Retiree Allocations with Housing

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Abstract : We investigate the costs of various suboptimal allocations in housing, consumption, bond and stock holdings of a retiree in a setting with recursive utility, considering the extensive empirical evidence that investors make suboptimal decisions in different ways. We find that suboptimal stock holdings impose only modest costs on the retiree. This may have a merit in explaining the limited stock investment in the data. The cost of suboptimal bond holdings is higher than that of stocks, but still small. This may partially explain why many more people hold bonds compared to stocks. We find that positive deviations from the optimal level are less costly relative to the negative ones in suboptimal housing allocations. This may help us to clarify why the elderly are over consuming housing, as seen in the housing data. The cost of suboptimal consumption is quite high and the highest of all. Our paper suggests that, in terms of welfare, the decisions of how much of liquid wealth to use for consumption and for saving are more important than the decision about the composition of liquid savings. Suboptimal stock holdings are twice more costly in power utility and suboptimal bond holdings are twenty times more costly in recursive utility. Recursive utility is superior to power utility in terms of rationalizing many people's preference for bonds instead of stocks in investment.

Keywords : housing, recursive utility, retirement, suboptimal decisions, welfare cost

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