

## Investors can learn from losses

COLIN READ, *Everybody's Business*

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— Many, economists included, feared opening their 401k statements the past two quarters. A colleague of mine went so far as to purposefully misspell the password for his online retirement statement so the Web site would automatically cut off his access. While he is much happier to open his retirement statements over the past couple of months, I expect his investment behavior will be affected for some time to come.

Now that markets are turning around and those that held on in the stock market are making gains again, we can ask the question — why does the pain of loss seem to outswamp the joy of gains of similar size?

There are actually a number of reasons.

Economists have developed a theory of diminishing marginal utility that predicts the economic pain we suffer from a loss is larger than the enjoyment we receive from a gain of identical size. It also predicts we would rather have ten small losses over time than a single loss ten times the size.

This theory of diminishing marginal utility explains why we buy insurance. We would rather pay the premiums than experience the rare catastrophic loss.

The reasoning behind this theory is that our enjoyment rises, but at an ever decreasing rate, as our wealth increases. As our net worth increases, each additional bit of wealth is less valuable to us. While entrepreneurs often prize, and even frame, the first dollar they earned, they never display their last dollar earned.

There is another reason for the more acute pain we experience from a significant loss. When we have more wealth, our tolerance for risk is higher. Because high-income individuals value their last dollar of income less than someone of more modest income, a high-income individual is more willing to risk some of their wealth. And because high income offers an economic security blanket, the wealthy can tolerate and suffer losses that may impose financial ruin on someone of lower income.

The recent global financial meltdown reduced wealth for most everybody, worldwide. Almost half of the global asset value of homes and investment was wiped out. Those who previously felt they were financially secure, and willing to tolerate some risk, found themselves much less wealthy all of a sudden. And with this loss of wealth came much greater anxiety with their loss of financial security.

The global financial meltdown made us all less financially secure, more appreciative of the remaining assets we have, less willing to take risks, and less willing to borrow for speculative purposes. These factors turned a global financial meltdown into a global economic meltdown.

These are values we have seen before. When we speak of the generation growing up during the Great Depression, we refer to a culture of individuals who preferred to spend within their means, who were averse to financial risk, and who appreciated a dollar earned.

The Depression Culture valued hard work, and was suspicious of wealth or income that came too easily.

The Depression Culture was the opposite of the Roaring Twenties Culture. We have once again become painfully aware of this boom-to-bust cycle. We realize that the economic lows we just experienced were simply the other side of the coin from the unsustainable highs we experienced just a few years ago.

No one would have wanted the decade-long boom to stop. The party was on and the punchbowl was constantly spiked. We have all sobered up now and we recognize the folly of growth based on debt and financial shenanigans, rather than hard work and dedication.

Many ask if our economy will recover just as quickly as it spiraled downward. They harbor hope that we are experiencing a V-shaped recession, with a steep downturn followed by an equally dramatic upturn.

I do not believe such a V-shaped recession will occur. It assumes we can return to exuberance just as rapidly as we plunged into economic despair. It assumes we have not learned our lesson about unsustainable financial growth.

Instead, I predict we will find consumers will come out from under cover only slowly. And we will be more careful and thoughtful with our spending. We will likely save at a much higher rate than before, and we will be loathe to incur significant debt. The recession has changed us, if not permanently, at least for the near future. If these new economic sensibilities put our economy on a much more robust and sustainable foundation, this change is a very positive transformation.

We will invest again. Those who were scared out of financial investment markets and parked their remaining cash on the sidelines are looking cautiously for investment opportunities in the stock market again. The market is beginning to rise, and should slowly recover at a much more measured pace.

Firms will begin to produce again, having drawn down their inventories for the past few months. As they rehire, they too will do so with much greater caution. They don't want to again be vulnerable in uncertain times, and they value productivity and efficiency more now.

Most firms are not going to rehire all those they let go. Some of the unemployed will remain unemployed for some time yet. It may actually take years of real economic growth to rid the economy of an unemployment rate driven sky high in just a year and a half.

This careful recovery is a good thing, too. Our memory of a scary economic period will force us all to think more about what we have to offer the marketplace, and how the marketplace will value us. Those who retained their jobs should feel fortunate that their economic pain will heal eventually.

And those who lost the jobs that are not coming back are forced to reinvent themselves in some pretty significant ways. They are the faces of this hardship. They are the real victims of financial skullduggery.

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