
RESEARCH ELSEWHERE

Robert A. Olsen

The Profitability of Active Stock Traders

By Ryan Garvey and Anthony Murphy

Journal of Applied Finance, Vol. 15, No. 2, 2005, pp. 93–100.

Are stock day traders much like Casino gamblers in that they tell about their gains but neglect to mention their losses? In this empirical study the authors give a detailed glimpse into the trading lives of 1,386 active day traders executing about 400,000 trades over a one month period. None of the traders were market makers and most could be characterized as non professional, but involved, investors. Most of the trades were executed thru a NASDAQ market maker or on Island ECN (INET).

The bottom line is that approximately 50% of the traders made money and 50% lost money, after commissions. About 55% of the round trip trades generated a profit and on balance the dollar value of profitable trades was about 100% greater than the dollar value of the losses. An examination of the stocks traded, the timing of trades, the dollar value of the trades, etc. did not suggest any significant differences between winning and losing traders. Thus luck (chance) rather than skill appeared to be the only explanation for winner/loser categorization.

Many previous studies have noted that the odds are against traders without skill or insight since stock markets generally rise more often than fall over time, giving an edge to a buy and hold strategy. This study appears to confirm this belief.

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Thy Neighbor's Portfolio: Word of Mouth Effects in the Holdings and Trades of Money Managers

By Harrison Hong, Jeffrey Kubik, Jeremy Stein

Journal of Finance, Vol. 60, No.6, 2005, pp. 2810–2824.

This empirical study utilizing market and mutual fund portfolio data is unique in that it investigates whether money managers spread information and ideas about stocks between each other by word of mouth. Word of mouth information transmission is often mentioned in writings about the market but there is little hard evidence about its existence, where professional money managers are concerned.

This study utilizes fund trade data on 2000 stocks and 1635 mutual funds headquartered in 15 large U.S. cities. After carefully controlling for other influences, the authors find that non family related funds in the same city trade in concert more often and to a greater degree than funds located in different cities. This own-city/other-city differential is pronounced across the whole range of market cap categories. As the experimental design allows the authors to rule out other possible explanations such as "reputational herding" and selective information distribution at the city level by corporate managers, the authors conclude that word of mouth information transmission appears to exist among many mutual fund managers at the city level.

Intangible Assets, Information Complexity and Analyst's Earnings Forecasts

By Feng Gu and Weimin Wang

Journal of Business Finance and Accounting, Vol. 32, No. 9, 2005, pp. 1673–1701.

Decision making research suggests that decision quality should be negatively impacted by complexity.

In particular, where information is incomplete, inconsistent or difficult to analyze, forecast accuracy should suffer. Consistent with this research, the authors hypothesize that analyst earnings forecast accuracy should be poorer for firms that derive a larger than normal proportion of their earnings from intangible and innovative technology oriented sources.

Using actual analyst forecasts and other firm specific data from 1981 to 1989 (approx. 18,000 observations), the authors find a positive association between analyst forecast error where the firm's intangible asset intensity deviates from its industry norm. In addition, firm diversity and technological innovativeness are positively associated with increased earnings forecast error. Industries with greater intangible intensity do not however have greater forecast error than those with low tangible intensity. Thus it appears that the greater forecast inaccuracy for firms with greater intangible intensity within a specific industry results from analyst forecasting methods that do not fully adjust for intra industry differences.

The authors also find evidence indicating that greater industry regulation leads to improvements in forecast accuracy.

Winners, Loses, and Biased Trades

By Joseph Johnson, Gerard Tellis and Deborah Macinnis

Journal of Consumer Research, Vol. 32, September, 2005, pp. 324–329.

The “hot hand” is a fallacy wherein individuals project a rising (falling) trend in a random sequence. Similarly, the “gambler's fallacy” refers to a situation where individuals project a reversal in a random sequence. Previous research has suggested that these two fallacies may be responsible for investor's tendency to sell winning stocks too soon and to hold on to losing stocks too long. However, what is behind investor's behavior to follow one fallacy over the other? Might trend length play a role?

Using a series of laboratory experiments involving investment decisions, the authors find that, *ceteris paribus*, subjects appear to use the length of a trend sequence to determine whether to follow the hot hand or the gamblers fallacy. Specifically, when a trend is shorter, subjects appear to follow the hot hand, but when a trend is longer the gambler's fallacy seems to dominate. In effect, people in a “buying frame” seem to follow the “hot hand” while those in a “selling frame” follow the “gambler's fallacy”.

Long Term Returns on the Original S & P 500 Companies

By Jeremy Siegel and Jeremy Schwartz

Financial Analysts Journal, Vol. 62, No. 1, 2006, pp. 18–31.

