



# The role of financial advice and word-of-mouth communication on the association between investor personality and stock trading behavior: Evidence from Chinese stock market

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## ARTICLE INFO

### Article history:

Received 21 April 2016

Received in revised form 29 October 2016

Accepted 20 November 2016

Available online xxxx

### JEL classification:

D83

G11

G12 G14

### Keywords:

Behavioral finance

The Big Five personality

Information sources

Trading behavior

Chinese Stock market

## ABSTRACT

The purpose of this study is to investigate how the strength of association between investor personality traits and stock trading behavior is sensitive to the key sources of information used by investors as the basis for their financial choices. The study utilized the Big Five personality framework from Costa & McCrae (1992) and examined the data collected from 541 individual investors in Chinese stock market. We provide empirical evidence that the key sources of information moderate the relationship of the Big five personality traits and stock trading behavior. Investors with openness and neuroticism traits trade stocks more frequently when they acquire information from financial advice whereas extraverted and conscientious investors trade stocks less intensively when they use financial advice. Investors with extraversion and agreeableness traits trade stocks more intensively when they acquire information via word-of-mouth communication. Open minded, conscientious and neurotic investors adjust their portfolio less frequently as a result of social interaction. No previous study has been conducted so far exploring variations in the impact of the Big Five investor personality traits on stock trading behavior by the key sources of information and this paper strives to fill this gap in Chinese stock market.

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## PsycINFO classification

3120

3920

## 1. Introduction

In recent years the growing responsibility of individuals to save for retirements has given rise to stock market participation (Campbell, 2006; Lusardi & Mitchell, 2007; van Rooij, Lusardi, & Alessie, 2011). In the meantime, the sophistication of financial products and the volatile financial markets have made it challenging for individuals to invest wisely (Lusardi & Mitchell, 2011a). Previous researchers have documented that a number of households lack financial literacy (Lusardi & Mitchell, 2007), do not possess information regarding financial markets (Guiso & Jappelli, 2006), fall prey to behavioral biases (Kahneman, Knetsch, & Thaler, 1991) and trade too much (e.g., Barber & Odean, 2001), which in turn leads to sub-optimal financial decision making

(e.g., Campbell, 2006; Goetzmann & Kumar, 2008; Polkovnichenko, 2005).

Given the individual investors' limited ability to make informed trading decisions under uncertainty i.e., where estimating expected returns and probability distribution of returns is difficult, the key sources of information play a big role in determining investors' financial choices. Investors may choose to acquire information from a variety of sources; some of the sources are specialized (e.g., advice of financial experts), whereas others are non-specialized (e.g., information acquired from friends, peers or by other means of social interaction). Each source of information is different in terms of the value of information as well as the costs incurred by investors. In the past literature, little attention has been paid to enhance the understanding of how the key sources of information used by investors as a basis for their financial choices are associated with investor personality and trading behavior. In this research we investigate how stock trading behavior of unique investor personality traits is influenced by the use of key sources of information.

The efficient market hypothesis (EMH), which is based upon the normative model of traditional financial theory, states that the market participants who are rational process all market information accurately. EMH also describes that markets are fully efficient as all market information is already incorporated in current securities prices, therefore no new information or rigorous analysis should result in additional

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trading in order to outperform a benchmark. On the other hand, behavioral finance theory suggests how market participants actually behave in reality, which is in accordance with the descriptive model of decision making used in psychology. The descriptive model shows how investors fail to process all market information because just like the decision outcomes in other walks of life, trading decisions of investors may also be influenced by numerous psychological processes such as affect, cognition, and heuristics. Human cannot process all relevant information because human behavior is influenced by either “*affective reactions*” such as emotion, feelings, and mood or by “*cognitive reactions*” such as being distracted or influenced by available information. Individuals, on the other hand, also use so called “*heuristics*” i.e., rules of thumb that people used to make decisions in a limited time frame in order to reduce complexity in a given situation (Pitters & Oberlechner, 2014). In current study we develop a conceptual framework by taking insights from yet another psychological discipline: personality psychology, to explain reasons for the variations in individual investors' trading behavior when they choose to acquire information from different sources. The theoretical model in our study seeks to explain that investors of various personality types may be influenced by various psychological processes which in turn may influence the way they interpret signals from different sources of information, thereby influencing their decisions to trade in stocks.

## 2. Literature review

### 2.1. Investor personality and trading behavior

In the emerging literature of behavioral finance, a number of studies have documented trading behavior of investors based on various psychological explanations. Odean (1998), Gervais and Odean (2001), and Daniel, Hirshleifer, and Subrahmanyam (1998) proposed theoretical models in which investors cannot accurately assess their investment ability because they are susceptible to behavioral biases. Investors in their models become overconfident about their investment skills over a period of time and trade excessively. Barber and Odean (2001) also provided support for overconfidence bias. They found that portfolios of overconfident investors exhibit excessive trading activities but poor investment performance. Grinblatt and Keloharju (2009) showed that investors who are more prone to psychological trait of sensation seeking trade stocks more frequently. They argued that the act of buying and selling stocks may provide more varied and novel experience to these investors than a buy and hold strategy. Similarly, other researchers showed further anomalies in the individual investors' trading behavior that can be attributed to other psychological foundations (see e.g., Barber & Odean, 2002; Barber & Odean, 2008; Dhar, Goetzmann, & Zhu, 2004; Rashes', 2001).

