Making S.M.A.R.T. Financial Decisions

Investor Behavior Part 3: Disposition Effect & Attention

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Another behavior that a lot of investors have is they tend to hold on to their losing investments and sell their winners. This is sometimes called the disposition effect. I've looked at this for US investors. Brad Barber and I looked at US investor taxable and tax-deferred accounts. We found that in the tax-deferred accounts, all year long people are selling their winners and holding on to their losers. And in the taxable accounts, only in December do they start to sell their losers at a faster rate than their winners. And from a tax point of view, that's pretty much what you should always do.

Now, I want to show you a graph from a different study that Brad Barber, Neil Lee, Jane Liu, and I did looking at Taiwanese investors. We look at investors in Taiwan because we have trading records for every investor in Taiwan. For this study, that's over a five-year period. And as you can see here, the bar for the individual investors is up to almost four. What does that mean? Basically, that means that if an investor went to bed last night only one stock for a gain and one stock for a loss, he was about four times as likely to sell the winner today. And this is pervasive behavior for most of the investor groups. In this study, only foreign investors and mutual funds didn't display the disposition effect.

If you're watching this video as part of my online course on personal finance, you've probably seen the video in which students are passing basketballs as a man in a gorilla suit walks by. As you watch the video, you're asked to count how many times one of the groups of students passes a basketball. Many people don't notice the gorilla because all of their attention is focused on counting. Attention is simply a limited resource. We can't pay attention to everything. When faced with many options, the choices we make may depend more on what we do and don't pay attention to than on our beliefs and our preferences. For example, investors who want to buy a stock face thousands of choices. How do investors choose which stock to buy? In our paper "All That Glitters," Brad Barber and I hypothesized that many investors simply choose from the stocks that catch their attention and ignore other stocks. So attention reduces the choice set from thousands of options to a few. Preferences matter but only for the stocks that get considered. For example, suppose there are two investors, Mr. A and Mr. B. Mr. A is a value investor who likes stocks with low price-to-earnings ratios. Mr. B is a momentum investor who likes stocks that have been going up lately. On a particular day, Mr. A and Mr. B both consider the same dozen stocks that they see mentioned on TV or in the news. They each buy a different stock. They buy the one that suits their own preferences. But they each buy from the small subset of stocks that attracted their attention that day.

Attention doesn't matter so much for selling simply because most investors only own a few individual stocks. And they only sell stocks they already own. Attention doesn't matter as much for institutional investors because when it comes to investing, they've got more attention. They don't trade in their spare time. They spend all day trading. And they're more likely to work in teams. So how does all of this affect investor behavior? Brad and I examined the trading records for more than 60,000 investors at a large discount brokerage firm, more than 600,000 investors at large retail brokerage firm, and about 14,500 investors at a small discount firm. In all three data sets, the individual investors tended to be on the buy side of the market for stocks that were probably attracting people's attention that day. And they tended to be on the sell side of the market for stocks garnering less attention.