Title: THE RELATIONSHIP BETWEEN HUMAN CAPITAL OF AN INDIVIDUAL AND PENSION FUND ASSET ALLOCATION

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ABSTRACT

There is a worldwide trend toward defined contribution saving plans and growing interest in pension schemes asset allocation. In both environments, individuals are given some responsibility to make their own asset-allocation decisions, raising concerns about how well they do at this task. This paper investigates one aspect of the task, namely diversification. Considerably, the role of an individual's human capital is questioned in determining its influence on asset allocation of his retirement benefits. This study aims to investigate comparatively whether firms whose employees have equity like human capital and those whose employees' have bond-like human capital take into account diversification in their strategic asset allocation. Human capital characteristics are derived from the optimal life-cycle saving and investment theory credited to Bodie, Merton and Samuelson (1992). An important implication of these models is that the proportion of financial assets invested in equity should decrease over the life cycle, thereby increasing the proportion of relatively safer securities such as bonds. Furthermore, it explains that young employees have more human capital than older employees do. As long as the correlation between labour income and stock market returns is low, a young worker may better diversify away equity risk with their large holding of human capital. The findings from this research reveal that the relationship between human capital and asset allocation of a pension fund is weak. Even so, a scenario analysis reveals that when human capital is considered in asset allocation, the returns obtained outperform the average market returns over a one-year period. The correlation of an individual's labour and other assets is a subjective aspect that requires the probing of investors' heuristics. Any typical investor need not worry about his or her human capital being highly correlated with the stock market when making asset allocation decisions; thus, most investors can invest the majority of their financial wealth in risky assets.