Laudatio by Prof. Guido Friebel

Do bad experiences have long-run effects on people's behavior?

Let me give you two examples from Germany. Observers are oftentimes puzzled, sometimes flabbergasted, about Germans' concerns about inflation – even in times when inflation is very low. Maybe, though, the historical experience with hyperinflation may explain this, at least, partially?

And, recently, (ex)candidate Friedrich Merz suggested a reform of the German pension system – people should invest part of their savings in shares, a subsidized system that was introduced as early as the nineties in NZ and Sweden. The media, though, were quick to recall the Telekom IPO campaign with Manfred Krug, which was followed by a steep decline of the share price and many investors losing their money. Would people really invest given this bad experience?

Two problems need to be solved to substantiate the hypothesis that bad experiences may shape economic behavior.

First, the magnitude of the effect on past experience on current economic decisions is hard to measure. In the inflation example, this seems natural, because almost a century has passed since the 1920s. But even in the case of more recent shocks, say the financial crisis of 2007-2008, we need to filter out a multitude of confounding factors. How can we do this? We cannot really design an experiment ourselves to test this causally but must rely on observational data.

And, second: which psychological force would be likely to cause behaviors that seem to be related to a crisis?

The paper "**Once Bitten, Twice Shy: The Power of Personal Experiences in Risk Taking**" by Tobin Hanspal with coauthors Steffen Andersen and Kaspar Meisner Nielsen provides compelling answers to both of these important questions.

The authors find clean causal evidence that experience with the financial crisis substantially affects investment strategies in more recent times. In the data set from Denmark that they use, people who have experienced the financial crisis first hand by losing parts of their assets have a substantially smaller propensity to invest in risky assets some years later. And, they show that this effect is large.

To understand what “large” means, it is useful to understand the setting that the authors consider.

The authors skillfully match a number of Danish data sets. (Some of you may know that the Nordic countries are a dream for empirical economists). The centerpiece of this matched data set is information about inheritance. When people die, they leave behind assets. Death is (pretty much) an exogenous event, but death of a family member may be anticipated. So, in order to exclude the (unlikely) effect that in anticipation of inheritance people adapt their investment strategy, the authors also look at a subset of sudden deaths.

Now back to the question of how the bad experience with the financial crisis may affect people’s investment. Let me introduce to you Ida, a typical Danish investor. Like many of her compatriots (actually a majority of people owning stock), Ida owned stock of the bank that managed her account before the financial crisis hit Denmark. And like many of her compatriots, she lost 15% of her assets when “her” bank defaulted.

Lucky Ida, because a few years later, she inherits an investment portfolio. How does Ida, who had bad experience with the financial crisis, decide on her portfolio compared to say Emma, who did not lose money in the crisis?

The authors find that Ida deliberately adjusts her investment portfolio by shifting assets from more risky investments such as stock and mutual funds to less risky assets (for instance government bonds). Had Ida -- after her inheritance --not adjusted her portfolio, she would have roughly one third of her liquid assets in stocks and mutual funds. However, because she was hit by the financial crisis before, she only holds 20% of her liquid assets in stock and mutual funds.

All of this sounds straightforward now, but when reading the paper, it becomes evident how much excellent work was put in this paper. The authors have created a very compelling real-world lab to investigate the mid-term effects of bad experience with risky assets. Their data also allow for them to go beyond measuring the effect of first-hand experience. They show that bad experience in the family (second-hand experience) also has some, but much smaller effect, while just knowing people, for instance on the level of the municipality, have no discernable effects.

Let us now get back to the second question of what causes these changes. We would be tempted to say that experience with risk causes a change of preferences for risk. There is however a main conflicting factor. People expose a good deal of inertia in their investment decisions. This is where, again, the real-world lab that the authors have set up, and their plethora of data comes handy: their paper measures precisely the active and voluntary readjustments of the portfolio after an inheritance, which kicks out the inertia explanation. If anything, because of inertia, the paper is likely to provide an underestimate of the preference shift to less risky assets as a consequence of exposure to the financial crisis.

This paper is a joy to read. The data are fantastic, and I would like to congratulate the authors to their lovely identification strategy.

The paper shows that using observational data can lead to great insights about very fundamental questions, here, how our preferences get shaped by good or bad experience.

The jury of the Sturm und Drang Prize agreed that despite very strong competitors, the paper was the best this year and that it continues a great tradition of this prize. Congratulations!