Return Heterogeneity, Information Frictions, and Economic Shocks

Josue Cox*
New York University

October 12, 2020

Abstract

This paper studies the effects of information frictions on returns to net worth and how these frictions amplify economic shock to the economy. Using a panel of American individuals, I present suggestive evidence that returns to net worth are heterogeneous and positively correlated with wealth. Then, I establish new dynamic empirical facts that propose wealthier individuals assumed to have information advantages earn higher returns after financial uncertainty shocks hit the economy. To interpret these facts, I build a heterogeneous-agent model in which households present some near-rationality behavior, which can be alleviated by receiving private information about future fundamentals. The model can match macro and financial moments in the data and the dispersion in forecast errors among professional forecasters. Using the model, I show that households with better information advantages can sustain higher net-worth returns. Then, I construct a model-based uncertainty measure similar to the one used in the empirical section. Using this measure, I show that better-informed households can better hedge against uncertainty shocks, resulting in higher relative returns to net worth. The model also suggests better-informed households are involved in a timing-the-market strategy by exploiting the fact that they receive more accurate information about future fundamentals.

Keywords: return heterogeneity, information frictions, financial uncertainty, heterogeneous-agent models
JEL Codes: E32, E44, E47, G17

*I am very grateful to my advisors Ricardo Lagos, Sydney Ludvigson, and Stijn Van Nieuwerburgh for their guidance and support on this project. I would also like to thank Jess Benhabib, Jaroslav Borovicka, Simon Gilchrist, and Venky Venkateswaran for helpful comments, as well as seminar participants at NYU.