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Professional trader discipline and trade disposition ☆

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Abstract

Recent evidence indicates irrational behavior among retail investors. They hold onto losses and sell winners in a manner consistent with the disposition effect. Market professionals often use the term "discipline" to indicate trading strategies that minimize potential behavioral influences. We investigate the nature of trading discipline and whether professional traders are able to avoid the costly irrational behaviors found in retail populations. The full-time traders in our sample hold onto losses significantly longer than gains, but we find no evidence of costs associated with this behavior. The successful floor futures traders in our sample exhibit trading

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behavior characterized as rational and disciplined. Moreover, measures of relative trading discipline have predictive power for subsequent trading success.

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1. Introduction

The behavioral finance literature suggests that certain market anomalies are consistent with the presence of irrational trading by investors (e.g., Bernartzi and Thaler, 1995).[1] Recent evidence, for example, Odean (1998a) and Grinblatt and Keloharju (2000), suggests that various populations of traders exhibit irrational behavior. Odean (1998a) finds that winning stocks sold by a sample of retail traders subsequently outperform the losers that they continue to hold, evidence he attributes to the disposition effect.[2] Grinblatt and Keloharju (2000) find that Finnish retail investors are reluctant to realize losses, after controlling for trading style (which Odean does not) and many other factors. They also find significant differences in trading styles between Finnish retail investors and foreign institutions, as does Grinblatt and Keloharju (2001), suggesting that professionals could differ from retail customers. However, little evidence has been offered as to whether the disposition effect influences the decisions of professional traders.[3]

Is it surprising that small retail investors have eccentric and potentially costly trading patterns? Evidence of irrationality, including the disposition effect or overconfidence (e.g., Odean, 1998b), is certainly consistent with conventional wisdom and anecdotal evidence. Generic trading advice literature typically warns against the type of trading patterns described by the disposition effect and proposes instead disciplined approaches, through which investors are advised to use predetermined trade exit points (times or prices) to mitigate any potential behavioral

[1]Barberis and Thaler (2002) define behavioral finance as the study of how irrational behavior could influence market prices, driving them from their fundamental values.

[2]Ranguelova (2001) shows that evidence of the disposition effect in Odean's sample is found only in highly capitalized stocks and that it could be mitigated by analyst coverage, suggesting informational explanations for the patterns. Fama (1998) discusses some of the pitfalls in interpreting empirical results as evidence of irrationality. In Shefrin and Statman (1985), the disposition effect is costly because of overpayment of taxes. Additional support for the behavioral basis for the disposition effect and associated costs is provided by Kahneman and Tversky (1979), Kahneman et al. (1990), Heisler (1996), Weber and Camerer (1998), Barber and Odean (2000, 2001) and Shapira and Venezia (2001). Other research, including Shefrin and Statman (1985) and Ferris et al. (1988), looks at volume patterns for stocks conditioned upon prior price changes. In an experimental setting, Kirchler et al. (2002) find a framing effect, as well as an apparent disposition effect, though this is mitigated by positive framing.

[3]Coval and Shumway (2005) examine behavior on the Chicago Board of Trade. Haigh and List (2005) find, in an experimental setting, that a small self-selected sample of 54 professional traders are *more* prone to show symptoms of myopic loss aversion than 64 undergraduate students.