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Coexistence of disposition investors and momentum traders in stock markets: experimental evidence

Andreas Oehler [a,*], Klaus Heilmann [b], Volker Läger [c], Michael Oberländer [a]

[a] *Department of Finance, Bamberg University, Kirschaeckerstr. 39, D-96045 Bamberg, Germany*

[b] *Allianz Group, Munich, Germany*

[c] *Merrill Lynch, Frankfurt, Germany*

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Abstract

Prior research documents that many investors disproportionately hold on to losing stocks while selling stocks which have gained in value. This systematic behavior is labeled as the "disposition effect". The phenomenon can be explained by prospect theory's idea that subjects value gains and losses relative to a reference point like the purchase price (PP), and that they are risk-seeking in the domain of possible losses and risk-averse when a certain gain is obtainable. Our experiments were designed to test whether individual-level disposition effects attenuate or survive in a dynamic market setting. We analyze a series of 36 stock markets with 490 subjects. The majority of our investors demonstrate a strong preference for realizing winners (paper gains) rather than losers (paper losses). We adopt different reference points and compare the behavioral patterns across three main trading mechanisms, i.e. rules of price formation. The disposition effect is greatly reduced only within high-pressure mechanisms like a dealer market (DM) when the last price (LP) is assumed as a reference point, which is a more market driven (external) benchmark. If disposition investors use the PP as a reference point, which is a more mental-accounting driven (internal) benchmark, they die hard in all market settings. Interestingly, our markets do not collapse or become illiquid by disposition investors' reluctance to trade. A main reason for this is the coexistence of two or more groups of investors, e.g. momentum traders and disposition investors.

* Corresponding author. Tel.: +49-951-863-2536; fax: +49-951-863-2538http://www.uni-bamberg.de/sowi/finanz.

E-mail address: finanz@sowi.uni-bamberg.de (A. Oehler).

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1. Introduction

Kahneman and Tversky (1979, p. 287) suggest in their analysis that "...a person who has not made peace with his losses is likely to accept gambles that would be unacceptable to him otherwise". Staw (1976, p. 27) indicates from his study that "...within investment decision contexts, negative consequences may actually cause decision-makers to increase the commitment of resources and undergo the risk of further negative consequences". He portrays such escalating commitment as "knee-deep in the big muddy". Shefrin and Statman (1985, p. 777) extended Kahneman and Tversky's (1979, 1992) general prospect theory to investment decisions to predict that investors have "the disposition to sell winners too early and ride losers too long". They labeled this behavioral phenomenon which is prompted by the human desire to avoid regret or losses "the disposition effect".

Prior empirical and experimental research give evidence that many investors tend to sell assets that have gained in value (so-called winners) too soon and keep assets that have lost in value (so-called losers) too long, instead of behaving rationally in accordance with the axioms of the expected utility theory. Shefrin and Statman explained the disposition effect by two main features of the prospect theory. First, decision-makers frame their choices in terms of potential gains and losses. Second, people behave as if evaluating the decision consequences on an S-shaped value function, which is concave for gains and convex for losses. This reflects risk aversion in the gain region and risk-seeking in the loss region. Kahneman and Tversky labeled the difference in risk attitude for gains and losses the "reflection effect".

The disposition effect as an individual behavior causes the investment pattern that the number of assets (stocks) intended for sale will be smaller for losers than for winners relative to a specific reference point. Such investment behavior has been well documented in several studies using data from real investors' accounts or experimental questionnaire designs with exogenous prices (not determined by trading actions). However, the authors know of no evidence of a market setting where prices are determined endogenously by an aggregation of demand and supply functions of both rational and disposition investors, i.e. investors who are affected by the disposition effect.

The crucial issue is whether the individual-level disposition effect attenuates, or perhaps worsens, by an institutional aggregation like trading in markets. In the literature several arguments exist which may lead to the prediction that individual biases are eliminated on the market level (e.g. financial incentives, learning; see the discussion in Camerer, 1990, p. 128). This means that the market result is unbiased as if investors behave rationally. Our results show that although the disposition bias

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