Beliefs drive investors more than preferences, study finds

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(Phys.org)—If experts thought they knew anything about individual investors, it was this: their emotions lead them to sell winning stocks too soon and hold on to losers too long.

But new research casts doubt on this widely held theory that individual investors' decisions are driven mainly by their feelings toward losses and gains. In an innovative study, researchers found evidence that individual investors' decisions are primarily motivated by their beliefs about a stock's future.

"The story is not about whether an investor hates losing or loves gains – it's not primarily a story about preferences," said Itzhak Ben-David, co-author of the study and assistant professor of finance at Ohio State University's Fisher College of Business.

"It is a story about information and speculation. The investor has a belief about where a stock is headed and that's what he acts on. Investors act more on their beliefs than their preferences."

Ben-David conducted the study with David Hirshleifer of the Paul Merage School of Business at the University of California, Irvine. Their results appear in the August 2012 issue of the journal *Review of Financial Studies.*

The researchers studied stock transactions from more than 77,000 accounts at a large discount broker from 1990 through 1996 and did a variety of analyses that had never been done before. They examined when investors bought individual stocks, when they sold them, and how much they earned or lost with each sale.

The result was a radical rethinking of why individual investors sell winning stocks and hold on to losers.

The findings don't mean that investors don't have an aversion to losses and a desire to sell winners, Ben-David said. But the trading data suggests that these feelings aren't dominating their decisions.

"People have a variety of reasons for trading stocks, which may include tax issues, margin calls, and an aversion to losses. These all may play a role, but what we show that beliefs are dominant for the trading of retail investors."

The tendency to sell winners too early and to keep losers too long has been called the "disposition effect" by economists.

"The disposition effect has been well-documented. The question is what we make of it. A lot of people look at the data and interpret it as meaning that the typical retail investor is irrational, simply reacting to their feelings about gains and losses," he said.

"But what we find is that, looking at the data, we can't really learn about their preferences. We don't learn about what they like or don't like. Surely, they don't like to lose money - but their reasons for selling stocks are more complex than that."

The simplest test was to see what investors do when a stock is trading just slightly higher or lower than the price they paid - in other words a small winner or a small loser.

If investors really did make stock trades based simply on their pleasure in making money and their aversion to realizing losses, a small winner should lead to more sales than a small loser.

But this study found that investors were not clearly more likely to sell when it was a small winner than when it was a small loser.

Another piece of evidence against the theory that investors' decisions are driven by their aversion to realizing losses was the fact that, the more a stock lost value, the more likely investors were to sell it.

"If investors had an aversion to realizing losses, larger losses should reduce the probability they would sell, but we found the opposite - larger losses were associated with a higher probability of selling," Ben-David said.

Interestingly, the stocks that investors sell the least are those that did not have a price change since purchase.

Another clue is the fact that men and frequent traders were more likely than others to sell winning stocks quickly to reap their profits and sell losers quickly to cut their losses.

"Past research has shown that overconfidence in investing is associated with men and frequent traders," Ben-David said. "They have a belief in their superior knowledge and so you would expect them to buy and sell more quickly than others as they speculate on stock prices. That's exactly what we found. They are engaged in belief-based trading."

The researchers also examined when investors were more likely to buy additional shares of a stock that they had previously purchased. They found that the probability of buying additional shares is greater for shares that lost value than it was for shares that gained value.

That shouldn't happen if investors are really acting on emotions rather than beliefs, Ben-David said.

"If you buy additional shares of a stock that has lost value, that suggests you are acting on your beliefs that the stock is really a winner and other people have just not realized it yet," he said.

"You wouldn't buy additional shares of a losing stock if your biggest motivation was to avoid realizing losses."

However, Ben-David noted that just because investors act on beliefs rather than feelings doesn't mean they are acting rationally.

"They may be overconfident in their own abilities. It is a different kind of irrationality from being averse to selling losers," Ben-David said.

This study's suggestion that investors act more on beliefs than preferences is likely to make waves in the economics profession, he said.

"In economics, these two stories are very different. Beliefs and preferences are very different concepts, and it is important to distinguish them and how they affect investors. Many economists had thought that an irrational aversion to selling losers was crucial for the trading decisions of retail investors."

Provided by Ohio State University

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