# Monetary Policy and Reaching for Income

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[1] The views expressed are those of the discussant and do not necessarily reflect official positions of Paraconic Technologies US Inc.

# Paper Summary

**Idea**

- Investors "reach for income": demand high D/P stocks in low interest rate environments

**Evidence**

- Retail brokerage: 1% decrease in Fed Funds rate (FFR) $\rightarrow$ 1% increase in high D/P stock holdings for next six months
- Mutual funds: 1% decrease in FFR $\rightarrow$ 5.18% increase in AUM for high-income mutual funds for three years

**Theory/Explanation**

- Asset pricing model with hyperbolic discounting as microfoundation

# Contributions

- In addition to the areas mentioned in the paper...
- Add to the discussion of monetary policy effects on portfolio choice and asset prices
  - Lucca and Moench (2015), Savor and Wilson (2014), Neuhierl and Weber (2018)
  - More broadly, Bernanke and Kuttner (2005), etc.
- Barber and Odean (2000) data to study monetary policy

# Investors Need Commitment Devices

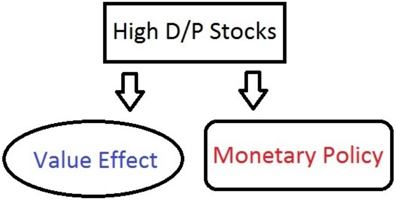
- Friedman (1953): Forget realistic assumptions, just make good predictions
  - This paper has a very realistic assumption
- Market participants appear to exhibit hyperbolic preference

$$\max_{\{C_\tau, \theta_\tau\}_{\tau=t}^{T-1}} u(C_t) + \mathbb{E}_t \sum_{\tau=t}^{T} \beta \delta^{\tau+1-t} u(C_{\tau+1})$$

- Hedge funds often have lock up periods
  - Investors may overreact to small changes in portfolios compared to their overall goals
  - Interventions are empirically suboptimal
  - Need commitment device to realize volatile risk premiums

# What About Value?

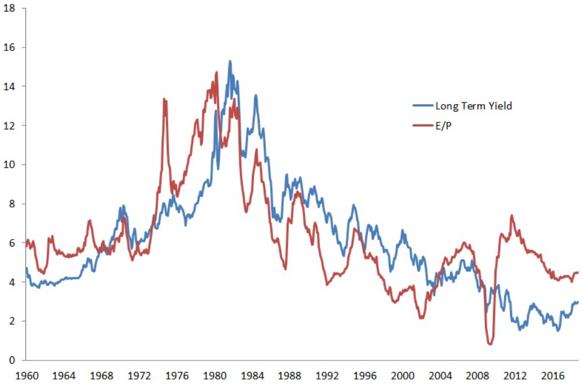
- High dividend yield stocks have high returns: value effect
- Attribute high D/P returns to different channels




- Maybe also interaction $\rightarrow$ monetary policy affects value stocks?
  - Neuhierl and Weber (2018): FOMC does not affect FF value
- Dividend yield is a fundamentally different measure from other price ratios?
  - Investor can eat dividends
  - What happens to high BE/ME, low D/P stock?

# A New Justification for the Fed Model?

$\frac{E}{P} = Y$, "money illusion" as a potential explanation (Asness, 2003)



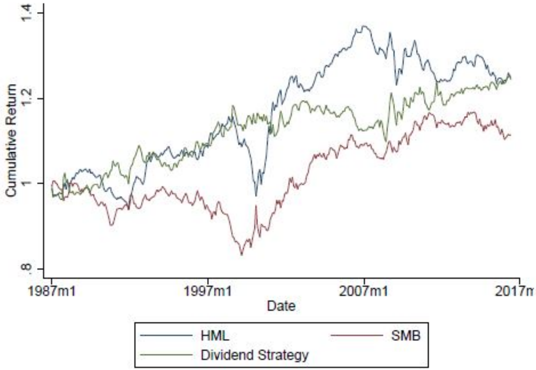

Compare to Figure 2 in the paper, which shows D/P to be more stable than E/P

# Liquidity, Market Microstructure, and Trading

- Paper tries to identify investor demand, and cleverly uses information besides asset prices to help identification
- Supply curve is not perfectly elastic in practice
- Who's on the other side of these trades?
    - Should "reach for income" have pricing implications?
    - Microstructure is often of first-order importance in practice
- Is there a liquidity premium for demanding high D/P stocks?
    - Liquidity effect not large enough to offset impact on asset prices

# A Dividend-Yield Timing Strategy

Long D/P-based value strategy when rates decline, short when rates rise:




- A timing strategy on value!
- Hedge out HML, what is the Sharpe? Isolate monetary policy part

# Additional Comments (Maybe Fanciful)

- Any fixed income instrument investors use to fund consumption should be impacted
- Investors with larger allocation to bonds should react more?
  - Double sort on consumption needs and percent invested in bonds
- Reaching for income = f(level of interest rates, aggregate dividend yield)
  - Level or change in interest rates?

# Conclusion

- Very interesting paper that explores the intersection of behavioral economics and monetary policy effects
- Intriguing interplay with value is worth additional attention
- Why are prices affected?