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When the nest egg cracks

For many, their paper gains seem to erode

By Lesley Mitchell
The Salt Lake Tribune

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Economists have long marveled at how rising home prices and a vibrant stock market can make people feel really good about their financial situations - so good in fact, that they spend more freely.

It's called the "wealth effect" - and even people who haven't actually realized a gain by selling their homes or stocks at a profit can feel it. Although this feeling can make them happy during good times, the wealth effect also can create despair in times such as these, when those paper gains evaporate and real losses loom.

Just ask Laura Polacheck of Salt Lake City.

Polacheck bought her home in the Avenues in April 2006, at the height of the Wasatch Front's red-hot real estate market. Prices in the Avenues had been rising by double digits for years, giving many homeowners gains - on paper anyway - of \$100,000 and beyond.

But Polacheck got married and bought a house with her new husband - and wound up with a home in the Avenues she no longer

needed. She put the property on the market in June, when the latest boom began to sour, and it has yet to sell.

So she has joined the ranks of others in Utah where, even though jobs remain plentiful and other economic signals remain comparatively strong, the downturn in real estate and the shaky stock markets have many families feeling worse off than they have in years.

"I haven't even had any offers - even though the asking price is now below what I paid for it," she said.

Rather than turn her paper loss into a real one, Polacheck is renting out her home to cover part of her mortgage until the market improves.

Polacheck said it doesn't help to see the balances of her retirement accounts, primarily in stocks, decline. She said she feels worse off financially than one year ago, when the stock market and housing market were doing better.

"Things you could take for granted now, you can't anymore," she said.

Painful either way

When it comes to the wealth effect, it doesn't matter whether you have cemented a loss by selling a home or stock for less than planned or are simply watching your stocks go down and neighboring homes sell for less and less.

Either way, it's painful, said Amar Cheema, a marketing professor at

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Washington University in St. Louis. And studies have shown that when consumers are in this situation, they are more likely to feel less wealthy and spend less, he said.

Where do they cut back? There are a number of expenditures consumers can't cut much - let alone eliminate - such as for groceries and gasoline.

"But they will cut out an extra vacation, they will reduce how many times they eat out - they will cut in other areas," Cheema said.

There is no clear-cut correlation in some matters, such as when it comes to charitable giving. In fact, research suggests it is affected less. "Charitable donations make people feel better about themselves" so they keep on contributing, he said.

Polacheck says declining home values and stock values have created a nagging worry she can't shake. Already a conscientious saver, she says she's much more focused these days on "financial security."

Cheema said falling housing prices can cause greater levels of concern than falling stock prices for some people, especially those who have tapped their home equity in recent years and view their homes as a piggy bank of sorts.

Rough on retailers

In any case, the downside of the wealth effect certainly doesn't bode well this

year for a variety of retailers, many just coming off what is considered the worst holiday spending season in five years. Could retail spending in the spring and summer be headed in the same direction? It could, experts say, if the nation's economy slips into recession and the stock market and housing markets continue to suffer.

Vera Eini, a retired social worker in Murray, knows she won't be shopping for much of anything beyond necessities this year. She has clamped down on her finances ever since the stock market - and her retirement account balances - hit the skids.

Even so, to boost returns and ensure that their money will last during their lifetimes, she and husband Shim are still heavily invested in stocks.

For the past couple of years, they have felt good about how their balances have grown. Now? "I feel like I'm watching retirement drift away," said Eini, who has been retired since 1999.

Eini said her husband, who also is retired, probably will have to go back to work. She can't because of health problems, so in the meantime, she's watching her pennies.

"We used to eat out a lot. We aren't doing that so much anymore."

The stimulus plan

Utah economist Jeff Thredgold said the

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wealth effect could even help undermine the economic stimulus plan in Congress that would provide rebates of \$600-\$1,200 to most taxpayers.

The plan is designed to encourage consumers to spend more despite all the angst about the economy.

Consumer spending accounts for two-thirds of economic activity in the U.S., and if Americans clamp down, it could help push the nation even deeper into the economic doldrums.

But Thredgold, a consultant to Zions Bank in Salt Lake City, said he wouldn't be surprised if half of Americans who get the rebate checks use them to pay down credit card debts or actually save the money instead of rushing out to Best Buy to purchase a nice flat-screen TV.

"The wealth effect is powerful - on the upside and the downside," he said. "There is a lot of anxiety out there."

He points out that squirreling away the money or using it to pay down debt, which may be the financially prudent thing to do, would undermine the government's economic plan.

"If most people did that, we definitely wouldn't get the spending stimulus the government wants to see."

Financial angst can grip even those who don't own a home or stocks.

University of Utah student Edward Cox of Salt Lake City is only 21, but all the problems of the nation are weighing heavy on his

mind.

"I am a college student so my financial condition couldn't be any worse, however, I am afraid of an inevitable recession that could very well greatly restrict my ability to acquire a job after graduation."

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The wealth effect

The idea that when people see the values of their homes and stocks increase, they feel "wealthier" and spend more - even if they haven't locked in any gains by selling. When home prices and stock values fall, consumers often feel less wealthy and more anxious. In this scenario, they curb spending, even if they have not had to sell.

Home plummeting in value?

* **The "wealth effect" may make it difficult** for those who must sell their home to do so at a loss - or for a lesser profit than they had hoped.

* **Take a hard look** at the cost of letting a home languish on the market.

* **There are many variables** that make decisions difficult when it comes to selling or holding. It depends on your income, neighborhood, how much income you can expect if you decide to rent the house, how quickly you expect the real estate market to turn around, your tolerance of risk and type

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of mortgage.

* **Consider cutting your losses and move on**, says Paul Winter of Five Seasons Financial Planning in Salt Lake City.

"Especially if it's becoming so emotionally draining that you're distracted at home and work."

Stocks plummeting in value?

* **It is difficult** to watch the value of your retirement holdings decline.

* **Experts say hold tight** - especially if retirement is years away - because over the long term, stocks deliver superior returns.

* **Past trends** don't guarantee the future.

* **If you are close to or in retirement** and are heavily invested in stocks, the best course is far from clear.

* **Older investors should hedge their portfolios** against stock market downturns through diversification, says Winter.

* **Retirees should have at least two years'** worth of living expenses in cash or a near-liquid investments for a cushion, says Winter.

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