

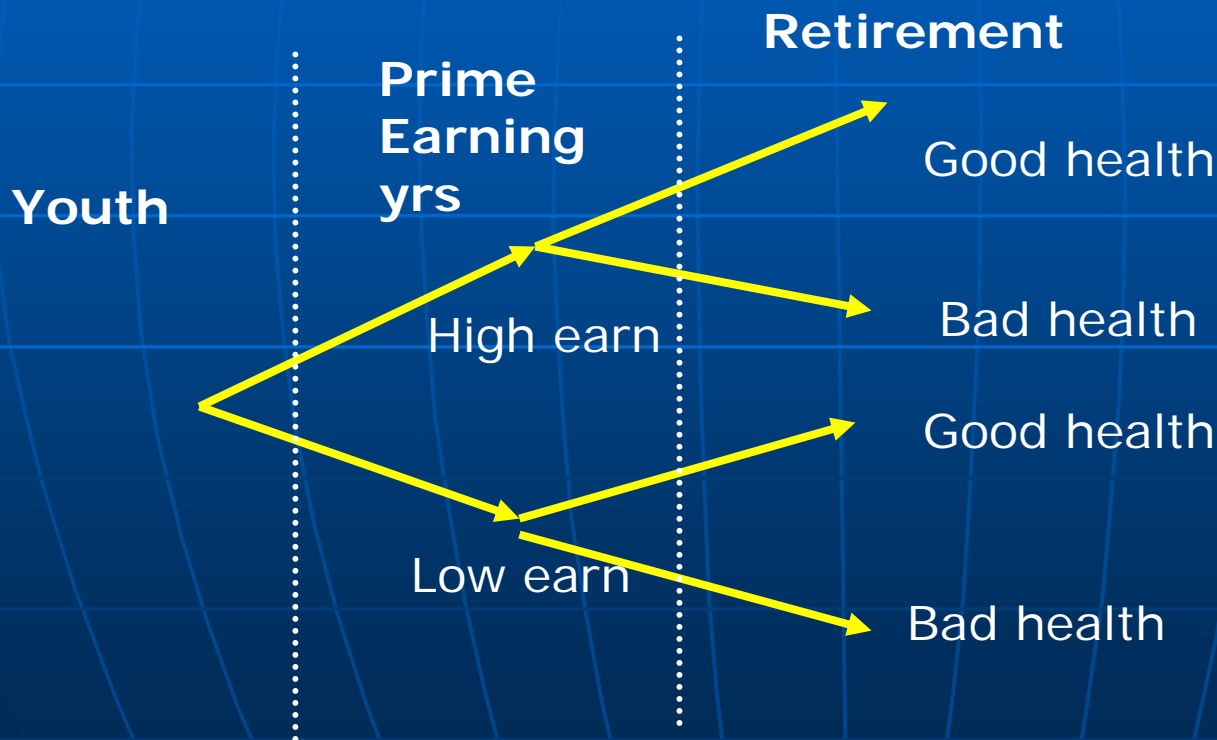
Discussion of
“The Theory of Optimal Life-Cycle
Saving and Investing”
by Bodie, Treussard and Willen

