



PROBLEMS OF INDIVIDUAL INVESTOR

1) Trade Frequently

- Most individual investors hold under diversified portfolios. Many apparently uninformed investors trade actively, speculatively, and to their detriment. And, as a group, individual investors make systematic, not random, buying and selling decisions.
- Many studies document that individual investors earn poor returns even before costs. Put another way, many individual investors seem to have a desire to trade actively coupled with perverse security selection ability!
- Barber and Odean (2001) compare the performance of men and women using data from the LDB dataset. Unlike the studies on cross-sectional performance discussed above, this study focuses on the net returns (i.e., returns net of spreads and commissions) of men and women. The study is motivated by the two observations: (1) men tend to be more prone to overconfidence than women in areas culturally perceived to be in the male domain (Deaux and Farris, 1977), and (2) models that assume investors are overconfident tend to predict investors will trade excessively and to their detriment. When combined, these observations predict that men will trade more than women and that excessive trading will hurt their performance. Consistent with these predictions, Barber and Odean (2001) document that men trade more than women; the annual turnover rates of men are about 80%, while those of women are 50%. The excessive trading of men leads to poor returns. While both men and women earn poor returns, men perform worse. Virtually all of the gender-based difference in performance can be traced to the fact that men tend to trade more aggressively than women. Neither men nor women appear to have stock selection ability (i.e., the gross returns earned on their trades are similar), so men's tendency to trade aggressively and the resulting trading costs drag down men's returns.
- Individual investors seem to trade frequently in the face of poor performance.
- A careful reading of the research on cross-sectional variation in performance yields three general conclusions. First, there is strong evidence of cross-sectional variation in trading skill. Second, security selection skill among individuals is rare (i.e., confined to a relatively small group of stocks or individuals). Third, even the best stock pickers have trouble covering transactions costs.
- In summary, a fair amount of evidence indicates that the better-than-average and Overestimation varieties of overconfidence are correlated with higher levels of trading by investors. While the evidence that miscalibration is linked to trading is weaker, we suspect this weak link might be partially explained by the current inability to measure miscalibration well.
- Even the best stock pickers have trouble covering transactions costs.

2) Wrong Stock Selection Ability

- The investors have wrong security selection ability.
- Real investors are influenced by where they live and work. They tend to hold stocks of companies close to where they live and invest heavily in the stock of their employer. These behaviors lead to an investment portfolio far from the market portfolio proscribed by the CAPM and arguably expose investors to unnecessarily high levels of idiosyncratic risk.
- Odean analyzes, the stocks bought by individuals underperform the stocks sold by 23 basis points per month in the 12 months after the transaction (with p-values of approximately 0.07) and that this result persists even when trades more likely to have been made for liquidity, rebalancing, or tax purposes are excluded from the analysis. These results are provocative on two dimensions. First, this is the first evidence that there is a group of investors who systematically earn subpar returns before costs. These investors have perverse security selection ability. Second, individual investors seem to trade frequently in the face of poor performance.
- Massa and Simonov (2006) analyze portfolio holdings of Swedish investors and document that investors tilt their portfolio towards stocks that are most closely related to them, either professionally (e.g., a financial professional investing in a finance stock) or geographically (e.g., a Seattle investor investing in a Seattle stock). They argue that this familiarity-based investing allows investors to earn higher returns because of the information advantage conferred by familiarity. Similarly, Ivkovic and Weisbenner (2005) use the LDB dataset to document individual investors tend to overweight local stocks and argue the returns on local stocks are strong.
- Investors face a huge search problem when choosing stocks to buy. Rather than searching systematically, many investors may consider only stocks that first catch their attention (e.g., stocks that are in the news or stocks with large price moves). This will lead individual investors to buy attention-grabbing stocks heavily. Since most individual investors own only a small number of stocks and only sell stocks that they own, selling poses less of a search problem and is less sensitive to attention effects.
- Back-of-the-envelope calculations indicate the net returns earned by individual investors in aggregate are 3.8 percentage points below market returns. Three factors contribute (roughly) equally to the shortfall: perverse stock selection ability, commissions, and the transaction tax, with a somewhat smaller role relegated to poor market timing choices.

