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Hedging against embarrassment

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ABSTRACT

This paper assesses the extent to which the expected disclosure to peers of an individual investor's financial performance influences his/her stock-trading decisions. In a lab experiment, participants trade in incentivized stock market simulations, knowing that their financial performance will be either made public or kept private. The results show a significant increase in the disposition effect when financial performance is to be made public, resulting from a spike in the realization of gains. We conclude by suggesting that this phenomenon may be due to individuals' strategic attempt to hedge against the embarrassment of ending the trading session at the bottom of the performance ranking.

1. Introduction

In a Wall Street asset management company, a regular meeting is conducted in order to evaluate the financial performance of its various fund managers. During the meeting, managers who had the worst performance over the past months are asked to come forward and explain to colleagues and to senior managers why they failed to achieve a good performance. An experienced fund manager, John, is concerned about being among the worst performers, which will force him to come forward in the next meeting. To minimize the risk of this unpleasant experience, John wonders about adopting an investment strategy that could avoid putting him in the bottom group.

The previous scenario illustrates the potential influence of social comparisons and, in particular, the role played by the disclosure of an individual investor's financial performance in determining investment decisions. Recent evidence suggests that, in fact, social comparisons play a major role in the way individuals make investment decisions (Linde and Sonnemans, 2012). In the previously described "fund manager" example, two questions arise: if John knows that his performance will be revealed to his peers at a later point in time, will he behave differently in the trading sessions relative to a scenario in which his performance is expected to remain private? If so, how would the expected disclosure of his performance impact his investment decisions?

In this paper we assess a yet unexplored route in the field: *whether*, and if so, *how* the expected disclosure to peers (vs. privacy) of individual investors' financial performance influences one of the most prevalent anomalies in behavioral finance,

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the disposition effect – that is, investors' higher propensity to sell the stocks that have increased (vs. decreased) in value relative to the purchase price (Odean, 1998; Shefrin and Statman, 1985; Weber and Camerer, 1998).

The expected disclosure of investment outcomes can be of relevance to both individual and professional investors. Professional traders and asset managers, for example, have their respective performances made public in various setting, such as bonus payments and the disclosure of managed-funds' performance. In fact, internal public disclosure of employees' performances is often used for the incentive purposes (Endlich, 2000; Derman, 2004). In his biography, *My Life as a Quant*, the famous physicist and later financial expert Emanuel Derman describes how annual bonus payment used to work during his time as an employee at the investment bank Goldman Sachs. At that time, the payroll system was unable to cut a check for more than $100,000 US dollars. If an employee's year-end bonus was, for example, $1,000,000, then he would receive ten checks, each one sealed in its own envelope, with the whole bundle neatly stacked and secured by a rubber band. "Thus, although bonus amounts were private, and you were encouraged to keep them that way, you could guess the order of magnitude of someone's bonus by the thickness of their deck of checks. Even a mini-bundle of two checks was instantaneously distinguishable from one. Some traders received a fat stack and some of them flaunted it. One well-paid young trader had a habit of taking his bundle and silently riffling through it, meticulously counting the envelopes one at a time in full view of his colleagues." (Derman, 2004, p. 185).

To test whether and how the expected disclosure to peers (vs. privacy) of individual investors' financial performance influences the disposition effect (hereafter DE), we conducted a lab experiment in which undergraduate students participated in a simulated trading session. Participants were either told that their performance in the simulation would be made public (vs. kept private). They then played the simulation, revealed, or did not, their performances to others, and were paid according to their final earnings. The findings show that participants made different financial decisions in the stock market simulation when they expected their performance to be made public compared to the situation in which they expected their performance to be kept private. Precisely, the disposition effect increased significantly in the public condition, primarily driven by an increase in people's propensity to sell stocks that had increased in value relative to the purchase price.

Although we do not provide direct evidence for the underlying process, we speculate that the spike in the realization of gains observed in the public condition may at least in part result from people's attempt to avoid the embarrassment of finishing the trading session at the bottom of the performance ranking. That is, investors derive explicit disutility from ending in the bottom group when having to disclosure his or her financial performance to peers, which contrasts to the notion of a rational investor who only derives utility over final wealth. Our evidence suggests that the spike in the realization of gains is the channel through which this process occurs. Put simply, selling gains may be seen as a good/safe strategy for someone who wants to avoid the bottom investors' performance rank.

The rest of the paper is organized as follows. In Section 2, we discuss the related research. In Section 3, we detail the lab experiment whereas in Section 4 we build a theoretical argument to understand and explain the results from our experiment. Section 5 provides a general discussion along with robustness checks and Section 6 concludes.

2. Related research

The DE represents one of the classic anomalies in behavioral finance (Shefrin and Statman, 1985; Barberis and Thaler, 2003). People are more prone to sell assets that have increased in value relative to the purchase price than those that have decreased in relation to the same reference point. Although it is difficult to explain from a rational standpoint, this phenomenon has been observed in conventional stocks markets (Ferris et al., 1988; Frazzini, 2006; Lakonishok and Smidt, 1986; Odean, 1998), e-trading (Lee et al., 2008), and behavioral and neuroeconomic laboratories (Frydman et al., 2014; Weber and Camerer, 1998).

Analyses at the individual level show that investor expertise tends to reduce the DE (Calvet et al., 2009; Dhar and Zhu, 2006; Feng and Seasholes, 2005). Nonetheless, the DE has, in general, been shown to be prevalent across markets and cultures. The phenomenon has been observed in Australia (Brown et al., 2006), Finland (Grinblatt and Keloharju, 2001), Japan (Bremer and Kato, 1996), and Taiwan (Barber et al., 2008), among other countries. We rely on this well-documented effect to address a yet unexplored research avenue in financial decision-making: the extent to which investors' decisions, and consequently, the DE, vary when they are aware that their financial performances will be made public (vs. kept private).

Whether consciously or not, an individual will naturally attempt to influence how others perceive him. These self-presentation or impression management concerns and tactics have been shown to impact people's feelings, thoughts, judgments, and decision-making (Goffman, 1959; Jones and Pittman, 1982; Schlenker, 1980). Consumers, for instance, feel more embarrassed when buying condoms next to strangers than alone (Dahl et al., 2001), and choose to purchase a greater variety of goods in public than in private because they expect the variety to be more valued by others (Ratner and Kahn, 2002).

There is also evidence suggesting that at least some institutional investors use impression management strategies when it comes time to disclose their financial performance to their clients. For instance, Lakonishok et al. (1991) showed that pension funds – particularly smaller ones, at the end of the fourth quarter – are disproportionally more likely to have their poorly performing holdings sold, to dispose of what the client would likely see as a 'bad bet' (see also: Musto, 1999). Similarly, Hertzberg et al. (2010) showed that loan officers are more likely to self-report bad news at times when it is expected to have a lower impact on their career prospects (see also Hertzberg et al., 2011). In those cases, however, the "window dressing" strategies are often explained by sheer financial reasons (e.g., to avoid losing a client, or avoid losing a