

Research Highlight: Portfolio selection with capital gains tax, recursive utility, and regime switching

Work of Professor DAI Min

Professor Dai Min and his coauthors develop a continuous time investment and consumption model with capital gains tax, Epstein-Zin recursive utility, and regime switching to explore implications of capital gains taxation for investors' portfolio choice decisions. In terms of asymptotic analysis, they find that various factors, such as tax rate, risk aversion, interest rate, stock return, and volatility jointly affect optimal portfolio allocation, whereas intertemporal substitution does not. In a regime switching market, investors may trade or stop trading purely because of a change in regime, and there is a distinct cross-regime effect on optimal portfolio allocation. In particular, investors tend to raise stock investment in a bear regime so as to reduce potential tax payments upon regime switching. Given reasonable parameter values, regime switching has a greater impact on optimal portfolio allocation in a bear regime than in a bull regime.

Reference

Jiatu Cai, Xinfu Chen, and Min Dai, Portfolio selection with capital gains tax, recursive utility, and regime switching, *Management Science* (2018) 64(5), 2308-2324