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Equilibrium Portfolios and Equity Premium with Wealth Heterogeneity and Uncertainty Aversion

Abstract

We provide a unified theoretical explanation for the following salient patterns of household investments: (i) a sizeable fraction of households do not participate in the stock market, with poorer households less likely to participate, and (ii) among the households that do participate, wealthier ones choose to invest a larger share of their wealth into risky assets than poorer ones. We develop a general equilibrium asset pricing model whose key ingredients are uncertainty aversion, wealth heterogeneity leading to heterogeneity in uncertainty levels across the households, and wealth effect. Solving analytically for equilibrium, we obtain that the equilibrium portfolios are consistent with the above patterns. We also find that a (occurring endogenously) lower participation is associated with a higher equity premium. Finally, we compare our predictions with and without the wealth effect, and find notable differences in equilibrium portfolios, while the link between participation and equity premium is not affected.