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Alessandro Bucciol, Raffaele Miniaci, Sergio Pastorello

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Return Expectations and Risk Aversion Heterogeneity in Household Portfolios

Alessandro Bucciol* Raffaele Miniaci[†] Sergio Pastorello[‡]

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Abstract

We develop a structural econometric model to elicit household-specific expectations about future financial asset returns and risk attitudes by using data on observed portfolio holdings and self-assessed willingness to bear financial risk. Our framework assumes that household portfolios are subject to short-selling constraints in stocks and bonds, and that financial investment decisions are taken conditional on real estate and business wealth. We derive an explicit solution for the model, and estimate its parameters using the US Survey of Consumer Finances from 1995 to 2013. The results show that our modified mean-variance model fits the data adequately, and that the demographic, occupational and educational characteristics of the investors are relevant in shaping risk aversion and return expectations. In contrast, wealth, income, and past market performance have limited impacts on expectations and risk aversion.

JEL codes: C34; D14; D81; G11

Keywords: Household finance; Risk aversion; Expectations; Mean variance analysis; Truncated and censored models

*Department of Economics, University of Verona, Via Cantarane 24, 37129 Verona, Italy. Email: alessandro.bucciol@univr.it.

[†]Department of Economics and Management, University of Brescia, Via San Faustino 74/b, 25122 Brescia, Italy. Email: raffaele.miniaci@unibs.it.

[‡]Department of Economics, University of Bologna, Piazza Scaravilli, 2, 40126 Bologna, Italy. Email: sergio.pastorello@unibo.it. [Corresponding author]

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