Deborah Lucas
Northwestern University and NBER

Conference on the Future of Life-Cycle Saving and
Investing
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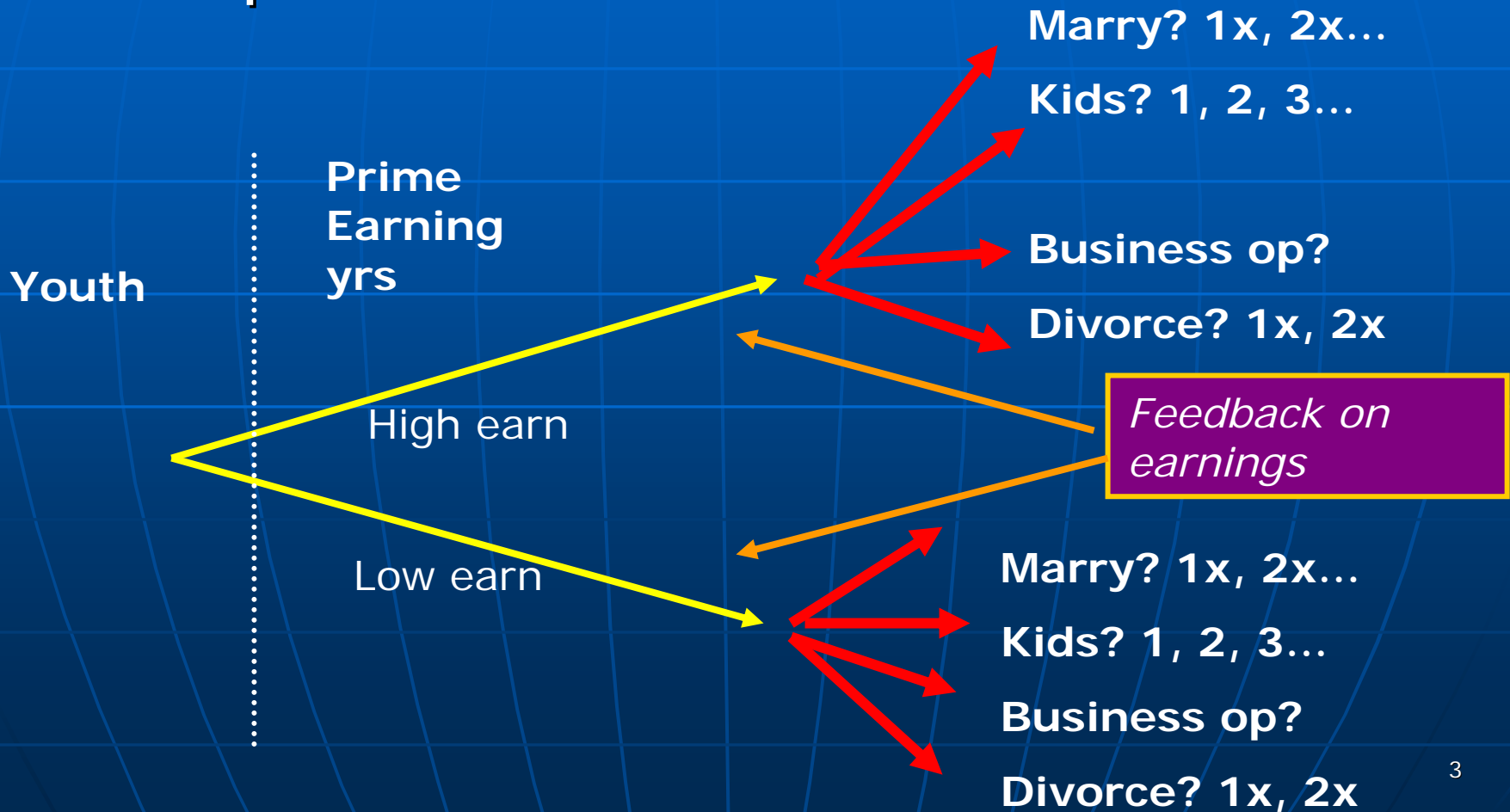
Focus on consumption plan, not financial plan

