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ABSTRACT

A scopic regime constitutes a state of permanent reciprocal observation and scrutiny among participants. We investigate whether this environment reduces the disposition effect among retail traders as they are constantly scrutinized by others, thus driving them to realize and limit their losses. We use two anonymous data sets, the first from a popular social trading platform (STP) governed by a scopic regime, and the second from a traditional foreign exchange broker. STPs allow participants to interact and copy each other's trades using mirror trading, thus implicitly creating two groups; trade leaders who execute unique trades to build their performance record, and copiers who allocate funds to be managed by the former. We find ample evidence of a weaker disposition effect among trade leaders in the scopic environment compared to traders in a traditional setting. Our findings suggest that a state of constant observation and scrutiny erodes the disposition effect as individuals become more self-conscious of their actions and limit their losses to avoid tarnishing their public trading record.

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1. Introduction

“Cut your losses” is an expression said to encourage a person to stop wasting valuable resources on something that is deemed as failing. While this may seem evidently logical, some individuals do not quite abide by this prescription. Shefrin and Statman (1985) termed this phenomenon as the “disposition effect,” which represents an investor's tendency to quickly realize gains and hold on to losses. This behavior, which has been extensively documented in the literature (Chen et al., 2007; Feng and Seasholes, 2005; Grinblatt and Keloharju, 2001; Linnainmaa, 2010; Nolte, 2012; Weber and Camerer, 1998), opposes rational economic models and has been shown to result in poor financial performance (Odean, 1998; Seru et al., 2010). Researchers have identified several cognitive illusions and emotional biases that contribute to the disposition effect, including mental accounting, loss-aversion, regret-aversion, self-control, and mean-reversion (Kahneman and Tversky, 1979; Odean, 1998; Shefrin and Statman, 1985). While these biases cannot be easily removed, individuals can still attempt

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to understand them and aim to prevent such predispositions by adopting a more systematic analysis of market conditions (Kahneman and Riepe, 1998). Consequently, correcting mechanisms may arise when one obtains a better understanding of circumstances (Wegener and Petty, 1995). Several studies have presented evidence showing that traders can learn from their past trading activities to reduce the disposition effect (Boolell-Gunesh et al., 2009; Chen et al., 2007; Dhar and Zhu, 2006; Feng and Seasholes, 2005; Grinblatt and Keloharju, 2001; Seru et al., 2010; Shapira and Venezia, 2001). This argument is based on the idea that individuals would examine their ex-post performance and sensibly distinguish and attribute specific poor performing trades to their tendency to realize gains prematurely and hold on to losses, thus adjusting for the disposition effect. Nevertheless, what happens when individuals find themselves in an environment where their actions are constantly being scrutinized in real-time, and where poor performance may instantly tarnish their reputation? Under such conditions, traders may exhibit a heightened degree of self-consciousness such that they become more aware of the negative consequences associated with poor performance. Hence, traders would adapt their behavior as they tend to avoid displaying poor decisions by limiting losses instead of holding on to them – this can be achieved by realizing the loss on an open positions to avoid further loss – and seek to realize larger gains in order to showcase their superior trading skills. Consequently, an environment that promotes constant scrutiny is expected to erode the disposition effect.

In a traditional financial setting, institutional investors typically circumvent constant scrutiny by the use of formal structured contracts that outline how much and what type of information is disclosed on predetermined dates. For instance, mutual funds are generally required to disclose their holdings only on a quarterly basis (Haslem, 2007), while disclosure by hedge funds is voluntary (Anson, 2002). Moreover, individual traders in a traditional setting tend to keep their strategies and holdings private. In recent years, however, the rising popularity of social media has reshaped the way individuals access and participate in financial markets through new channels of communication, information sharing, and investing. One particular phenomenon that has attracted an increasing number of retail traders is social trading, which embeds the traditional online trading model into a social media network. This novel concept has been acclaimed for the high level of information transparency and disclosure that occurs in real-time, and the tools that are provided by these social trading platforms (STPs), which allow participants to interact with each other and even copy each other's trades using a mirror trading algorithm that is provided by the platform. We call this environment a “scopic regime,” which designates a state of permanent reciprocal observation and scrutiny among participants (Knorr Cetina, 2003). We use this term in an interdisciplinary fashion to distinguish the trading environment on STPs from traditional trading settings. The notion of a scopic regime is meant to characterize the organization of an activity, such as trading, where participants reciprocally observe each other's actions and receive information in real time about the decisions of other participants. For instance, under the traditional organization of the trading floor, traders on the New York Stock Exchange could not directly observe the decisions of traders on the London Stock Exchange. Under a scopic regime, embodied by the integration of social media within the trading process, traders in London, New York, and elsewhere can reciprocally observe each other's actions in real time. Furthermore, there has been heightened interest in how participation in social media changes the attitudes, behavior, and the decisions of individuals. Experimental field studies conducted outside the sphere of finance show increased emotional contagion, as well as polarization of opinions among social media participants (Bail et al., 2018; Coviello et al., 2014; Kramer et al., 2014). Within the broader context of such findings, it is relevant to understand the impact of social media on decision making in financial markets.

Participants on STPs can be divided into two main groups, which we label as trade leaders and copiers. The former are typically aspiring money managers who invest the funds allocated to them by the latter in return for monetary compensation that may be directly or indirectly based on performance. Copiers can allocate their funds using the mirror trading algorithm by easily and explicitly copying the future trades of another participant with a click of a button, thus receiving a price identical to that received by the copied participant. Nevertheless, our study focuses on the behavior of trade leaders. We define a trade leader as an individual who only personally enters trades into the STP. In other words, a trade leader is someone who executes original trades and refrains from explicitly copying others.

Given this definition, we use a unique data set from a highly popular STP, which we call SocialTrade, with around 2.5 million trades executed by 77,476 trade leaders in 2013 to test whether exposure to a scopic environment decreases the disposition effect. We adopt two methods: (1) the disposition spread proposed by Odean (1998), which estimates a trader's propensity to realize gains relative to losses, and (2) the Cox proportional hazards model, which allows us to control for trade-specific characteristics. Furthermore, we compare the results obtained for trade leaders on SocialTrade to those of traders on an anonymous traditional online trading platform, which we call TradeStream, where trading activity is kept private. We use the full data sets as well as subsets with overlapping periods and common assets in order to examine whether the difference in disposition of traders between the two platforms is due to the characteristics of the trading environment. Data limitations do not allow us to identify and examine distinctly comparable subgroups of traders on the two trading platforms or control for demographic effects, such as age, gender and occupation among others. However, given the global popularity of SocialTrade, and the large number of traders in both data sets, we work on the assumption that traders on both platforms come from similar demographic distributions. In other words, traders on the two platforms are assumed to inherently have similar propensities to exhibit the disposition effect; thus any difference in disposition levels between the two platforms can be attributed to the effect of the trading environment. Supporting evidence for this assumption is provided by Heimer (2016) who finds no significant difference in the characteristics of traders between those who joined the STP and those who never joined.

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