3) Tend to Sell the Winners and Hold the losers

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- They construct portfolios that mimic the trading of individuals and institutions, respectively. When portfolios are constructed assuming holding periods that range from one day to six months, the stocks bought by institutions (sold by individuals) earn strong returns, while stocks bought by individuals (sold by institutions) perform poorly. A long-short strategy that mimics the buying and selling of individual investors and assumes a holding period of 140 trading days earns a negative abnormal return of 75 basis points per month before accounting for transaction costs ($p < 0.01$)
- We believe that buying is forward-looking and selling backward-looking. Investors buy stocks because of what they hope will happen and sell stocks because of what has already happened. When investors buy a stock (that they have not recently owned), they look to the past only to divine the future. Many investors employ the simple heuristic of assuming that the recent past is indicative of what is to come. Selling is different. When selling, investors are concerned about what a stock has done prior to the sale (and since being purchased). In most cases, this leads investors to sell winners and hold losers (i.e., the disposition effect), though, late in the tax year, investors tend to sell losers. It is unlikely that investors sell winners because they believe past winners are future losers; rather investors find it emotionally unpalatable to sell for a loss.
- Individual investors have a strong preference for selling stocks that have increased in value since bought (winners) relative to stocks that have decreased in value since bought (losers). Shefrin and Statman (1985) labeled this behavior the “disposition effect”—investors are disposed to sell winners and hold losers. In this section, we begin by illustrating the basic effect. We then survey the empirical and experimental work documenting the disposition effect, which we summarize.
- The research discussed above presents a remarkably clear portrait of a prototypical individual investor who sells his winners and holds his losers. This behavior is broadly categorized as an investment mistake because it is tax inefficient.⁵ Thus, while taxes clearly affect the trading of individual investors, they cannot explain the disposition effect. Investors' reluctance to realize losses is at odds with optimal tax-loss selling for taxable investments. For tax purposes, investors should postpone taxable gains by continuing to hold their profitable investments. They should capture tax losses by selling their losing investments, though not necessarily at a constant rate. Constantinides (1984) shows that when there are transactions costs, and no distinction is made between the short-term and long-term tax rates, investors should increase their tax-loss selling gradually from January to December by discussing possible explanations for the disposition effect.

- We believe that buying is forward-looking and selling backward-looking. Investors buy stocks because of what they hope will happen and sell stocks because of what has already happened. When investors buy a stock (that they have not recently owned), they look to the past only to divine the future. Many investors employ the simple heuristic of assuming that the recent past is indicative of what is to come. Selling is different. When selling, investors are concerned about what a stock has done prior to the sale (and since being purchased). In most cases, this leads investors to sell winners and hold losers (i.e., the disposition effect), though, late in the tax year, investors tend to sell losers. It is unlikely that investors sell winners because they believe past winners are future losers; rather investors find it emotionally unpalatable to sell for a loss.

4) Poorly Diversified Portfolio

- Risk averse investors should hold a diversified portfolio to minimize the impact of idiosyncratic risk on their investment outcomes. A fair bit of evidence suggests that many investors fail to effectively diversify idiosyncratic risk. Investors who overinvest in the stock of their employer (company stock) are left exposed to the fortunes of their employer (idiosyncratic risk). Famously, Enron employees had 62% of their retirement plan assets invested in company stock at the end of 2000. By December 2001, the company had declared bankruptcy and its employees had lost both their jobs and a large fraction of their retirement income. Similar stories unfolded at Global Crossing, Lucent, Polaroid, and Kmart. Poterba (2003) analyzes the 20 largest defined contribution plans managed by corporations and documents that 44% of plan assets are invested in company stock. Mitchell and Utkus (2003) estimate that five million Americans have over 60 % of their plan assets invested in company stock. Benartzi (2001) documents that some of the allocation to company stock is discretionary on the part of employees. Moreover, this discretionary allocation is largest for companies with strong return performance over the prior 10 years, which is consistent with the general stock buying behavior of individual investors.
- They document that investors tend to hold portfolios that are highly volatile and consist of stocks that are more highly correlated than one would expect if stocks were chosen randomly.
- In a related paper shows that, individuals prefer stocks with high individual volatility, high individual inequality, or low stocks prices. It shows that the same demographic characteristics that predict lottery participation (e.g., education, income, and religious affiliation) also predict the strength of lottery-like preferences in stocks.
- Investors also prefer local stocks within their domestic portfolio.
- In summary, some investors fail to take advantage of the full benefits of diversification. Under-diversified investors might overinvest in company stock, local stocks, familiar stocks, and domestic companies. Doing so may make them feel safe, but it leaves them exposed to increased volatility in their investment returns.