Investors are often advised to “upgrade” their investment portfolios if they are benchmarked to the S & P 500 Index. The reason given is that the new companies being added represent the vibrant future while those being dropped are old and dying firms. As the authors of this paper suggest, this is bad advice because “good companies” often are not necessarily “good investments” and vice versa.

In this empirically focused paper the authors compare the performance of “alternative” S & P 500 portfolios from 1975 to 2003. By 2003 the original indexed S & P firms represented only 31% of the current index value and a total of 917 firms had been added and dropped from the Index. The baseline portfolio is the updated S & P 500 index. The others are constructed using alternative assumptions about reinvestment of funds released from stocks dropped from the 1975 Index. The results unequivocally reveal that returns were higher and risks lower for all portfolios that were not “updated” to follow the S & P 500. For example, a portfolio of remaining S & P original firms would have generated a geometric return of 11.3% per year with a standard deviation of 15.7% while the updated S&P portfolio would have earned 10.8% with a standard deviation of 17.0%. The results favoring the original index stocks would have been even stronger if taxes and transaction costs were included. The authors argue that the poorer performance for the updated S & P portfolio primarily results from the overvaluation and price pressure caused by the benchmarking portfolio changes of many stock funds. The superior performance of the original S & P firms tended to be spread across all industry sectors.

The Effects of Imprecise Probabilities and Outcomes in Evaluating Investment Options

By Ning Du and David Budesu

Management Science, Vol. 51, No. 12, 2005, pp. 1791–1803.

Previous research has generally suggested that investors dislike vagueness and that attitudes toward vagueness are somewhat independent of attitudes toward risk. Vagueness can be associated with different attributes of an investment. In this laboratory study, the authors investigated the influence of vagueness about

probabilities, outcomes, and gains versus losses in an investment setting.

Using an experimental design involving the computation of “certainty equivalents”, pair wise comparisons and an information acquisition task, the authors arrived at the following conclusions;

1. Decision makers are more sensitive to vagueness in outcome than probabilities.
2. Decision makers are more vagueness averse in gain domains as opposed to loss domains.
3. As vagueness increases, vagueness avoidance increases at an increasing rate.

The principal implication of this study is that how investors respond to vague information appears to be influenced by its source and presentation.

CEO Overconfidence and Corporate Investment

By Ulrike Malmendier and Geoffrey Tate

Journal of Finance, Vol. 60, No. 6, 2005, pp. 2661–2700.

Previous studies of “over investment” by corporate officers have focused on the impact of asymmetric information between stockholders and managers and the “perks” that might accrue to managers as a result of over investment in corporate assets (i.e. agency problems). This study is unique in that it focuses on manager overconfidence as cause of over investment in firm assets.

The study uses company investment and personal manager portfolio data from 477 large U.S. firms over the period 1980 to 1994. Manager confidence is proxied by using managers’ personal transactions in their company’s stock. Specifically, situations suggesting “over investment” by managers in their own company’s stock are seen as indications of overconfidence by managers in newly acquired company assets. Multiple regression results indicate that managers’ corporate investment decisions are positively associated with firm cash flow and manager confidence. More specifically, when manager confidence is high, the sensitivity of corporate investment to company cash flow is significantly greater than when confidence is low. Ade-

quate internal corporate cash flow appears to be a necessary but not sufficient condition for firm over investment. Even with high confidence, managers refrain from investment if they must use external funds to acquire new assets.

The Effectiveness of Simple Decision Heuristics: Forecasting Commercial Success for Early Stage Ventures

By Thomas Astebro and Samir Elhedhli

Management Science, Vol. 52, No. 3, March 2006, pp. 395–409.

The use of heuristics by experts has come under much scrutiny and criticism as many studies have indicated that simple linear models usually result in more consistent and better decisions when the decision making process is repetitive. This study is informative in that it investigates expert decision making in a repetitive but very complex environment. This study looks at the decision behavior of analysts at the Canadian Invention Assistance program, CIAP. The CIAP is faced with the task of forecasting the commercial feasibility of inventions submitted to it by Canadian citizens.

Analysts at the CIAP rate each invention on 37 informational cues and then subjectively combine the results to arrive at a recommendation for the inventor. The data collection process is standardized but the analysts have no formal historical “base rate” for reference and must work with information that is often vague and incomplete. Very seldom do they know whether their advice was taken, and if so, what the ultimate outcome was. The analysts also have minimal or no personal contact with the submitting inventors. The data set for this study involved 561 inventions submitted between 1989 and 1994. The significant result was that the analysts correctly predicted success at a higher rate than that of the best statistical model. Experts were correct about 86% of the time while the best model was correct 79% of the time. The experimental design was such that the analysts’ superior performance could not be interpreted to be the result of a “self fulfilling prophecy”. The superior analyst performance appeared to be the result of using a conjunctive decision model that heavily weighted negative cues.

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