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Do individual currency traders make money?★



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ABSTRACT

Using a unique online currency transactions dataset, we examine the performance, trading activity, drawdown, and timing abilities of individual currency traders. Evidence from 428 accounts during the 2004–2009 period shows that currency traders earn positive abnormal returns, even after accounting for transaction costs. Additionally, the results reveal that day traders not only trade more frequently than non-day traders, but also outperform them in terms of raw, a passive benchmark and risk-adjusted returns. Finally, sorts on trade activity, measured as the mean number of trades per day per account, and account turnover, show a positive association between performance and trade activity.

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1. Introduction

Interest among individual investors in currency trading as an investment class has increased considerably over the past decade. This growing interest in foreign exchange market is due largely to the online trading by retail investors.² However, government regulators are greatly concerned that individual currency traders have been losing significant amounts of money ([Commodities Futures Trading](#)

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² See, for example, [Luke \(2005\)](#), [King and Rime \(2010\)](#). The 2010 Triennial (<http://www.bis.org/publ/rpfx10t.htm>) shows a 20% increase in foreign exchange market trading over the past three years with the average daily turnover reaching \$4 trillion.

Commission (2010)). This concern arises because leverage at some currency brokers is as high as 400:1. Such leverage creates an environment where investors can gain, and lose, significant amounts of capital.

Previous research reveals that some professional currency managers are able to earn positive and significant alphas (Pojarliev and Levich (2008), (2010b), (2011)). Pojarliev and Levich (2008) examine the performance of currency hedge funds and find that such funds, on average, are unable to earn positive alphas, although approximately 24 percent of the currency managers have alpha generating skill. Addressing the question of how active professional currency managers should be evaluated, Melvin and Shand (2011) show that certain managers have timing and loss avoidance abilities.

To date, however, it is unknown whether individual currency traders are able to earn positive abnormal returns and whether they possess skill trading spot currencies. To the best of our knowledge, no empirical study has analyzed the performance and skill of individual currency traders. This is mainly due to the lack of individual currency trading data. The primary objective of this paper, then, is to address these issues by using online advisory service currency data which consist of spot currency transactions, net daily returns and gross daily returns. To gauge the performance of individual currency traders, we employ three performance metrics: raw returns, a passive benchmark model, and alpha from the four-factor currency model of Pojarliev and Levich (2010b). Furthermore, to assess the skill of individual currency traders we first examine individual transactions to find out whether their performance is driven by skill or by luck and then examine drawdown to detect whether individual currency traders possess skill at moderating losses. Our second inquiry of skill explores the ability of individual traders to time the Pojarliev and Levich (2010b) currency factors by following the Melvin and Shand (2011) timing approach.

The theoretical stream of behavioral finance reveals that individual equity investors tend to be overconfident, which can lead to excessive trading and underperformance (Odean (1999); Barber and Odean (2000), Barber et al. (2004), (2006)). On the other hand, studies by Jordan and Diltz (2003) and Garvey and Murphy (2005) examine the performance of high-frequency equity traders and show that investors can earn profits despite trading frequently. In the context of this study we also aim to shed light on this issue by analyzing the trading characteristics of high-frequency currency traders.

To investigate this issue we examine the performance of high-frequency currency traders (day traders) and non-day traders. We also examine performance based on trade activity proxied by the mean number of roundtrips per day and account turnover. This approach is taken because the psychological literature shows that overconfidence can increase or decrease over time, based upon the level of feedback received from trading (Russo and Schoemaker (1992); Skata (2008)). Feedback can decrease overconfidence and thus increase one's ability to determine probabilistic outcomes (Russo and Schoemaker (1992); Skata (2008)), implying a positive association between trading activity and performance. Finally, since it has been documented that equity traders tend to increase their trading activity by selling winners at a higher rate than losers in response to increased recent past performance (Barber and Odean (2000)), we examine the association between past performance and current trade activity to determine whether the disposition effect gains support in the context of currency markets.

Our analysis demonstrates that the average trader is able to earn positive and statistically significant net and gross returns when using raw returns and a passive benchmark model. Alphas from a four-factor currency model are also positive and significant when gross returns are used, but statistically insignificant when estimated using net returns (i.e., accounting for transactions costs). Overall, our results show that approximately 25 percent of individual currency traders realize abnormal returns, even when accounting for transaction costs.

The analysis of trading characteristics supports the contention that individual currency traders are well-calibrated, but any resulting benefit is eroded by transaction costs. More specifically, we find that day traders outperform non-day traders on a gross return basis, but the difference in net performance is insignificant. Additionally, sorting on trading activity, proxied by the mean number of roundtrip transactions per account per day, and on turnover the results show to be consistent with the prediction of the calibration hypothesis. Furthermore, we find a positive association between past trade activity and future performance suggesting that trade activity can predict future performance. Finally, we find a positive relation between current currency trade activity, proxied by the number of trades per day, and past return performance. This result supports the view that the traders in this sample are prone to the disposition effect.

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