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Bad Stock-Market Timing Fueled Wealth Disparity

Research Shows Many Households Sold Shares During Downturn

By Josh Zumbrun

Millions of Americans inadvertently made a classic investment mistake that contributed to today's widening economic inequality: They bought high and sold low.

Late in the stock-market booms of the 1990s and 2000s, more U.S. families clambered into stocks as indexes surged. Then, once markets tumbled, many households sold and took losses.

Those that held on during the most recent collapses reaped the benefits as stocks nearly tripled between 2009 and today.

The split path is one driver of stark inequality in the U.S. Many workers have seen their wealth and incomes drop despite more than five years of economic expansion in the U.S. Some fear the gap, widening for decades, could fracture society and slow the nation's potential for economic growth in the long run.

"One unfortunate effect of recessions and stock-market declines is they often induce people to exit the market at exactly the wrong time," said Dean Maki, chief U.S. economist at Barclays and a former Fed researcher on consumer balance sheets. "In retrospect, anyway, the right thing to do would have been to buy more equities at the trough, not to sell equities at the trough."

With markets again gone wobbly after a half-decade surge in stocks, the pattern threatens to repeat. The S&P 500 index closed down as much as 7.4% from its mid-September peak until mid-October, unsettling some investors.

New research from the Federal Reserve and the University of Michigan shows the role that panic about the market played in widening wealth inequality.

The Fed's Survey of Consumer Finances shows that among the bottom 90% of households by wealth, families bailed out of the stock market between 2007 and 2010—the central bank's study is conducted every three years—and between 2010 and 2013. The total share with stockholdings declined by 4.4 percentage points. That's the equivalent of 5.4 million households selling stocks, even as the market rebounded. Only households in the top 10% have been increasingly likely to own stocks.

To be sure, some households that sold stocks had little choice.

The 2007-2009 recession pushed the unemployment rate to 10% just as equities declined more than 50%. Families struggling with job loss or mortgage problems may have had no choice other than selling at a loss.

But the data suggest some investors simply sold at the wrong moment. "Even at the worst of the recession, most people still had jobs," said Mr. Maki. "Certainly, some of the people who got out of the equity market were doing it because of fear rather than need."

That's also the finding of new research from economists Bing Chen and Frank Stafford at the University of Michigan. They plumbed the Panel Study of Income Dynamics, a survey that tracks the same households over time, to evaluate the factors behind their fluctuating incomes and wealth.

Households with the highest education and strong portfolios to begin with were likely to keep buying stocks during the decline, they found. Those with less education and smaller account balances were more likely to sell during the downturn.

When the subsequent rebound happened, the already rich got even richer.

The finding holds even after controlling for job loss or mortgage distress, meaning some families simply sold at the wrong time. Even those that outearn 80% of other families—an income of about $120,000 a year—are 5% less likely to own stocks now than in 2007, according to the Fed’s survey.

Mr. Stafford speculates that many households, after being burned by the market, won’t have anything to do with it. The Fed’s survey suggests many of these households have bailed from traditional assets and only increased the amount of saving that they are doing in transaction accounts.

Imagine two well-off households, each with $100,000 in the stock market in 2007. A family that sold in 2009 after losing half its portfolio’s value may now have $50,000 in a savings account. A family that held on would now have about $130,000 in stocks. The inequality has yawned merely because of the investing decisions. In the long run, those savings accounts have a vanishingly small chance of outperforming stocks.

“I have colleagues who say that these small-scale guys got burned and won’t come back, and I don’t think that’s the right answer,” said Mr. Stafford. “Unless we get a flash of brilliance for a new pension system, stocks are a really important ingredient.”

The gains in wealth have especially accrued to just the top 3% of families in recent decades, according to the Fed. Those families held 54% of wealth in 2013, up from 45% in 1989. The bottom 90% now hold 25% of wealth, down from 33%.

Wealth inequality in the U.S. has many causes, some of which precede the recent booms and busts, and the new research doesn’t quantify exactly how much the stock-market timing contributed to it. The widening gap in incomes stretches back nearly 31/2 decades. Long-term unemployment rose in the recession and has yet to recover. And the decline in real estate hit many middle-class families that stored much of their wealth in their homes.

In addition, many households never owned stocks to begin with. Among those with earnings in the bottom fifth, for example, 89% don’t own stocks, up from 86% in 2007.

There are signs that investors may now be returning to stocks since the latest Fed survey was conducted. Last year was the strongest for inflows into stock mutual funds since 2004, according to the fund tracker Lipper.

It could be the case that a stock collapse is around the corner and those who stayed in the market will lose even more money than those who sold in 2009. Maybe this time is different and panic will be warranted.

But history suggests stocks will do well in the long run, despite their volatility, for those who hang on to the investment. University of Pennsylvania economist Jeremy Siegel has calculated stocks have returned an average 6.7% a year over the past two centuries, outperforming bonds, gold and the dollar.

Still, market declines continue to spook some investors into selling at huge losses.

“We haven’t come up with the solution to prevent people from doing it yet,” said Shai Akabas, an economist at the Bipartisan Policy Center in Washington who works on the center’s Personal Savings Initiative.

“But there certainly is a widening gap there in terms of the return that higher-income people are receiving in the market,” said Mr. Akabas. “Lower- to middle-income people aren’t privy to those gains. That’s exacerbated by the fact that many of them have taken their money out of the stock market.”

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