

Household financial behavior: implications of the current turmoil

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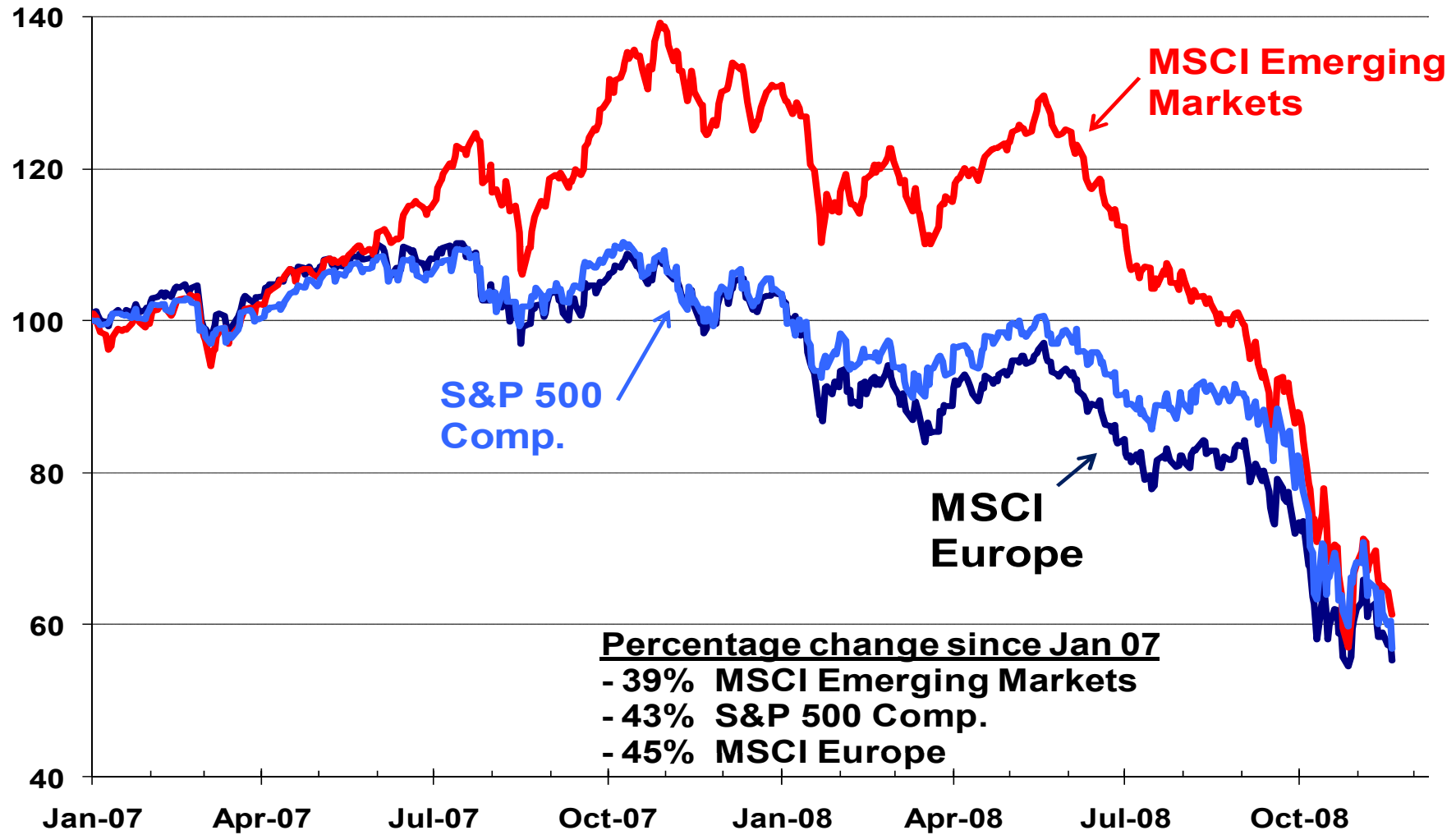
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Global Stock Market Indices

(January 2007 = 100)



Household financial wealth has fallen substantially...

