

## Research Roundup

By Kerry Pechter    Thu, Feb 13, 2020

*These five research papers explain why many institutional investors still work with 'high-touch' brokers, why the economy may slow as populations shrink, why parents might save more than they need to, why middle-aged rural whites are unhappy, and why 401(k) balances aren't higher for older workers.*



Last year, a dark book justly titled “Darkness by Design” (Princeton, 2019), warned that the equity trading world we grew up with—one dominated by the New York Stock Exchange and kept more or less honest by its human market-making “specialists”—has all but vanished.

The author, Oxford political economist Walter Mattli, documents the advent since 2000 of a very different trading world—one that’s fragmented, opaque, and algorithm-driven. It’s a world of high-speed institutional trading and “[dark pools](#)” run by and for insiders to the detriment of individual investors.

Mattli makes a powerful (and scary) case. But a new paper from the National Bureau of Economic Research (NBER Working Paper 26147), “[The Value of Intermediation in the Stock Market](#),” by Mark L. Egan and Marco Di Maggio of Harvard Business School and Francesco Franzoni of the Swiss Finance Institute, tells a slightly different story.

Human intermediation still exists, they write—at least for institutional investors. Studying over 300 million institutional trades, the three economists found that “more than half of all institutional investor order flow is still executed by high-touch (non-electronic) brokers... Trading is and always has been a relationship business.”

While Mattli emphasizes the arms race in electronic trading speeds, Egan et al found that “Investors prefer to trade with equity traders located in the same city as the investor. Even though the equity orders are placed either electronically or over the phone, physical proximity to the broker influences an investor’s trading decisions.”

Large investors are less interested in fundamental research on stocks than in order flow information, the NBER authors found. Such information helps them avoid moving the market ahead of a large trade or, conversely, helps them anticipate other investors’ large

trades and buy or sell ahead of it.

“Hedge funds appear to place a premium on the other types of information produced by brokerage firms, such as whether or not the broker has access to informed order flow,” Egan et al found.

Where Mattli finds that brokers worry less about protecting their personal and professional reputations today, in part because they are employees rather than partners in small firms, Egan et al found that reputation matters to investors.

“A one percentage point increase in the number of traders engaging in misconduct (roughly one additional trader for a median-sized brokerage firm) is associated with a 2% decline in the brokerage firm’s trading volumes,” they write.

### **Dynastic Precautionary Savings**

Uncertainty about a child’s success or failure in adulthood may determine how much the parents try to save during their own working years and how much they refrain from spending in retirement.

That statement may seem obvious, given most parents’ natural concern for their children. But new research suggests that this motive may be stronger than the usual explanations for frugality among retirees, such as their desire to hoard money against the risk of living too long or needing long-term care.

New York University economist Corina Boar calls this type of thrift, “[\*\*Dynastic Precautionary Savings\*\*](#),” in her paper of the same name (NBER Working Paper 26635). She claims that parents generally create and keep a safety net for their children from roughly the time children enter the workforce until the parents die, about 30 years later.

“Parents of children younger than 40 consume on average \$2,528 less per year because at that stage most of children’s income uncertainty is yet to be resolved,” Boar writes.

“Holding everything else equal, the consumption of a parent whose child is a construction worker is 2.5% lower than the consumption of a parent whose child is a services worker because of the dynastic uncertainty difference.”

Boar’s theoretical model predicts that “16.7% of total wealth is held for dynastic precautionary reasons, and that children’s income risk is the main driver of intergenerational transfers.” It also predicts that this parental savings accounts for about

one-fourth of the adult children's own cushion against a big drop in income.

### **Unintended Consequences of a Declining Population**

It's America's low fertility rate, not just the jumbo size of the baby boom generation, that's causing fiscal imbalances in government programs, demographers will tell you. Falling fertility and shrinking populations is, in fact, expected to act as a drag on economic growth in all of the wealthy industrialized countries.

"The emergence of negative population growth in many countries... has profound implications for the future of economic growth," writes Charles I. Jones of Stanford's Graduate School of Business in his new paper, "[The End of Economic Growth? Unintended Consequences of a Declining Population](#)" (NBER Working Paper 26651, January 2020).