5) Unduly Influenced by Media And Past Experience

- Retail investors have a taste for stocks with lottery-like payoffs.
- The simplest form of learning may be to repeat behaviors that previously coincided with pleasure and avoid those that coincided with pain. Several studies suggest that individual investors engage in such simple reinforcement learning. Choi, Laibson, Madrian, and Metrick (2009) document that investors overextrapolate from their personal experience when making savings decisions; investors whose 401(k) accounts have experienced greater returns or lower variance increase their saving rates. Strahilevitz, Odean, and Barber (2011) find that investors are more likely to repurchase a stock that they previously sold for a profit than one previously sold for a loss. Huang (2010) demonstrates that investors, particularly unsophisticated investors, are more likely to buy a stock in an industry if their previous investments in this industry have earned a higher return than the market. De, Gondhi, and Pochiraju (2010) show that individual investors trade more actively when their most recent trades are successful. Kaustia and Knupfer (2008) document that investors are more likely to subscribe to initial public offerings (IPOs) if their personal experience with IPO investments has been profitable. Malmendier and Nagel (2011) establish that investor age cohorts who have experienced high stock market returns throughout their lives are less risk averse and more likely to invest in stocks.
- Chasing the Action - Individuals have a limited amount of attention that they can devote to investing. Attention can affect the trading behavior of investors in two distinct ways. On one hand, directing too little attention to important information can result in a delayed reaction to important information. On the other hand, devoting too much attention to (perhaps stale or irrelevant) information can lead to an overreaction.
- Investors face a huge search problem when choosing stocks to buy. Rather than searching systematically, many investors may consider only stocks that first catch their attention (e.g., stocks that are in the news or stocks with large price moves). This will lead individual investors to buy attention-grabbing stocks heavily. Using abnormal trading volume, the previous day's return, and news coverage as proxies for attention. Individual Investors buy orders for more attention grabbing stocks.

- Even investors who have never previously owned a stock are more likely to buy when stocks hit these limits. Seasholes and Wu also find that other (rational) investors systematically profit at the expense of the attention driven individual investors.
 - Both buying and selling increase, though buying somewhat more than selling.
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- They find that the market reaction is greater following recommendations made when viewership—based on Nielson ratings—is higher. Furthermore, consistent with Barber and Odean’s hypothesis that attention matters more for buying than selling, they find that “While first-time buy recommendations have a large overnight return of 2.4%, first-time sell recommendations have overnight returns that are smaller in magnitude (-0.29%).”

To preview our conclusions, the aggregate (or average) performance of individual investors is poor. A big part of the performance penalty borne by individual investors can be traced to transaction costs (e.g., commissions and bid-ask spread). However, transaction costs are not the whole story. Individual investors also seem to lose money on their trades before costs.

In Dorn and Sengmueller (2009) survey, **Investors are asked whether they agree or disagree (on a five-point scale) with the following four statements: (1) I enjoy investing, (2) I enjoy risky propositions, (3) Games are only fun when money is involved, and (4) In gambling, the fascination increases with the size of the bet. Investors who agree with these statements tend to trade more. Investors who report enjoying investing (question 1) or gambling (questions 2-4) trade at twice the rate of other investors.**

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