Homeownership as a Constraint on Asset Allocation

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Abstract Personal preferences and financial incentives make homeownership desirable for most families. Once a family purchases a home they find it impractical (costly) to frequently change their ownership of residential real estate. Thus, by deciding how much home to buy, a family constrains their ability to adjust their asset allocation between residential real estate and other assets. To analyze the impact of this constraint on consumption, welfare, and post-retirement wealth, we first investigate an individual’s optimal asset allocation decisions when they are subject to a “homeownership constraint.” Next, we perform a “thought experiment” where we assume the existence of a market where a homeowner can sell, without cost, a fractional interest in their home. Now the housing choice decision does not constrain the individual’s asset allocations. By comparing these two cases, we estimate the differences in post-retirement wealth and the welfare gains potentially realizable if asset allocations were not subject to a homeownership constraint. For realistic parameter values, we find that the homeowner would require a substantial increase in total net worth to achieve the same level of utility as would be achievable if the choice of a home could be separated from the asset allocation decision. The robustness of the analysis is evaluated with respect to the model’s parameters and initial state variables. We find that changes in the values of the constraint (i.e., the value of the home) and the expected real rate of home value appreciation are the only

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