Your financial crisis is different from my financial crisis

By Editor Test *Wed, Jun 22, 2011*

New research from Olivia S. Mitchell of Wharton's Pension Research Council et al shows that financial crises are felt differently by the young and the old, and by those who either suffer "triple whammys" or are "doubly fortunate."

Different people respond to major financial crises in different ways, depending on their age when the crisis hits, on whether they hang onto their jobs or not, and how much their portfolios were exposed to equities.

So says a new research paper written by Olivia S. Mitchell of Wharton's Pension Research Council along with Jingjing Chai, Raimond Maurer, and Ralph Rogalla and published by the National Bureau of Economic Research.

The paper contrasts the outcomes for the young and the old as well as the different consequences felt by those who suffer "triple whammys" and those who are "doubly fortunate."

"Not all households may be affected similarly by the business cycle," the authors write. "An individual suffers from a '*triple whammy*' if he experiences a financial/economic crisis at the beginning of the analysis, is unemployed in at least two of the first four years thereafter, and also suffers from below-first quartile cumulated stock market returns until age 62 when he becomes eligible for Social Security benefits.

"By contrast, we define a *doubly fortunate* individual as someone that never experiences a financial/economic crisis, is never unemployed to age 62, and experiences above-average capital market returns to age 62 with cumulated stock returns in the top 25 percentile."

The authors also looked at how a financial crisis can change people's investing habits, their appetite for annuities or liquid investments, and their decisions about when to retire. With regard to older people, they wrote:

"Households near retirement will reduce both short- and long-term consumption, boost work effort, and defer retirement. Younger cohorts will initially reduce their work hours, consumption, saving, and equity exposure; later in life, they will work more, retire later, consume less, invest more in stocks, save more, and reduce their demand for private annuities.

"When older persons are hit by a combined financial and economic crisis, they are predicted to boost work effort slightly, around 0.3-1.3 percent, over the rest of their work lives. Moreover, their average retirement age rises slightly as well (less than one month). The crisis is felt, instead, in more marked declines in annual consumption, both short- and long-term.

"Compared to a non-crisis scenario, consumption drops by 3.5% before retirement and by around 4.5% after age 80. Households reduce their asset withdrawals by about 2.5% over the short-run and by about nine percent later in life. During the immediate crisis, households reduce their equity exposure by more than 20%, on average, in favor of risk-free bonds.

"Over the longer run, however, investors have a marginally higher appetite for liquid assets, both stocks and bonds, than investors in a non-crisis scenario. Consequently, the level of annuitization decreases.

"Those older households hit especially badly by unemployment and stock market shocks must substantially boost their work effort, by over 20% in their early 60s. Moreover, they cannot afford to retire early and must postpone retirement by about one year, on average. Yet they still experience consumption losses of about 10% in the short-term and about 15% later in life.

"While they are able to dampen the immediate impacts of the crisis through an increase in withdrawal of financial assets (about 30% at age 55), the corresponding drop in financial wealth results in substantial cuts in withdrawals later in life (more than 40% from age 70). These households reduce their equity exposure only by 10% early in the crisis. Over the remaining life-cycle, allocation to stocks is substantially higher than that of households in the non-crisis scenarios.

Regarding younger people, the authors wrote:

"We show that for young households, the financial/economic crisis will have little impact on either work effort or retirement behavior, though they do suffer from a long-term decline in annual consumption accompanied by lower saving. Stock fractions are marginally lower at the onset of the crisis, but over the remaining life-cycle, asset allocation does not change much.

"Young households hit particularly badly by the financial/economic crisis do have more response, reducing their work effort during the crisis by up to 10%; later in life, they must boost work hours substantially – over 20% at age 60 compared to the non-crisis scenario, and must defer retirement by one year on average. Lifetime consumption is also lower: in their early 20s, it is about 15% less, and five percent less even after age 70.

"The other effect is that young households must save substantially more than non-crisis households later in life, to build up at least some financial wealth. Low savings early in life go hand in hand with low stock investment; thereafter, from about age 40 on, equity exposure is continuously higher than that of non-crisis households, while both bond investments and annuity purchases are reduced.