Life cycle consumption and portfolio choice under real interest rate risk

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We study the implications of real interest rate risk in a realistically calibrated life cycle model. Optimal consumption-investment decisions differ with both the level of the interest rate and its volatility. Higher interest rates lead to higher consumption and lower stock investments. Ignoring the time-varying nature of real interest rates leads to suboptimal consumption-investment decisions, and ultimately, welfare losses. Extended periods of low interest rates, such as in the recent past, can lead to substantial welfare losses, even when behaving optimally.