



# The shadow of the past: Financial risk taking and negative life events



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## ABSTRACT

Based on data from the four 2004–2010 waves of the US Health and Retirement Study (HRS), we show that financial risk taking is significantly related to life-history negative events out of an individual's control. Using observed portfolio decisions to proxy for risk taking, we find correlation with two of such individual-specific events: having been victim of a physical attack and (especially) the loss of a child are associated with lower and less frequent investments in risky assets, with an intensity similar to that of the beginning, in 2008, of a collectively experienced event such as the recent financial crisis. We also find evidence that the correlation of risk taking with a child loss is long-lasting, as opposed to the correlation with a physical attack that disappears after few years. Our analysis is more in favor of a preference-based – rather than a belief-based – explanation of the observed change in risk taking. Overall our findings indicate that the past, especially through the loss of a child, casts a long shadow that extends over individuals' current decisions also within unrelated domains.

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## 1. Introduction

Risk taking may well be one of the most fundamental dimensions that economists investigate in order to explain individual differences in behavior. Empirical studies by economists have identified a wide range of individual characteristics, such as age, gender, education, wealth, parental education, cognitive ability and financial literacy, that appear to be correlated with risk taking (see, e.g., Guiso & Paiella, 2008; Dohmen et al., 2011). However, despite these important discoveries, risk taking still remains, to a large extent, a 'black box' as relatively little is known about its determinants, i.e., how it gets formed (see, e.g., Dohmen, Falk, Huffman, & Sunde, 2012). Recent studies show that genetic traits account for about 20% of the variation across individuals in financial risk aversion (Cesarini, Johannesson, Lichtenstein, Sandewall, & Wallace, 2010). Other work indicates that risk attitudes can vary in the short-term for the same person as a function of, e.g., identity priming

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(Benjamin, Choi, & Strickland, 2010). There is also a small but growing body of research by economists, which we review in the next section, examining the impact of life experiences on risk attitudes. Part of this research has investigated the role of prior experiences, such as financial busts, that could plausibly change people's expectations of likely outcomes; that is, for example, living through the Great Depression could make people believe that depressions are more likely to occur or are likely to be more severe.

In this paper, we aim to contribute to this strand of literature by providing an empirical analysis focusing on the relationship between individual-specific *life-course negative events* and financial risk taking. Drawing on research in psychology showing that traumatic events can produce wide-ranging and long-lasting consequences on one's dispositions, we hypothesize that individuals who have experienced negative past events out of their control will significantly differ in their willingness to take financial risks. In other words, one's personal history might cast a long shadow extending to current decision-making also within unrelated domains.

We proxy financial risk taking with panel observations on the holdings of stocks in the financial portfolio taken from the 2004–2010 waves of the US *Health and Retirement Study*. An already established strand of literature looks at the financial decision to hold stocks to infer risk taking (since the seminal contributions of Cohn, Lewellen, Lease, and Schlarbaum (1975) and Friend and Blume (1975)) and connects it to macroeconomic events in life history, such as the recent financial crisis (Malmendier & Nagel, 2011; Bucciol & Miniaci, 2014). The contribution of this paper is fivefold: first, unlike most of prior economics work on the theme, we mainly focus on the relationship between risk taking and individual-specific, *idiosyncratic* – rather than collectively experienced – events out of an individual's control; second, we are able to compare the impact on portfolio choice of such personal events with the impact of a macroeconomic shock such as the recent financial crisis; third, we jointly consider different shocks, which allows us to compare the relative strength of different effects; fourth, we analyze the relationship between financial risk taking and the timing of the events that we examine; fifth, we seek to understand whether financial risk taking varies as a result of a shift in preferences or via a change in beliefs.

We provide evidence that risk taking is significantly correlated with two types of prior life experience, that is having been victim of a serious physical attack and the loss of a child. Specifically, we observe less frequent investment in stocks when any of these two events is present. These correlations survive after controlling for classic socio-demographic determinants of risk taking as well as for the impact of the recent financial crisis. The effects of the two personal events are quantitatively similar to that of the collectively experienced event of passing from year 2004 to year 2008, i.e., going through the first phase of the current crisis. Our analysis further reveals that the negative correlation of risk taking with child loss is long-lasting, as opposed to the correlation with a physical attack that disappears after few years. Next, we provide evidence suggesting that financial risk taking seems to vary as a result of a shift in preferences more than via a change in beliefs.

The remainder of the paper proceeds as follows. Section 2 provides a short and selective review of the streams of literature investigating the long-term effects of prior life experiences. Section 3 describes our data and methodology. Section 4 illustrates our core findings and Section 5 concludes.

## 2. Prior life experiences and current decision-making

In the last decades, several papers both within and outside the economics literature explored the effects of prior life experiences on current individual decisions and well-being. Outside the economics literature, a number of recent studies have shed light on the adverse (direct and indirect) *economic* consequences later in life of negative life events such as losing a child (e.g., Knodel & Im-em, 2004), having a life-threatening illness (see, e.g., Sachs & Malaney, 2002, on malaria; Yach, Stuckler, & Brownell, 2006, on obesity) and suffering a physical loss (e.g., Miller, Cohen, & Rossman, 1993, on injuries from violent crime; Boden, Biddle, & Spieler, 2001, on workplace illnesses and injuries). On top of economic consequences, a large variety of articles in medicine and psychiatry document that exposure to trauma can produce lasting consequences on *mental* and *physical health* (Carmil & Breznitz, 1991), including the well-known 'post-traumatic stress disorder' (Yehuda, 2002). In the psychology literature, Sacco, Galletto, and Blanzieri (2003) examine the psychological impact of the 9/11 terrorist attack on Italian subjects' risk aversion, offering evidence of an indirect effect of that traumatic event. Holman and Silver (1998) investigate the relation between temporal orientation and long-term psychological distress in three samples of traumatized individuals. Their findings indicate that a tendency to focus on prior life experiences is correlated with high levels of distress long after the trauma had passed. Elder (1999) documents that individuals are most affected by seismic events early in life.

In economics, the empirical literature examining the influence of negative past experiences on individuals' preferences, beliefs and other economically relevant variables is relatively new. Some recent papers focus on the impact on individuals' risk attitude of collectively experienced events such as natural disasters (e.g., floods, hurricanes and earthquakes), wars and economic crises. In particular, the works closest to ours are Eckel, El-Gamal, and Wilson (2009), Malmendier and Nagel (2011), Cassar, Healy, and von Kessler (2011), Voors et al. (2012), Callen, Isaqzadeh, Long, and Sprenger (2014), Cameron and Shah (2015) and Kim and Lee (2014).<sup>1</sup> Eckel et al. (2009) examine the short-term effects of Hurricane Katrina and find that the evacuees exhibit risk-loving behavior. Malmendier and Nagel (2011) investigate whether the experience of a large macroeconomic shock such as the Great Depression shaped the willingness to take risks of so called 'Depression Babies' later in life.

<sup>1</sup> However, it is worth noting that, compared to these papers, we consider a larger set of potentially meaningful events characterizing people's past life. Next, as we made clear in the Introduction, we focus on individual-specific, rather than on collectively experienced, life events.

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