Risk aversion

The bonds of time

Jan 8th 2009 | SAN FRANCISCO
From The Economist print edition

Financial decisions are heavily influenced by early experiences

MANY economists are unsettled by the idea of a generation of "Depression babies"—people who grew up during the Depression and, scarred by the poor stockmarket returns of their formative years, were unusually risk-averse in their investments throughout their lives. Standard models assume that individuals use all available information about the present and past to make financial decisions, not that choices are disproportionately affected by their personal economic experience.

Yet new research from Ulrike Malmendier of the University of California at Berkeley and Stefan Nagel of Stanford University seems to confirm that people born at different times make very different financial choices, even in similar economic environments.

Ms Malmendier and Mr Nagel examined detailed survey data about American households' finances between 1964 and 2004. Because they knew when the people in the sample were born, they could calculate the average stockmarket returns and inflation that individuals had experienced over the course of their lives. And because the data tracked financial choices over time, they could also control for factors like age, which matters because the composition of people's portfolios is likely to change as they grow older.

Their work confirmed the Depression babies idea. Under identical market conditions, and controlling for age, people who had experienced lower stockmarket returns over the course of their lives put a smaller fraction of their money into stocks than people who had lived, on average, in times when stocks had done better.

Part of the explanation appears to be that beliefs are disproportionately affected by lived experience. In ongoing work, Ms Malmendier and Mr Nagel also find that people who have lived through periods of high inflation systematically expect future inflation to be higher than those who have not experienced high inflation for themselves.

What is more, the effect of the distant past dissipates much more slowly than the authors had expected, with the impact of events early in life persisting decades into the future. They were also surprised to find that people's eventual appetite for risk is affected by the economic environment during their childhood, well before financial matters could possibly have been of interest.

Then again, Ms Malmendier's interest in these questions arose in the first instance not from her own experiences, but from hearing her father, who was born in 1930s Germany, talk about his worries about inflation. Just be careful what you say when you tell the children about today's crisis.