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Revealed stock preferences of individual investors: Evidence from Chinese equity markets

Lilian Ng [a,*], Fei Wu [b,1]

[a] *University of Wisconsin-Milwaukee, School of Business Administration, PO Box 0742, WI 53201-0742, USA*
[b] *Massey University, Department of Finance, Banking and Property, Palmerston North, New Zealand*

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Abstract

We examine the stock preferences of Chinese individual investors as revealed by their executed trades. Results show that their stock preferences vary with wealth levels. Wealthier individuals prefer stocks with high liquidity and volatility, greater state-ownership, high growth potential, and strong past performance. Less wealthy individuals, however, prefer stocks with high beta, high liquidity, poor past performance, low price, and small capitalization. Overall, the investment choices of Chinese individual investors do not necessarily suggest only behavioral biases as existing studies might have implied, but instead, they reveal to some extent the rational investing behavior of Chinese individual investors.

JEL classification: G1; G15
Keywords: Individual investors; Trading preferences; Stock characteristics

1. Introduction

Empirical research has shown that equity holdings of financial institutions reveal the institutions' preferences for certain stock characteristics. Studies on the U.S. and other developed countries show that financial institutions generally prefer stocks with large market capitalization, highly liquid stocks, and stocks with international visibility and investor recognition.[2] However,

* Corresponding author. Tel.: +1 414 229 5925; fax: +1 414 229 6957.
E-mail addresses: lng@uwm.edu (L. Ng), f.wu@massey.ac.nz (F. Wu).
[1] Tel.: +64 6 350 5799x4744; fax: +64 6 350 5651.
[2] For studies using U.S. data, see Falkenstien (1996), Gompers and Metrick (2001), Aggarwal et al. (2005), and for those using data on foriegn markets, see Kang and Stulz (1997), Dahlquist and Robertsson (2001), and Covrig et al. (2004).

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similar research on the stock preferences of individual investors is lacking. The goal of this paper is to examine whether trading activities of individual investors reveal any of the investors' preferences for stock-specific characteristics. In particular, we examine whether individual investors with varying levels of wealth exhibit similar or different stock preferences. In addition, our study also includes analyzing the revealed stock preferences of a small group of institutions. Studying the preferences of both individual and institutional investors from the same market allows us not only to compare the preferences of the two types of investors on the same basis, but also to determine the robustness of prior results on financial institutions.

This paper makes several contributions to the existing literature. First, this study represents the first to examine for evidence of stock preferences of individual investors, as revealed by their trading activities. In particular, we examine whether the trading decisions of individual investors are influenced by the fundamental financial information of a firm. To the best of our knowledge, none of the existing research has investigated whether individual investors exhibit preferences for basic stock characteristics, such as a stock's riskiness, liquidity, growth potential, or past performance. Instead, the current finance literature has largely looked at the behavioral biases associated with the trading behavior of individual investors. Investors, particularly individual investors, tend to exhibit various types of behavioral biases that may lead them to make cognitive errors (Hirshleifer, 2001). Also, individual investors tend to use "heuristics" in making financial decisions (Kahneman and Tversky, 1973 and Tversky and Kahneman, 1974).

There is a voluminous amount of research that examines effects of cognitive biases on investor decision-making processes. For example, Odean (1999) finds that individual investors tend to trade excessively, are more risk taking, and make poor investment decisions. Barber and Odean (2003) argue that because individuals face great difficulty in searching the stocks they can potentially buy, they tend to engage in attention-based buying. Sirri and Tufano (1998) provide evidence that fund investors' buying decisions are consistent with reducing search costs, and that media coverage of mutual funds is an important determinant of consumer decisions. Zhu (2002) and Ivkoviĉ and Weisbenner (2005) find that individual investors exhibit local bias by investing a disproportionate share of the equity portfolios in geographically proximate stocks. Zhu argues that accounting numbers and information asymmetry matter less to individual investors' local bias, whereas Ivkovic and Weisbenner contend that individual investors' preferences for local stocks are induced primarily by their superior information about local stocks. Dhar and Zhu (2002) find that sophisticated individuals, in particular those who are wealthy and work in professional occupations, show significantly smaller local bias. Chen et al. (2004) extend existing U.S. studies by using Chinese brokerage accounts data and find that Chinese individual investors tend to be overconfident, inclined toward a disposition effect, and exhibit representativeness bias.

The implication of all these prior studies is that individual investors are less likely to make rational decisions. As such, their decisions are not influenced by stock fundamentals that are related to a firm's financial information or future prospects. Instead, individuals' decisions are more likely driven by their emotions, e.g. acting as noise traders, and hence a stock's fundamental financial information plays no role in their trading decisions. Our study therefore allows us to explore this implication for the investment behavior of individual investors.

Second, we examine a wide heterogeneity of active individual investors in Chinese equity markets. Our analysis employs a new unique data set that contains 64.2 million trades of A-