

THE EDUCATED INVESTOR

FEATURE ARTICLE

January 2004

FOCUS
Asset Management Company

What Triggers Investors to Trade?

University of California Professor Brad Barber and Associate Professor Terrance Odean have done a series of landmark studies that focus on the intricacies of human behavior and its impact upon investor performance. Their studies have provided a growing collection of data that has contributed significantly to the field of behavioral finance. For example, following are conclusions from past studies they have co-authored:

- σ In general, individuals who traded the most frequently produced the lowest net returns. (**Do Investors Trade Too Much?** *American Economic Review*, December 1999.)
- σ The average investment club lagged a broad market index by 3.8 percent per annum and underperformed on a risk-adjusted basis by 4.4 percent per annum. (**Too Many Cooks Spoil the Profit: The Performance of Investment Clubs**, *Financial Analysts Journal*, January/February 2000.)
- σ Individual investors typically underperformed their appropriate benchmarks due to excessive trading. (**Trading Is Hazardous to Your Wealth**, *Journal of Finance*, April 2000.)
- σ While women's stock selections did not outperform men's, women have generally produced higher net returns due to lower turnover (lower trading costs). Married men's investments have outperformed single men's for similar reasons. (**Boys Will Be Boys**, *Quarterly Journal of Economics*, February 2001.)
- σ Individuals who switched from discount broker telephone trading to e-trading performed worse after the switch. Again, increased trading and resulting costs appeared to be the cause. (**The Internet and the Investor**, *The Journal of Economic Perspectives*, Winter 2001.)

A clear common thread that runs among their studies is that excessive trading and its related costs seemed to have had a direct negative impact on an investor's returns. Barber's and Odean's latest collaboration, not yet published, is entitled, **All That Glitters: The Effect of Attention and News on the Buying Behavior of Individual and Institutional Investors**.¹ In it, they further analyze what triggers individual investors to trade. They hypothesized as follows:

Investors manage the problem of choosing among thousands of possible stock purchased by limiting their search to stocks that have recently caught their attention. Investors do not buy all stocks that catch their attention; however, for the most part, they only buy stocks that do so. Which attention-grabbing stocks investors buy will depend upon their personal preferences. Contrarian investors, for example, will tend

to buy out-of-favor stocks that catch their eye, while momentum investors will chase recent performers.

The authors also proposed that individuals don't face the same search problem when it comes to *selling* stocks. Logically, they tend to only sell those they already own — because of the incremental costs and risks of selling a stock short (borrowing the stock and selling it with the expectation it can be bought back at a later date at a lower price).

To test their hypothesis, Barber and Odean examined the accounts of more than 725,000 individual investors from a large discount brokerage, a large retail brokerage and a small discount brokerage. They also examined the trading patterns of 43 professional money managers. Their findings provide some insight not only into individual investor behavior, but also into why individuals generate such poor results.

Their main conclusion was that individual investors tend to be net *buyers* of stocks on “high-attention days,” which included any of the following:

- σ Days during which stocks experienced high abnormal trading volume
- σ Days during which stocks were featured in the media — with good or bad news
- σ Days immediately following extreme price movements — either big gains or big losses

On such days, individuals bought nearly twice as many stocks as they sold. Since for every buyer there must be a seller, institutional and other “professional” investors tended to be the net *sellers* on high-attention days. It seemed that the professional investors were “less prone to indulge in attention-based purchases” (as they presumably had the resources and time to conduct research on, build filters for and develop familiarity with a wider range of stocks).

In short, individual investors who succumbed to such behavioral patterns ended up being taken advantage of for failing to recognize how efficient markets work. They failed to understand that the publicly available information that was grabbing their attention was already incorporated into the price of the stock.

In fact, the speed of the stock market's response to new information seems startling. A study on the after-trading hours quarterly earnings announcements of 100 NYSE and 100 NASDAQ firms found that the majority of the price response was realized during the *opening* trade. For earnings announcements that occurred during trading hours, the results were not much different. For NYSE stocks, the price adjustment occurred during the first several post-announcement trades. For NASDAQ stocks, the price adjustment was concentrated in the very first post-announcement trade.²

By confusing attention-getting news with useful knowledge that can help them select undervalued (mispriced) stocks, investors succumb to the poor trading results that Barber and Odean consistently found in their series of studies. In their most recent All That Glitters study, they found that “the underperformance of stocks purchased relative to those sold is both economically and statistically significant.”

And it gets worse for individual investors reacting inappropriately to high-attention “information.” Attempting to outperform the market is a zero-sum game (for every trader who “loses,” there must

be a trader who “wins”), even before expenses. That means someone must have benefited from the underperformance of individual investors responding to high-attention days.

It’s not difficult to guess who those beneficiaries likely were. First, brokerage firms secure commissions and market makers earn a bid/offer spread, regardless of who gets to sell high and who ends up buying low. In addition, Barber and Odean found that the institutional investors they studied did not display attention-based buying. This is especially true for those that were value oriented. Thus it seems the institutional investors were benefiting from the irrational behavior of individual investors.

The bottom line is that Odean, Barber and others of their academic colleagues who shed light in the field of behavioral finance are continuing to demonstrate that individual investors who react to the noise of the market can expect negative results, even before the costs of the trades. It seems that if investors ignore the noise, particularly on “high-attention days,” they can not only expect to earn better returns, but they can instead devote more of their attention to pursuits such as family or hobbies that truly add value to their lives. Barber and Odean concluded with the following advice: “We believe that most investors will benefit from a strategy of buying and holding a well-diversified portfolio. Investors who insist on hunting for the next brilliant stock would be well advised to remember what California prospectors discovered ages ago: All that glitters is not gold.”

¹ Brad M. Barber and Terrance Odean, **All that Glitters: The Effect of Attention and News on the Buying Behavior of Individual and Institutional Investors**. <http://faculty.haas.berkeley.edu/odean/papers>, October 2003.

² Jason Greene and Susan Watts, **Price Discovery on the NYSE and the NASDAQ: The Case of Overnight and Daytime News Releases**. *Financial Management*, Spring 1996.

This material is derived from sources believed to be reliable, but its accuracy and the opinions based thereon are not guaranteed. The content of this publication is for general information only and is not intended to serve as specific financial, accounting or tax advice. To be distributed only by a registered investment advisor. Copyright © BAM Advisor Services, 2004.