In one of the sub-disciplines of psychology, i.e. personality psychology, it is argued that personality is a key determinant of human behavior. In a given situation, personality forms a specific inclination towards a certain characteristic reaction; therefore, personality can be regarded as a key driver of human behavior (Heinström, 2003). Psychologists believe that trading decisions of investors represent a form of human behavior which may be attributed to investor personality. In behavioral finance literature, a few studies have modeled the trading behavior of investors based upon rich insights taken from personality psychology. Pompian and Longo (2004) argued that by identifying the basic investor personality type, advisors can help their clients achieve investment goals by reducing non-rational behavior arising from behavioral biases. Van Witteloostuijn and Muehlfeld (2008) showed that personality traits of traders such as locus of control, maximizing tendency, regret disposition, self-monitoring, sensation seeking and type-A and type-B are associated with trading behavior. Durand, Newby, and Sanghani (2008) showed that the Big Five personality is associated with investors' trading behavior. They found negative relationship between extraversion and trading. These findings are odd compared with the previous

theoretical prediction that sociable individuals tend to trade more. In the same way Durand, Newby, Tant, and Trepongkaruna (2013) also found negative relation of extraversion with trading. They suggested that extraverted individuals tend to have higher bid-ask spread and therefore are less willing to trade frequently. Durand et al. (2008) found positive relationship between negative emotion and trading frequency, which is in line with the argument that neurotic investors trade more to reduce unpleasant feelings brought about by external stimuli. Durand, Newby, Peggs and Siekierka (2013) found positive association of conscientiousness with trading behavior. These findings also match with those of Durand et al. (2013) who postulated that conscientious individuals exercise their efforts to achieve desired results and hence trade more. More recently while analyzing the relationship between personality traits of Finnish individuals and stock trading behavior, Conlin et al. (2015) found that various personality traits (novelty seeking, reward dependence, harm avoidance, persistence) and sub-scales of the traits, measured by Temperament and Character Inventory (TCI) of Cloninger, Svrakic, and Przybeck's (1993), are significant predictors of investors' stock market participation. The above-mentioned studies have discovered how differences in investors' psychological characteristics result in variations in their financial behavior. These variations are yet largely unexplained, and therefore, new approaches are required to discuss how investors' psychological characteristics, such as personality, may influence investor decision making in financial markets.

### 2.2. Sources of information and trading behavior

#### 2.2.1. Financial advice

Financial advisors may impact trading behavior of investors in two opposite directions. As financial professionals are less likely to suffer from behavioral biases, they can limit excessive trading of their clients (Shapira & Venezia, 2001). Researches categorize behavioral biases according to some framework. Some define biases as heuristics, beliefs, judgments, and preferences while others categorize them into cognitive and emotional biases. Cognitive biases originate from faulty reasoning and include heuristics, availability, and representative biases. Conversely, emotional biases stem from impulse or intuition and include loss aversion, self-attribution, and conservatism. Both types yield non-rational judgments, therefore, better information may help investors to avoid harmful effects of these biases (Pompian, 2012). On the other hand, the fact that financial advisors have incentives to earn higher trading commission may drive them to increase trading of their clients (Haigh & List, 2005; List, 2003). Financial advisors are able to moderate trading activity (Campbell & Viceira, 2003). It has been argued that the quality of information source has a positive impact on trading as news from more reliable sources leads investors to adjust their portfolios more frequently (Epstein & Schneider, 2008). Fischer and Gerhardt (2007) suggested that financial advice has a positive impact on trading because it allows investors to have better self assessment of their own skills and thus leads to more rational investment decisions. Shapira and Venezia (2001) found that the number of different stocks and stock transactions per year increases when investors get professional advice. These findings suggest that financial advisors promote diversification of their clients' portfolios, showing a positive impact of financial advice on trading. Using data from German bank, Gerhardt and Hackethal (2009) examined the influence of financial advisor on households' trading while controlling for self-selection bias, and found negative association between financial advice and trading. These findings were confirmed by Karabulut (2013) who also showed the negative relationship of financial advice and trading frequency. On the other hand, Hackethal, Haliassos, and Jappelli (2012), while studying German investors from internet brokerage firm, found that investors increase trading when they get financial advice. Kramer (2012) also found the similar evidence while examining Dutch investors. They showed that advised investors execute more trades as compared to self-directed investors.

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