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The propensity for local traders in futures markets to ride losses: Evidence of irrational or rational behavior?

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Abstract

Behavioral studies of individual traders' decisions indicate that the ''disposition effect'' – the propensity of traders to ride losses yet realize gains – is motivated by psychological rather than rational economic considerations. Consistent with previous studies by Heisler [Rev. Futures Markets 13 (1994) 793], Odean [J. Finance 53 (1998) 1775] and Locke and Mann [Do professional traders exhibit loss realization aversion? Working Paper, George Washington University, 2000], we find evidence of a disposition effect for both on-floor professional futures traders (''locals'') and a matched sample of non-local traders. After controlling for potential differences in trader characteristics, comparisons reveal a stronger disposition effect among locals than non-local traders. Given that locals must trade profitably to survive, it is improbable that they are more irrational in their loss riding than non-locals. To the contrary, evidence is provided that paper losses for local traders are more likely than for non-locals to become either realized or paper gains by the time of the next transaction. This result is consistent with the hypothesis that locals, by their presence on the trading floor, have privileged albeit short-lived information on order flow that allows them to form relatively accurate probability predictions of the direction and strength of short-term market price shifts.
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1. Introduction

This paper examines the propensity of futures traders to realize profitable positions, but "ride" equivalent losing positions. Shefrin and Statman (1985) describe this asymmetry, observed among investors in mutual funds, as the "disposition effect". [1] Based on the seminal work of Kahneman and Tversky (1979), the disposition effect is explained using a "prospect theory" of investment under uncertainty. Prospect theory assumes that the utility (psychological "value") function of investors is defined with respect not simply to levels of wealth but to gains and losses relative to some cognitively determined starting point (e.g. a pre-existing market value). Importantly, this function is concave and relatively flat in gains (consistent with risk aversion), and convex as well as relatively steep in losses (consistent with risk seeking). It follows that investors achieve greater psychological "value" from the recovery of a dollar lost than from an added dollar of gain, and thus have more to achieve psychologically by holding losses than gains. The effect is sometimes known as "loss aversion", meaning an aversion not to losses per se but to their realization.

Odean (1998) found strong evidence of a disposition effect in the transactions of a vast group of share traders operating through a discount brokerage firm. He compared the frequencies with which gain and loss opportunities are realized by traders, and observed significantly higher rates of realization of gains than losses. Two previous studies have examined the disposition effect in a futures market setting. Heisler (1994) examines the disposition effect amongst a group of small off-floor traders in Treasury Bond futures listed on the Chicago Mercantile Exchange. This study finds that the average round trip trade is significantly longer in time for positions that show an initial loss than for those showing an initial paper gain, and that the magnitude of the disposition effect is negatively related to the success (profit per trade) of traders. Based on these observations, it is concluded that traders exhibit irrational loss aversion. In a more recent study, Locke and Mann (2000) examined the disposition effect for a sample of floor traders trading for their own account in Deutsche Mark, Swiss Franc, Live Cattle and Pork Belly futures contracts traded on the Chicago Mercantile Exchange, whom they describe as professional traders. Similarly to Heisler (1994), traders are observed to hold losing positions longer than winning positions, and the strength of this effect is negatively related to trader success. The implication is that even professional traders are subject to irrational loss aversion.

Neither Heisler (1994) nor Locke and Mann (2000) compared the behavior of professional floor traders against small off-floor traders, and thus no evidence is provided of whether one group of traders is more or less prone to the disposition effect. Our study makes this comparison and tests the extent to which loss riding by professional traders is explained by their informational advantages relative to off-floor traders.

[1] Shefrin and Statman (1985) provide evidence, albeit statistically insignificant, that the ratio of redemptions to purchases of mutual fund shares is higher in months that mutual funds generate capital gains than months in which they generate capital losses.

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