

The Theory of Optimal Life-Cycle Saving and Investment

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discussion by

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For the layman...

- Life-cycle models of consumption and investment
 - Time preference
 - Risk preference
 - Insurance
 - Risk-reward
 - Borrowing constraint
- Implementation plan

Good Faith Disclosure

- I agree with the paper's goals.
- I agree with most of the assertions in the paper.
- I am offering “friendly amendments.”
- I hope and expect my written discussion will be redundant once my suggestions are incorporated in the paper.

Simple Case

- known lifetime, known wage pattern, possible health risk
- “shadow riskless rate”
 - solve foc for riskfree rate instead of consumption
 - discussion of marginal utilities too mysterious
 - distinguish more clearly dollar value versus utils
- “taste for moderation” may be interpreted as does not prefer more to less: “balance?.” discuss IES separately “impatience”

I would emphasize more

- mortality risk (fear of outliving savings)
- unemployment risk and risky wages (especially correlation with the market)
- precautionary savings (when insurance is not complete)
- contingent claims: for insurance and for managing compensated risk and transaction costs
- “prices matter”: discuss stocks too (good investment versus good company, common retail investor’s mistake)

Implementation: Marketing

The discussion in the paper sounds like a plan for a “wholesale” contingent-claims product to be marketed to institutional investors or big corporations who are sophisticated. For those sorts of clients, marketing consists mainly of communicating accurately the features of the product and describing why it is good for the client.

For retail investors, marketing is paramount. Even if we have a superior product for consumers, how can we communicate that to them?

Implementation: Regulatory Issues

Retirement products, investment products, and insurance products have different regulatory restrictions that must be met or changed.

For example, insurance companies have lobbied successfully for special tax treatment and for exclusive domain over products whose economic function is conceptually no different than other sorts of hedging products. (Insurance textbooks on why they are different: nonsense.)

ERISA restrictions are rigid and old-fashioned (with many of the specific rules based on 1970's actuarial science that was at odds with financial principles). This is not news to the authors; Zvi is famous for his views on this topic.

Summary

The paper is useful for making the implications of the growing literature in personal finance more accessible.

I offer some minor friendly amendments.

We still have work to do before our recommendations are as easy to understand as “hold a more risky portfolio when younger,” but this paper is a step in the right direction.