Centre for International Finance and Regulation

Working paper summary

Dynamic asset allocation when bequests are luxury goods

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Earlier studies have focused on theory and evidence in support of the proposition that luxury bequests raise the average level of risky assets in portfolios. This study goes a step further in considering the impact of dynamic asset allocation, and has implications in the area of investment advice.

There is a popular rule of thumb which states that an investor's percentage allocation to equity should be set at 100 minus their age, even in retirement. This contrasts with the results of this study, which examines the impact on asset allocation when bequests are luxury goods.

Previous studies have focused on luxury bequests to explain the high average allocation to equity in the portfolios of well-off investors. Other studies have concluded that as luxury bequests and precautionary savings rates rise, there is a corresponding decline in take-up rates for annuities and long-term care insurance.

When bequests are luxury goods, the decline in their marginal utility is less than that of consumption. This is essentially a manifestation of lower risk aversion. As a retiree approaches death, their expected remaining lifetime utility becomes increasingly oriented towards bequest utility, which, in turn, progressively lowers their aversion to risk. The retiree consequently tends to increasingly favour an asset allocation oriented towards higher-return and risk assets.

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The study data shows the effect of luxury bequests on expected asset allocation for a given initial level of wealth. The findings show that, when bequests are luxury goods, there is a major impact on asset allocation late in retirement. This applies irrespective of the size of the planned bequest.

The study has implications particularly in the area of investment advice: The standard case of constant relative risk aversion assumes a similarity of preferences, implying that advice on asset allocation is scalable. Luxury bequests are at odds with this assumption, thereby strengthening the case for customised advice. Notably, a more aggressive allocation stance may be suitable for more well-off investors with bequest motives.

Concerning financial plans for people of middle means, allocations at the outset of retirement generally need to be conservative. If there is a bear market on the cusp of retirement, it becomes difficult for investors to fully recoup any losses, as ongoing drawdowns deplete remaining wealth and outweigh any boost from rebounding markets. Entering retirement with a high present value of protected consumption relative to wealth represents a theoretical justification for a conservative allocation in the early phase of retirement. Luxury bequests warrant a more aggressive allocation stance later on, thus strengthening the case for an upward tilt throughout retirement in an investor’s expected percentage exposure to equities.