In Jones' view, we're nearing a tipping point on declining human replacement rates. "If society waits too long to adopt good institutions, the optimal allocation switches from one of sustained exponential growth in population, knowledge, and living standards to one of stagnation and an empty planet," he warns.

Long-term improvement in living standards could depend on whether a smaller population can manage to generate the innovation needed to deal with future economic threats. Jones ends with a suggestion that automation—perhaps artificial intelligence—could offset the reduced number of human innovators.

### **Unhappiness and Age**

People in their 50s—those bearing the most responsibility, debt, and dependents—are less happy than people younger or older, according to David G. Blanchflower, an economist at Dartmouth College. In "[Unhappiness and Age](#)" (NBER Working Paper 26642), he writes, "There appears to be a midlife crisis."

Blanchflower gathered data on fifteen different aspects of unhappiness among nearly ten million respondents across forty European countries and the United States. Those aspects included "despair; anxiety; loneliness; sadness; strain, depression and bad nerves; phobias and panic; being downhearted; having restless sleep; losing confidence in oneself; not being able to overcome difficulties; being under strain; feeling a failure; feeling left out; feeling tense; and thinking of yourself as a worthless person," according to the paper.

While there has always been a midlife crisis, Blanchflower believes, the 2008 Great Financial Crisis made the situation worse, especially for people living in rural areas, dependent on manufacturing jobs, and with less than a college education. Urban areas bounced back after the crisis, but mortality rose in rural areas. “The death rate in rural areas from heart disease, cancer, unintentional injury, chronic lower-respiratory disease, and stroke” was much higher than in urban areas.

While the age-adjusted suicide rate in urban counties in the U.S. rose 16% between 1999 and in 2017, it rose 53% in rural counties, Blanchflower’s data shows. By 2017 the suicide rate in rural counties (20 per 100,000) was nearly double that of urban counties. Drug-overdose death rates were higher in cities in 1999, but by 2015 it was higher in rural areas.

Linking his findings to the political arena, Blanchflower asserts that President Donald Trump in the U.S. and Prime Minister Boris Johnson in the U.K. recognized this despair and leveraged it into political victories. “Areas that were left behind voted for Trump and Brexit,” the paper says. “In both instances the votes for change were positively correlated with the unemployment rate, low life expectancy, drug use, the smoking rate, the obesity rate and how poor the area was.”

#### **Why Are 401(k)/IRA Balances Substantially Below Potential?**

While 401(k) retirement plans have helped millions of workers amass trillions of dollars in wealth over the past 35 years or so, millions of participants in those plans fail to accumulate enough savings by age 65 to finance their retirements.

In a recent paper, [\*\*“Why Are 401\(k\)/IRA Balances Substantially Below Potential?”\*\*](#) Alicia Munnell and Anqi Chen of the Center for Retirement Research at Boston College, and Andrew Biggs of the American Enterprise Institute quantify and explain that failure.

“Most workers have 401(k)/IRA balances at retirement that are substantially below their potential,” they write. “For example, a 25-year-old median earner in 1981 who contributed regularly [6% of pay with a 3% employer match] would have accumulated about \$364,000 by age 60, but the typical 60-year-old in 2016 had less than \$100,000.”

They identify four drivers of this shortfall—the fact that the 401(k) system is relatively new, the fact that people don’t always work for an employer that offers a 401(k) plan, so-called “leakage,” which refers to withdrawals from plan balances during job-changes, and fees that act as a drag on accumulation.

Of those factors, immaturity of the 401(k) system is the biggest problem, they found. On average, it shaves \$116,200 off the \$364,000 ideal accumulation. Inconsistent contributions, which is related to the “coverage gap” (only about half of workers have access to a plan at any given time), reduces accumulations by another \$111,600.

Leakage and fees have less of an impact. Leakage—hardship withdrawals, for instance—reduces the ideal balance by \$30,600. Fees, which have fallen in recent years, reduce the ideal balance by only \$13,400, the authors found.

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