- Stock price declines have led to dramatic reductions in household wealth
- Equity losses from 10/07 peak → 11/20/08
 - \$ 2.5 trillion (401(k) and IRA plans)
 - \$ 4.5 trillion (other households assets)

In response, households are likely to ...

- Reduce consumer spending
- Delay retirement
- Modify their portfolios

Consumers will cut back spending...

- Wealth effect (3% – 5% of wealth decline)
 - Depends on accumulated wealth, equity share, age
 - Probably largest for those near retirement
- Fear of future job and income loss
- Precautionary saving (greater uncertainty)
- all point to **lower** spending, on both durables and non-durables

Workers will delay retirement ...

- Empirical evidence from past episodes mixed
 - Some evidence that bull market of 1990's delayed retirement (stockholders vs non-stockholders)
- Recent suggestive survey evidence (IFEBP)
 - 1089 pension plan sponsors, week of 10/20/2008
 - 46% said employees considering delaying retirement
 - 25% cited an increase in actual number of eligible workers postponing retirement

How will households alter their portfolio allocations?

- Potential active changes
 - Change equity allocation of monthly contributions
 - Transfer existing balances into or out of equities
- Potential passive changes
 - Due to stock price movements (with no rebalancing)

401(k) asset allocations: few active portfolio changes

- Most people choose an initial allocation when they join the plan, and then make very few changes afterwards
- Our study found 44 % of active contributors made NO active changes over a 10 year period to either
 - Allocation of new inflows
 - Allocation of existing balances
- An additional 21% made one change along either or both dimensions

Source: Ameriks and Zeldes, 2004, based on data on 16,000 TIAA-CREF retirement account participants over 10 years

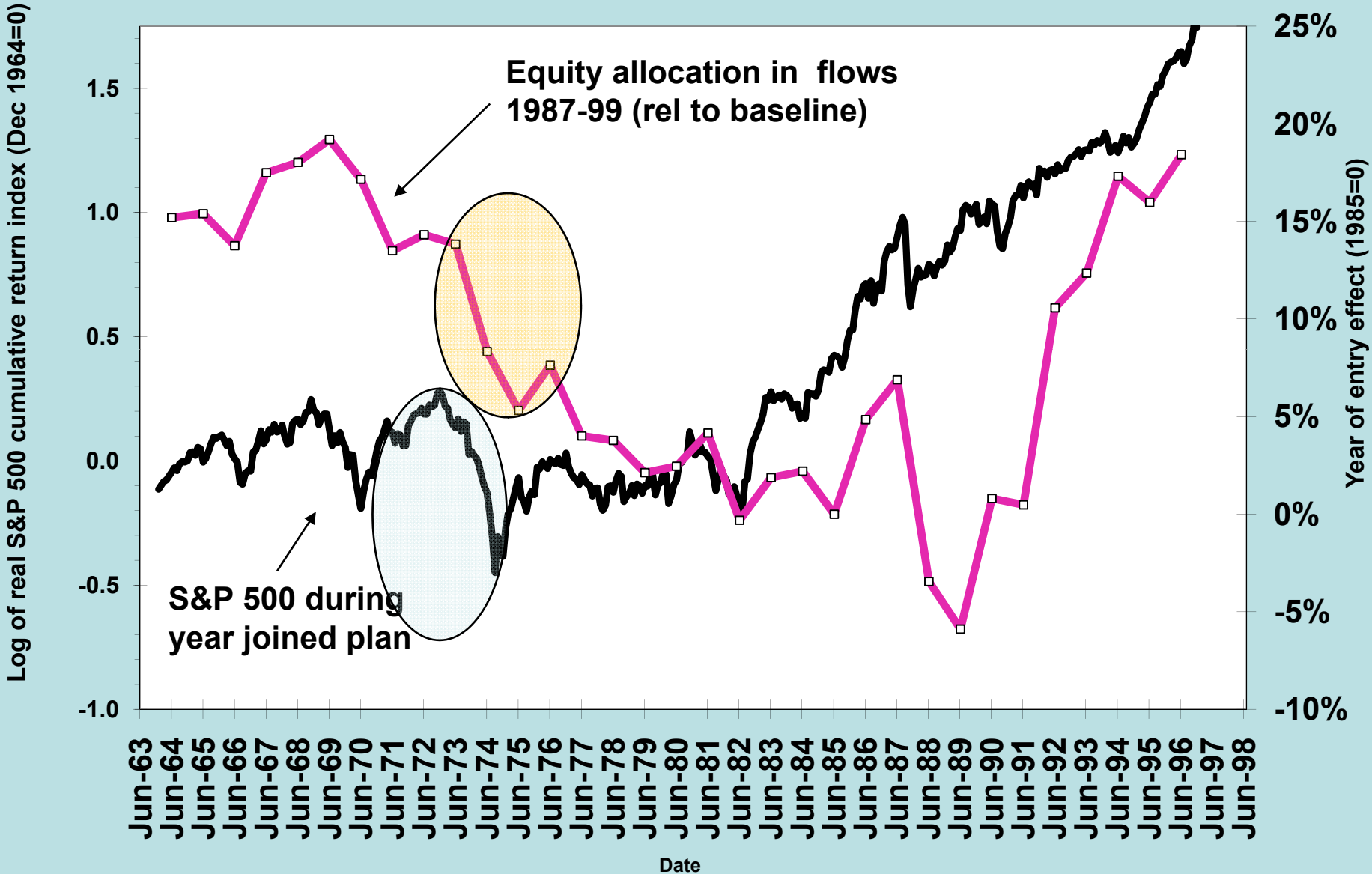
Suggests the importance of examining initial portfolio decisions ...

