DOES RECKLESS RISK OR CAREFUL PLANNING MAKE HOUSEHOLDS WEALTHY?

A Study of the US Based on the Luxembourg Wealth Study Database

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ABSTRACT

In this article I study how financial risk taking and planning of US households affect their probability of having a higher position in wealth distribution between 1995 and 2016. To this end, I analyze the Luxembourg Wealth Study data by means of ordered logit models. My analysis shows that average financial risk taking and long planning horizons (over ten years) are the most beneficial for household wealth. Comparing them with other characteristics, I find that age, education, and income of the household head exert considerably stronger positive effect on wealth. However, both higher risk and long planning horizons do pay off.

HYPOTHESES

01. Higher willingness to take financial risk increases the probability of households to be in a higher wealth quartile group

02. A longer financial planning horizon increases the probability of households to be in a higher wealth quartile group

03. The effect of willingness to take financial risk on the probability of households to be in a higher wealth quartile group is different for every group

04. The effect of a longer financial planning horizon on the probability of households to be in a higher wealth quartile group is different for every group

METHOD

Ordered logit model:
\[ P(Y_i = j) = \frac{e^{\beta_0 + \beta_1 X_i + \beta_2 X_i^2}}{1 + e^{\beta_0 + \beta_1 X_i + \beta_2 X_i^2}}, \quad j = 1, 2, \ldots, M - 1 \]

\[ \beta_0, \beta_1, \beta_2 \] - vector of expression coefficients; \( \beta_1 \) - number of categories of ordered variable

Parallel-lines assumption test
\[ H_0: \beta_1 = \beta_2 = \ldots = \beta_{M-1} \]

Multicollinearity test
Wald test for parallel lines
Proportional odds model
Generalized ordered logit
Automatic Selection procedure

RESULTS

FINANCIAL RISK:
- Substantial
- Above average
- Average

FINANCIAL PLANNING:
- Over 10 years
- Next 5-10 years
- Up to 5 years

+11 control variables

CONCLUSIONS

- The marginal effects of both behavioral factors changed after the global financial crisis.
- The average level of financial risk is the most beneficial for household wealth.
- The correlation between the level of financial risk and wealth depends on wealth group.
- Longer financial planning horizons are inducing to wealth.
- Correlation between the length of planning horizon and wealth depends on the wealth group.
- Age, education, and income-related factors have the strongest positive effect on wealth.