FAILURE TO DIVERSIFY

WHAT ARE YOU GOING TO LEARN?

- Insufficient diversification
  - Investors fail to diversify their portfolio holdings adequately.
  - Home bias puzzle
    - Preference for local stocks
  - Familiarity and aversion to ambiguity

WHAT IS THE HOME BIAS PUZZLE?

- Investors exhibit a pronounced 'home bias'.
  - Investors have a strong tendency to underweight foreign equities in their portfolios of risky assets.

WHAT IS THE HOME BIAS PUZZLE?

- Even though U.S. equities make up only about 40% of the world market portfolio, U.S. investors concentrate their holdings in U.S. stocks..
  - More than 80% invested in U.S equities.
- European investors concentrate their holdings in European stocks.
- Japanese investors concentrate their holdings in the Japanese stocks.

HOME BIAS *WITHIN* COUNTRIES

- Investors are much more likely to hold and trade stocks that are located close to them geographically.
- Investors prefer firms whose CEO shares their cultural background.
- Strong bias towards own company stock in 401K plans.

WHY?

- Familiarity and aversion to ambiguity
  - Fear of the unknown!

FAMILIARITY OR INFORMATION?

- U.S. mutual fund managers tend to hold stocks whose company headquarters are located close to their funds' headquarters.
- These local holdings subsequently perform well!
- Information story – it is less costly to learn about local firms!

SUMMARY

- Insufficient diversification
  - Investors fail to diversify their portfolio holdings adequately.
  - Home bias, preference for local stocks, preference for own company stocks
  - Familiarity and aversion to ambiguity

NAÏVE DIVERSIFICATION

NAÏVE DIVERSIFICATION

- When investors do diversify, they do so in a naïve fashion.
- Individuals divide their money evenly across all the choices available in their 401(k) plans.
- 1/n rule – naïve diversification

SO WHAT?

- Depending on the choices available, this heuristic can lead to individuals taking up too little risk or excessive risk.

SUMMARY

- Individual investors typically have a very primitive understanding of what constitutes a well-diversified portfolio.

EXCESSIVE TRADING

WHAT ARE YOU GOING TO LEARN?

- Excessive trading
  - Individual investors, on average, earn mediocre returns because they trade too much.
- Why do investors trade so much when net effect is to reduce their returns?
  - Overconfidence

EXCESSIVE TRADING

- Rational models predict there should be very little trading.
  - Individuals trade more than can be justified on rational grounds.

TRADING HISTORIES OF 60,000 INVESTORS

- Barber and Odean (2000) examined the trading activity of 60,000 investors over a six-year period.
  - After transaction costs, the average return is well below the return of standard benchmarks.
  - Those who traded the most earned by far the lowest returns.

WHY?

- Investors are overconfident in their abilities.
  - They overestimate the precision of their information.

OVERCONFIDENCE

- Evidence from psychology that men are typically more overconfident than women.
- Men trade more and earn lower returns on average.
  - Single men traded 67% more and earned 2.3% less on a risk-adjusted basis!

ONLINE REVOLUTION

- Online trading has made it cheaper and easier for individual stocks to trade stocks.
  - Typical online trader between 25-45
    - 75% men
    - 30-34 age group being the most active cohort
- Overconfidence and optimism appear to be particularly more severe among day-traders.

SUMMARY

- Excessive trading driven by individual investors' overconfidence.
  - Securities Act and Securities Exchange Act of 1930s can be seen as a response to the impulses of overconfident traders of the 1920s.
  - In 1999, SEC Chairman Arthur Levitt warned that online trading was like a 'narcotic'.
- Clearly, technology has changed, but human psychology remains the same.

INDIVIDUAL INVESTORS' BUYING AND SELLING DECISIONS

WHAT ARE YOU GOING TO LEARN?

- Disposition effect
  - The tendency of investors to hold on to losing investments.
- Attention
  - Buying decisions are more driven by attention than are selling decisions.

DISPOSITION EFFECT

- Investors are typically reluctant to sell assets at a loss.

ODEAN AGAIN!

- Odean (1998) based on a study of 163,000 customer accounts at a U.S. nationwide brokerage house.
  - Individual traders are more likely to sell winners than losers.

WHY?

- Loss aversion!
  - Investors have great difficulty to come to terms with losses.

INDIVIDUALS' BUYING DECISION? ALL THAT GLITTERS!

- Stock purchases are in part due to an attention effect.
- Attention-grabbing stocks
  - Stocks with abnormally high volume
  - Stocks with abnormally high or low returns
  - Stocks with news announcements

ALL THAT GLITTERS!

- Human beings have bounded rationality.
  - Both cognitive and temporal limits to how much information we can process.
- Attention is more likely to determine individuals' buying decisions than selling decisions.

SUMMARY

- Individual investors' selling decisions are characterized by the 'disposition effect'.
- Individual investors' buying decisions are more likely to be driven by 'all that glitters' – attention grabbing stocks.