

Overconfidence and Excessive Trading Harm Investor Returns

By Dan Richards
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Dan Richards interviewed Professor Odean on January 4 at the annual meeting of the American Economic Association in Atlanta, GA. This interview is one of a series that Dan conducted at that conference, and we will provide links to videos of his other interviews. Dan is president of Toronto-based Strategic Imperatives.

How exactly do you define behavioral finance?

Behavioral finance is basically the same as classical finance with the added twist that you take into consideration that people are not always rational with respect to money. These departures from rationality can make a difference – to behavior and to welfare, particularly for individual investors. A lot of us believe that they make a difference in markets. Markets do not behave as smoothly as they would if everyone were always rational.

Let's talk about the research you and your colleague, Brad Barber, have done digging into the trading behavior of individual investors.

We've done a lot of studies looking at different aspects of investor experience and what individual investors do. We looked at trading activity and the effect of active trading on people's returns. The first study I did on this was as part of my dissertation. I was able to obtain trading records for 10,000 investors at a large discount brokerage firm.

The question I asked is if someone sells a stock and then buys another stock, on average does the stock they bought outperform the one they sold by enough to cover their trading costs? Somewhat to my surprise, I found out that, not only do people not cover their trading costs – and I had expected that – but on average the stocks they bought went on to underperform the stocks they just sold. The shortfall was 2-3% over the course of the year, on average.



People were not doing well. They were clearly trading too much.

So that was the first study you did. Where did you go from there?

I obtained a second dataset from a large discount brokerage firm. My colleague Brad Barber and I looked at this. We wanted to get at the same issue. Are people trading too much? What is the effect of active trading on the return for average individuals?

We looked at trading records for over 60,000 households. These were self-directed accounts. We put them in five groups based on how actively the portfolios were being traded – the turnover rate in the portfolio. We had the virtual buy-and-hold portfolios right on up to the very active traders, and for each group we calculated the average annual net return (after trading costs).

We found that the buy-and-hold investors were, on average, outperforming the active investors by about 6% per year. Thus, we titled the paper, “Trading is Hazardous to your Wealth.”

And where did you take your research from there?

We looked at the same topic one more time, from a little bit of a different angle. I had written a theory paper that said that, due to overconfidence, people are likely to trade more than they should and earn a little less than they would if they hadn't traded as much. The theory was that overconfidence is one of the things that leads people to trade too much.

An ideal test of that theory was to get a large sample of investors and to somehow separate them into those who tend to be more overconfident and those who tend to be less overconfident. We had data on a large sample of investors, but we didn't have any way to send out a psychological test of over-confidence to 60,000 investors.

For over 30,000 of those investors we had a lot of demographic data. We looked at the psychology literature and reflected on our own anecdotal observations. We realized that on average, men and women differed in their average degree of overconfidence. What surprised some people – but not my wife – was to find out that men tended to be more overconfident.



How did this translate into investment returns?

We divided our group into men and women. We started with a prediction: men are going to trade more actively, and this trading will hurt their returns. That's exactly what we found.

Men traded 67% more actively than women in our sample. When we looked at the effect of trading on people's returns – what people earned versus what they would have earned if they had taken a buy-and-hold approach. Men and women were both underperforming a buy-and-hold approach, but men were underperforming by an additional 1% a year. This is consistent with the idea that overconfidence can lead you to trade too much and that excessive trading hurts your returns.

What are the key conclusions that an individual investor should take away from your research? What are the one or two takeaways?

The advice I give is pretty much the advice I think you get from most, if not all, financial advisors. Generally speaking, you should buy and hold, invest for a long horizon, pay attention to your trading costs and taxes, and diversify.

There are various ways you can do that, but the easiest, most straightforward way is to buy a low-cost, well diversified mutual fund. Pay attention to the fees they are charging you. Buy it and hold it for a long time.

Don't tinker a lot and don't try to market-time. The reason not to market-time is not that it's impossible to do it; it's that most investors get it wrong.

I've done another study with Brad Barber and other colleagues in Taiwan. One of the things we looked at was the market-timing of individual investors as opposed to institutional investors.

We found that when individuals put money into the market, the market does less well over the next six months. When individual investors take money out of the market, the market subsequently performs better.

There is a Seinfeld episode where George decides that since everything he does goes wrong, he's going to always do the opposite of what his instincts tell him. It might be that you could make money going against your own instincts, but my advice is to diversify and buy and hold, and pay attention to your costs.



Lets talk a little bit about two or three of the common “traps” in behavioral finance that research has found.

For individual investors, one is trading too much and the other is under-diversifying. These are both very harmful.

People who hold too few stocks are subject to a lot of risk. The worst thing you can do is to only own the stock of the company you work for. If the company goes bankrupt, you lose your job and your savings.

Getting diversification is really easy these days. You simply need to buy a well diversified mutual fund. It’s a very simple problem to solve.

If you look at the portfolios of individual investors, as I have, you see that they are often very under-diversified.

Why is it that?

The under-diversification comes in part from a lack of understanding of how probability works and a lack of understanding of what the appropriate behavior is in the markets.

I’ve had financial advisors say to me “everyone talks about diversification, but Bill Gates didn’t get to where he is today by diversifying.” My response is “you are absolutely right.” If you hold a well-diversified portfolio, you will never be as wealthy as Bill Gates. On the other hand, if you hold an under-diversified portfolio, you will never be as wealthy as Bill Gates either.

The issue is that if you hold an under-diversified portfolio you may end up like the Enron employees who had all their money in their company stock.

Diversification protects you from the extreme lows, but you’re not going to win the lottery either. You are going to get a good return.

We talked earlier about overconfidence. How does overconfidence relate to the lack of diversification?

It clearly leads to trading too often, and it contributes to under-diversification. If you are sure you are right, there is no need to hedge your bets and diversify.

If you get an idea and you say to yourself, “Oh, that’s a great idea,” then you are more likely to act on that. If you say to yourself, “I think that this might be a great stock, but really I don’t know that much about it. I should do more research before I act,” then you are not as likely to trade.



The impulsive, overconfident, and often male investor trades too much.

What is another common behavioral finance trap?

Investors tend to hold their losers and sell their winners; that is referred to as the disposition effect. It is problematic for a couple of reasons.

First, it is contrary to the advice that most financial advisors and accountants would give you. At least in a taxable account in the US, there is a tax deduction for realizing a loss and a tax hit for a gain.

I did a study and looked at people's behavior month-by-month. I found that only in December were investors in the US tending to sell their losers instead of their winners. Throughout the rest of the year, they kept realizing gains. The reason they realize gains is that it feels good to sell something for a profit and it feels bad to sell something for a loss. So people hold onto their losers and tell themselves, "It's going to bounce back. It's only a paper loss. When the market figures out what I already know, this thing is going to do okay."

They postpone their regret. They realize the good feelings of selling for a gain. They increase their taxes and, it turns out, they lower their future returns. In the sample I looked at of 10,000 individual investors, the winners that were sold went on to outperform the losers that people held on to.

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