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over the Life Cycle

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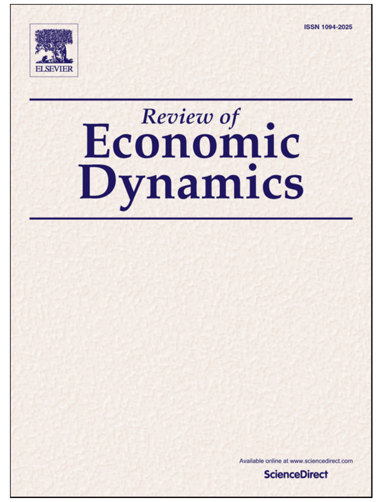

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Financial Sophistication and Portfolio Choice over the Life Cycle*

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Abstract

We develop a novel model of rational choice in the presence of information frictions–frictions which we interpret as arising from imperfect financial sophistication. In our framework, investors with smaller information frictions are better able to distinguish between potential investment vehicles, which both allows them to identify higher-quality assets and reduces the subjective uncertainty about returns to investment for any given asset. We embed our framework into an otherwise-standard quantitative model of saving and investment over the life cycle. Our calibrated model generates substantial financial income inequality across investors and is fully consistent with the empirical evidence that financially unsophisticated investors save at lower rates, participate less in the stock market, obtain less well-diversified portfolios when they do, and as a result, accumulate less wealth by retirement than their financially sophisticated peers.

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