Return Heterogeneity, Information Frictions, and Economic Shocks

Josue Cox*
New York University

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Abstract

This study investigates the effects of information frictions on returns to net worth and their role in amplifying wealth inequality in the wake of big economic shocks. Using a panel of American individuals, I present new evidence that top-wealth returns among individuals holding similar asset classes are heterogeneous, in part, because of how those individuals respond to economic shocks. Specifically, I show that wealthy individuals who survey data suggests are better informed earn significantly higher returns after big uncertainty shocks compared to less well-informed wealthy individuals. To interpret these facts, I build a dynamic, stochastic, general equilibrium economy subject to uncertainty shocks in which individuals with bounded rationality are heterogeneous in the quality of their private signals about future fundamentals. I show that those with more precise signals earn higher average returns because they are better able to hedge against uncertainty shocks by undertaking a market-timing strategy that exploits their more accurate information about future fundamentals. The model implies that disparities in the quality of economic information lead to greater wealth inequality after adverse shocks.

Keywords: return heterogeneity, information frictions, financial uncertainty, heterogeneous-agent models

JEL Codes: E32, E44, E47, G17

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