A MATTER OF OPINION

A new study supports the notion that individual investors tend to sell winners and hang on to losers. Understanding the underlying psychology can help you fight it.

Why Investors Tend to Trade Too Much—And What to Do About It

By James B. Cloonan

A study—"Why Do Investors Trade Too Much?" by Terrance Odean, based on his doctoral dissertation at the University of California at Berkeley, has been repeatedly quoted in the media recently.

The study provides excellent documentation that some investment tendencies on the part of many individuals that we all suspected to exist are, in fact, true. Some interpreters, however, have taken the conclusions a step further, stating that they indicate individuals are not good investors. The study does not show this, nor does it claim to.

The entire study can be obtained over the Internet from http://haas.berkeley.edu/~odean. Basically it shows that, for discount brokerage customers, the stocks they sold outperformed the stocks they purchased; the study included controls to eliminate most of the ordinary reasons this could happen justifiably (portfolio rebalancing, risk reduction, etc.).

There was also some evidence that individuals tended to buy stocks that had made a recent run-up. A separate study by the same author showed a tendency to sell winners and hold losers.

The existence of all these characteristics among many individual investors has long been suspected based on cumulative observation, but there has been no large-scale scientific research. Mr. Odean is to be thanked for the research and for reminding us of the problem once again.

Given that individuals tend to sell winners and keep losers and thereby reduce performance because the sold stocks outperform the retained stocks (which is even worse on an aftertax basis), what can be done to reverse this tendency?

Knowing the "Right" Time to Sell

The answer requires understanding the reasons for this behavior and finding ways to overcome it.

I will be the first to admit that, even though I know the tendency is there and I regularly measure the negative impact of it, I still sell stocks too quickly. The way I check myself, and I would strongly recommend this as an important step for any individual investor, is to maintain an artificial portfolio of all stocks I sell using the sale price as the purchase price. I then monitor that portfolio to see how it performs.

It is also important to understand that there are times stocks *should* be sold even if they are doing well. For instance, if a stock has zoomed up and your holding in it is too large a percentage of your total stock portfolio, at least some shares should be sold to rebalance. In addition, if you have rules about "value" and a stock's price goes up so much that it violates your investment rules, it should be sold. Be sure, however, that your definition of "overvalued" is based on current information and not on data that existed when you made the purchase.

Overcoming the Tendency: Know Thyself

There are several ways of dealing with the tendency to hold losers and sell winners that don't require understanding the psychological factors at work. One way is to have rules based on your strategy that you adhere to religiously. Another is to use the team approach. One person on the team selects stocks and a different person decides when to sell them—all based on strategy.

To develop a discipline of your own, it helps to understand what you are fighting against. Psychologically, not all gains (of the same amount) are equal—nor are all losses. Why this is true will be explained differently by different schools of social science, but there are some almost universal attitudes. Look at the following possibilities:

- *You buy a stock and it goes up.* Most investors would give this a satisfaction rating of 1.
- *You buy a stock and it goes down.* Most investors would give this a satisfaction rating of –1.
- *A stock you bought goes up, but then turns around and goes down.* Most investors would give this a satisfaction rating of –2.
- *A stock you bought goes down, but then turns around and goes up.* Most inves-

James B. Cloonan is chairman of AAII.

tors would give this a satisfaction rating of 2.

In other words, most investors feel better about an up move in a stock that previously went down than they do about an up move from the purchase price. And most investors feel worse about a stock going down from a previous gain than they do about a stock that is down from the purchase price. If this is true, and I believe it is based on my experience, it has the following ramifications:

- Investors will sell winners because an X% move down from the current gain will feel more negative psychologically than an X% further gain will feel positive.
- Investors will hold onto losers because a reversal of X% will feel more positive than an additional loss of X% will feel negative.
- If investors hold a loser and it reverses, they will tend to sell when they get even because going down again will feel more negative than continuing up will feel positive.

All of the above actions are historically losing tactics over time, but our emotions drive us toward them.

Is forewarned, forearmed?

I hope so. My ego and I are still fighting the battle.

INVESTMENT RESEARCH

Investment research presented in papers, academic journals and other periodicals that may be of interest to individual investors.

Finding Mutual Fund Winners

Does Historical Performance Predict Future Performance? Looking at Mutual Fund Risk: Latest Study Results, *by Ronald Kahn, presented at the IMCA Investment Management Expo in Chicago, October 11, 1996, an update from research originally appearing in the Financial Analysts Journal, November-December 1995 (Andrew Rudd co-author).*

Do winners repeat?

An affirmative answer to that question is implied by the numerous performance reporting services that are in existence today. And it is unlikely that an investor would feel comfortable investing in a fund that underperformed its peers long-term.

But how much emphasis should be placed on performance statistics?

An updated study of the question, presented by author Ronald Kahn at a meeting last October, supports previous research that found a fund's past return history isn't enough to predict the fund's future returns or level of risk. Mr. Kahn is director of research at BARRA, an investment management consulting firm.

The original study included all equity funds dating back to the early 1980s and ignored funds with a passive investment style.

The fixed-income funds included dated back to 1988, but excluded junk bond funds, money market funds, international bond funds and index funds.

For each fund type, two periods were examined to see if performance persisted from one period to the next—in other words, were the winners in one period also the winners in the other period?

The study examined returns based on style performance (performance relative to a style benchmark) and performance relative to risk, and found no evidence that the equity winners in one period repeated their performance in the other period. The implication for investors, according to the study, was that, absent some other selection criteria, an indexed approach would be best, since it would assure average performance at low cost.

The study did find some indication that fixed-income winners repeated. Since large fees and expenses have a large impact on fixed-income returns, their influence on persistence was examined, but the study found that some performance persistence remained even after these costs were taken into consideration.

However, the average performance advantage of the fixed-income winners was unable to overcome the average underperformance (relative to a fixed-income index fund) of fixed-income funds in general as a result of fees and expenses. The original study concluded, ironically, that if an investor still preferred to choose fixed-income funds based on past performance, they would be best served by choosing only one fund, since diversifying among funds would only ensure an average rate of return, which would be below a passively managed index fund.

The updated study examined an additional time period and focused in particular on equity growth funds.

However, the update found results similar to the original.

"There may be skillful and persistent managers out there, but it's hard to find them," Kahn summarized.

Historical analysis of returns alone can't pick out the persistent mutual fund winners, he said. Instead, he suggested that investors combine historical information with their own understanding of what the fund is doing, the fund manager's tenure, and his style.

The bottom line: Don't give up your subscription to the performance-reporting services, but don't make them the only basis for a decision.