

Hedging Permanent Income Shocks

Abstract

This paper estimates the individual correlation between permanent earnings shocks and an aggregate shock affecting both earnings and stock market returns, exploiting the co-movements across agents' earnings shocks. These estimates imply larger hedging motives than previously thought in both Dutch and US data. They retain statistical significance in predicting both portfolio choice and participation when other measures do not. They explain participation both out-of-sample and for the same individual over time. All results, including others based on the correlation between permanent income shocks and stock returns, consistently support the theoretical prediction that individuals rely on asset markets to help hedge their earnings' shocks.

This paper is joint work with Fabio C. Bagliano, Raffaele Corvino, Carolina Fugazza (University of Torino, CEPR, CeRP - Collegio Carlo Alberto - and Netspar)

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