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Do investors hold that they know? Impact of familiarity bias on investor's reluctance to realize losses: Experimental approach

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ABSTRACT

In this article we investigate the impact of familiarity bias on the individual investor's reluctance to realize losses. Our experimental approach reveals a strong correlation between familiarity and disposition effect. We conducted 714 tests in which different respondents could sell stocks of two types – winners and losers. One group of respondents "owned" familiar assets and another group operated anonymous portfolios. The results of the experiment show that an individual investor's tendency to ride losers too long is more than twice as high in the case of unfamiliar stocks as it is when assets are familiar to the holder.

Abbreviations: PG, paper gains; PL, paper losses; RG, realized gains; RL, realized losses; PRG, proportion of realized gains; PRL, proportion of realized losses.

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1. Introduction

This article asserts that familiarity bias has a strong impact on the individual investor's reluctance to realize losses.

Despite the ever multiplying number of researches on familiarity bias and disposition effect, no study has been reported to date on familiarity bias' impact on individual investor's reluctance to realize losses. Nevertheless, even classical papers on behavioral finance find root of the disposition effect in the field of human fears and mental exaggeration such as familiarity bias.

Daniel Kahneman and Amos Tversky, authors of prospect theory, posit that the disproportion in the number of purchases and sales is strongly connected with investor's loss aversion – the asymmetry between the values that people put on losses and gains. Evaluating possible losses more heavily than possible gains, an investor behaves irrationally when sells winners too soon and hold losers too long (Kahneman and Tversky, 1979; Kahneman and Riepe, 1998). This intuition is confirmed in later studies. Particularly Hersh Shefrin and Meir Statman come to similar conclusions by placing behavioral pattern labeled "disposition effect" into a wider theoretical framework which includes mental accounting, regret aversion, self-control and tax-considerations (Shefrin and Statman, 1985). Terrence Odean prove that investors' preference for selling winners and holding losers does not depend on rational considerations (Odean, 1998). Nicholas Barberis and Wei Xiong suggest that though the disposition effect is still a reliable postulate of behavioral finance, its cause remains unclear. Their original research argues that prospect theory often predicts the opposite of the disposition effect, namely that investors prefer to sell a stock trading at a paper loss more readily than one trading at a paper gain. According to Barberis and Xiong data, the disposition effect is more likely to fail when the expected risky asset return is high and when the number of trading periods is low (Barberis and Xiong, 2009).

Studies of the impact of familiarity bias on investor's behavior gradually extend the conventional understanding of the disposition effect laws. The results of recent collective research on home bias in foreign investment decisions by Dongmin Ke, Lilian Ng, and Qinghai Wang suggest that familiarity is the source of the local bias fund managers have toward foreign firms that have presence in their home country (Ke et al., 2010). Matti Keloharju, Samuli Knüpfer and Juhani Linnainmaa find a strong positive relation between customer relationship, ownership of a company, and size of the ownership stake in the sphere of brokerage and automotive industries in Finland. Analyzing daily panel data on stock holdings, trades, and broker–customer relationships of Finnish investors, they come to a conclusion that patrons of a given broker are more than twice as likely to invest in the corresponding broker stock, and have 13% larger ownership stakes conditional on investment. This evidence suggests that a customer relationship is about as important to stock selection as home bias (Keloharju et al., 2012). Another example of impact of familiarity bias on investor's behavior comes from the latest research on familiarity in American mutual fund manager portfolio choice initialized by Veronika K. Pool, Noah Stoffman and Scott E. Yonker. Authors affirm: familiarity bias becomes a "scourge" for both individual investors and professionals. Average fund outweighs stocks from its managers' home states, as managers might simply be more familiar with home-state companies, even if they have no real information about them (Pool et al., 2012).

Thus, the knowledge on the problem of familiarity' impact on reluctance to realize losers is not rich and abundant. Several researches demonstrate a correlation between familiarity bias and the disposition effect, but no one answers the question of how familiarity affects the individual investors' intentions to realize losses?

Joint work "Is the Aggregate Investor Reluctant to Realize Losses? Evidence from Taiwan" by Brad M. Barber, Yi-Tsung Lee, Yu-Jane Liu, Terrance Odean (Barber et al., 2007) served as a source of intuition for the present paper. Barber and colleagues analyze all trading activity at Taiwan Stock Exchange for five years ending in 1999. Using a dataset that contains all trades (over one billion) and the identity of every trader (nearly four million), they quantify the extent to which investors sell losers and winners (relative to the opportunities to sell each). The main finding is that investors in Taiwan are about twice as likely to sell a stock if they are holding that stock for a gain rather than a loss. One detail mentioned by the authors became a trigger for our research: although 84% of all