Entrepreneurs' stock losses bruise their businesses

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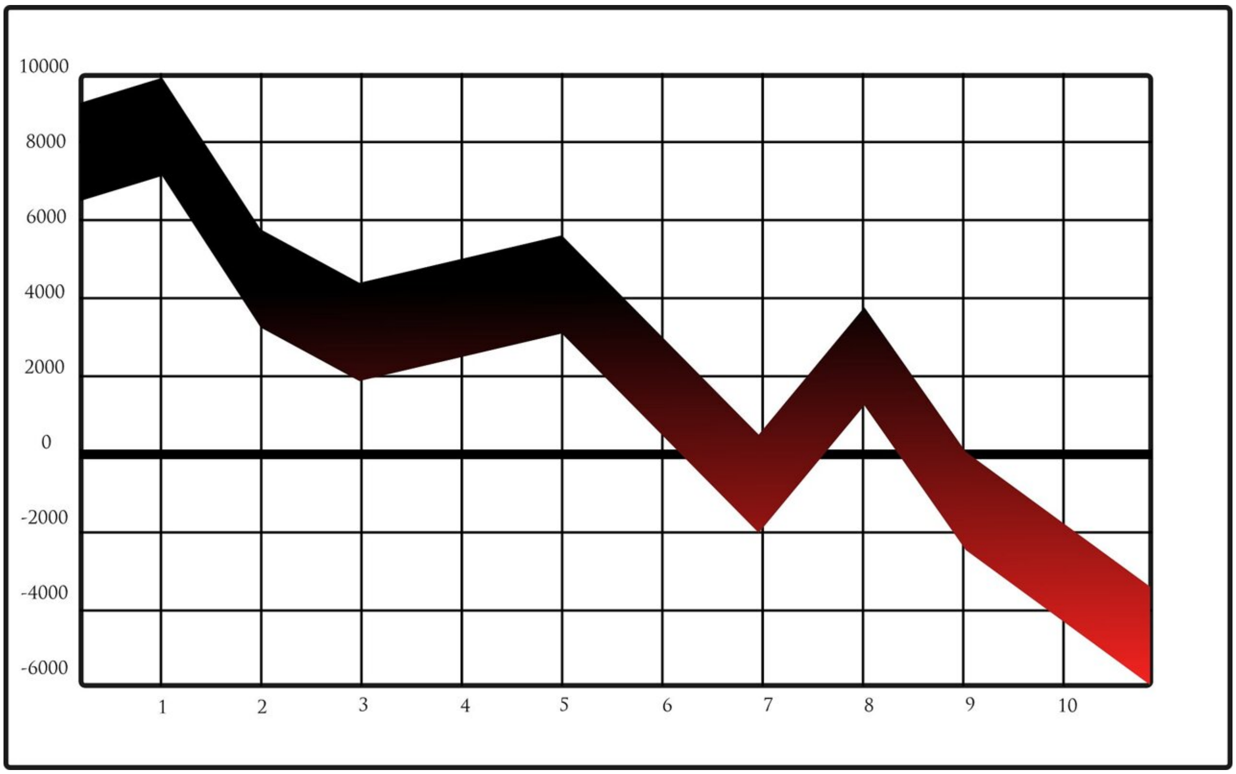

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When a recession takes a bite out of an entrepreneur's personal stock portfolio, does that person's business suffer more than those of older and larger competitors?

New research by Marius Ring, assistant professor of finance at Texas McCombs, finds a link between the wealth of small-business owners and the health of their companies during economic downturns. When their stock portfolios lose value, their businesses suffer ripple effects: less financing and curtailed hiring.

The findings are published in *The Journal of Finance*.

"Entrepreneurial wealth follows the ups and downs of economic cycles," Ring says. "I show that for entrepreneurs whose stock portfolios take a hit, their businesses are adversely affected to a greater extent than established businesses."

Such business constrictions are concentrated among younger companies, he noted, because older companies have more financial options.

Ring studied stock portfolios of entrepreneurs during the 2008-2009 financial crisis in Norway, where detailed income and investing data are available. He merged the data with information from education and employment registers to trace the crash's impacts on investors, the businesses they own, and their employees.

He found that owners' stock shortfalls hurt businesses in multiple ways, with fledgling companies faring worse.

Hiring hiatuses

A stock loss of 10% reduced employment growth by an average 5 percentage points from 2007 to 2010. In younger companies, job levels still had not recovered five years after the crisis began.

Shrinking employment resulted not from firings, but from less hiring. Ring says, "Investing in new employees is likely not a top priority in a recession."

Investment lessened

A 10% drop in the owner's wealth led to cutbacks in capital available for business growth.

- It reduced injections of outside equity 22%.
- For younger companies, it meant an 84% decline in the two-year rate of investment in plants and property.

Why are younger businesses more sensitive to their owners' investment setbacks? The answer, says Ring, is that "more mature firms seem to be able to substitute other sources of financing, such as banks."

Mature companies, he found, took on more bank debt after an owner's wealth shock. Younger ones, on the other hand, saw a decrease in bank debt.

An important policy question, says Ring, is whether reduced business activity is driven more by financial forces or by psychological ones, such as a decrease in entrepreneurs' willingness to take risks.

His results suggest that financial constraints are more likely at play. That means government interventions, such as small-business lending subsidies, might help counter those constraints and help small businesses weather recessions.

"Small businesses are important in most economies, and most of these firms rely heavily on their owners for financing," Ring says. "Owners can be a viable source of financing, but unfortunately, the owner's personal wealth is likely to be hit at the same time as the firm is experiencing a downturn."

More information: Marius A. K. Ring, Entrepreneurial Wealth and Employment: Tracing Out the Effects of a Stock Market Crash, *The Journal of Finance* (2023). DOI: 10.1111/jofi.13280

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