- Clear and reasonable in theory



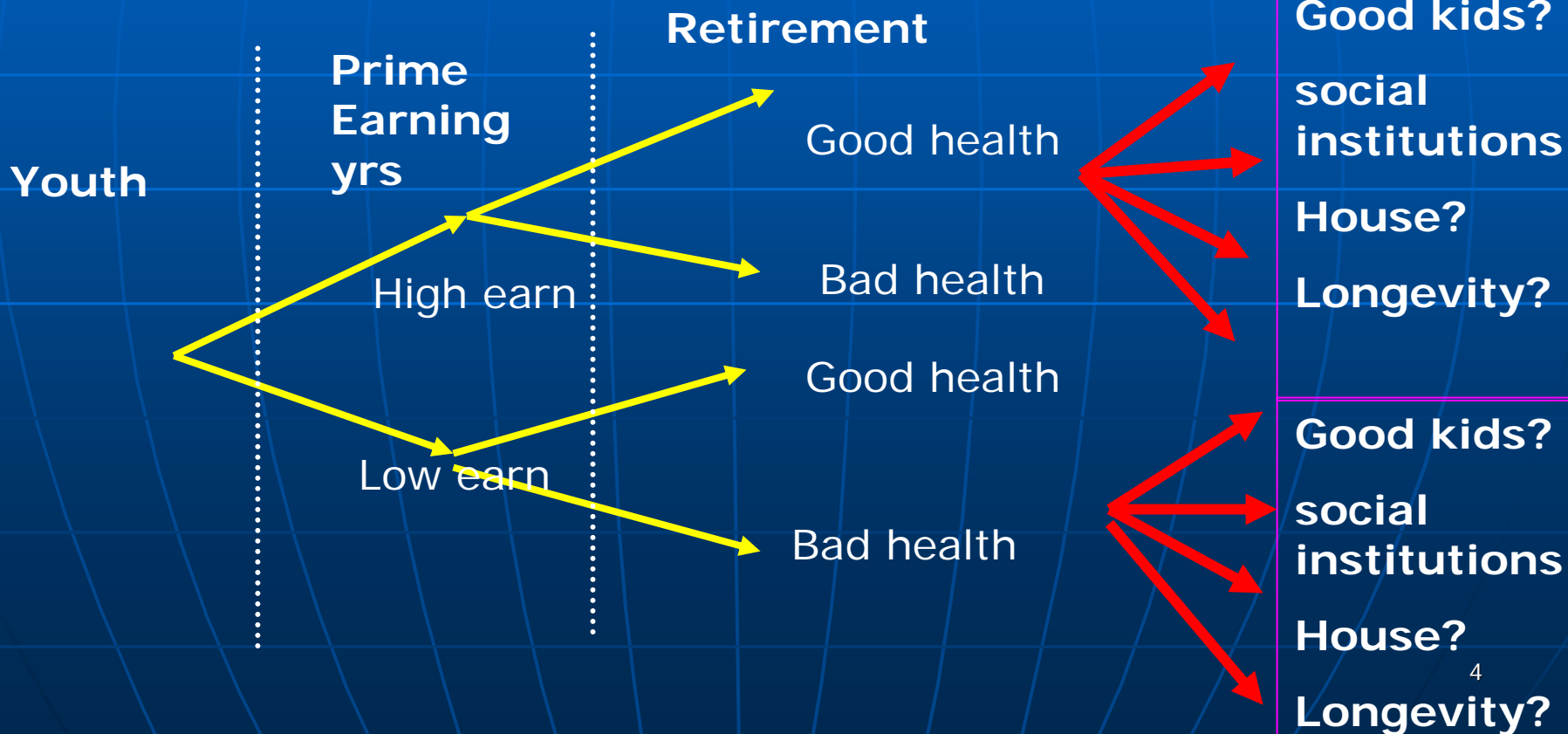
Focus on consumption plan, not financial plan

■ Is it practical?



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Six Concepts in a Complex World:

Less relevant

1. Lifetime budget constraint

- Poorly defined in complex, incomplete mkts
- Can't forecast
- Practical implications not obvious

2. Asset allocation over life-cycle

- Theory offers little guidance, results very sensitive to assumptions
- Heterogeneity of circumstances, preferences, suggests caution in offering dogmatic advice

3. Phases of the life-cycle

- Broadly true, but can lead to over-simplification...
 - Liquidity needs before retirement too often neglected by theory

Six Concepts in a Complex World:

Highly relevant

4. Importance of contingent claims

- Potential to significantly increase welfare
- More important/general than idea of consumption smoothing

5. Prices of securities matter

- Absolutely!
- Cost of insurance can be prohibitive
- Heterogeneity of expectations about expected returns and risk also affects demand
- Pricing is difficult, even for financial engineers
- Prices for specialized/consumer products have high mark-ups

6. Role of portfolio constraints

- Short positions expensive
- Markets incomplete
- Product offerings limited b/c of moral hazard, adverse selection, thin markets

Lessons from Commercial Derivatives Product Market

- Simple, multi-use products can gain wide acceptance and are priced competitively
 - E.g., swaps and index options
- Specialized products are expensive, illiquid
- Many seemingly useful products fail
 - E.g., inflation and catastrophe futures

Where are lessons from theory most valuable?

- Expect private financial service vendors to use any idea that will sell
 - Advice/products for high-end clients already very sophisticated
 - Less informed investors are right to be wary, and will always find it difficult to evaluate advice

Where are lessons from theory most valuable?

- Conclude that insights most relevant for design/reform of social institutions
 - Useful in identifying where/how gov't intervention can improve welfare
 - Public pensions, private pension regulation, design of social insurance contracts
- Examples: where modern nuanced theory (contingencies, prices, constraints) might help
 - Why don't people elect to annuitize pensions?
 - How does institutional design affect value?
 - E.g., rethinking DB pensions
 - Strengths: may provide insurance not otherwise offered
 - Weaknesses: lack of portability, equal treatment restrictions