- Examine behavior when individuals first sign up for their 401(k) plan
- What factors influence the choice of percent of monthly contributions that are put into stocks?

Initial decisions when joining a plan

- Ameriks / Zeldes find evidence of “year of entry effects”
 - knowing what year a person joined a plan informative about allocations to equity many years later
- Large stock market moves just prior to joining influence equity allocations (flow and balance) 20-30 years later
- Stock market fell dramatically between 1972 and 1975
- Equity allocations of inflows in 1987-1999 for those who joined in 1976 were 6 percentage points **lower** than for those who joined in 1972

Relationship between stock prices when participants first joined the plan and equity allocations in 1987-1999



Implication for today...

- New entrants into 401(k) plans likely to allocate a substantially smaller percentage of contributions to equities
- These “year of entry” effects likely to stick with individuals for many years to come
- Caveat: recent rise in popularity of target date funds as default investment will mitigate these effects

What about individuals who do make changes later on?

- Some evidence suggests they react to recent history of stock market returns as well
- E.g. flow equity allocations rose considerably during the bull market of the 1990s

Passive changes

- In the absence of rebalancing, percent of balances held in equities falls automatically when stock prices decline
- Example:
 - 60% initial equity share, 50% price decline

	initial	after decline
stocks	60	30
bonds + cash	40	40
total	100	70
stock/total	60%	43%

Overall: how will the recent turmoil affect equity allocations?

- initial decisions
 - those making active changes
 - passive changes
- Predicted drop in equity exposure, that is likely to persist for a number of years

What advice should be given about equity allocations?

- Depends on our answers to a few questions ...
 - Will current drop be reversed over time or is it permanent?
 - Is the equity premium a compensation for short-run or long-run risk ?
 - Have households changed their understanding of or tolerance for risk?

References

- Ameriks, John and Stephen P. Zeldes. “How do Portfolio Shares Vary with Age?” working paper, Graduate School of Business, Columbia University, 2004.

Other slides

Infrequency of active changes (over 10 years)

Asset Allocation Changes	Flow Allocation Changes						
Count	Zero	One	Two	3-5	6-10	11+	Total
Zero	44.3%	15.3%	6.6%	5.3%	1.1%	0.2%	72.8%
One	1.9	4.2	3.2	3.5	0.8	0.1	13.7
Two	0.5	0.8	1.1	1.9	0.7	0.0	5.0
3-5	0.4	0.6	0.6	2.4	1.0	0.1	5.1
6-10	0.1	0.2	0.3	0.4	0.7	0.2	1.9
11+	0.0	0.1	0.2	0.4	0.4	0.3	1.5
Total	47.1	21.2	12.0	14.1	4.7	0.9	100.0

Source: Ameriks/Zeldes 2004, TIAA-CREF data