

Do Investors Trade Too Much?

Dr. Terrance Odean, American Economic Review © 1999

Odean analysed the stock trades of 10,000 randomly picked US discount brokerage (eg. E*Trade, COMSEC) customers from Jan 1987 to Dec 1993 concluding retail trading is excessive. He discovered that over-confident investors actually lowered their returns from trading, even before the cost of trades were considered. Investors tend to buy securities that have risen sharply, probably after media coverage or analysis, which under-perform after purchase. Stocks sold to fund these purchases were those that had also risen in prior periods, as investors were reluctant to take losses from those that underperformed (the latter they kept in their portfolio). Unfortunately stocks sold later outperformed the new stocks purchased and would have been better kept.

This work provides support for buy and hold strategies and emphasizes the need to benchmark returns from direct share portfolios managed by yourself or a stockbroker.



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About the experiment (Odean's PhD dissertation)

Odean was uniquely given access to data for a random 10,000 active customer accounts as at January 1987 for a large US discount brokerage (Charles Schwab???)

Data are for all trades of this group until December 1993. Closed accounts not replaced so "survivorship bias" exists (ie. bias towards successful traders who kept accounts open)

- **55% of the original accounts dropped out over the seven years studied, including ½ in the first year after the 1987 crash**

Trades are for the NYSE, AMEX and NASDAQ exchanges

97,483 trades occurred (49,948 purchases, 47,535 sales; market value ~ \$0.6b)

Average number of securities held at any one time was a modest 3.6

Average account turnover is 6.5%/month or 76% pa

Average commission is 2.2%; total "round trip" buy/sell cost est. at 5.9% incl. spread

Retail investors studied as additional agency effects (eg. brokers churning portfolio to earn commissions, active fund managers trading to justify fees) could be eliminated

Not shown here, but Odean also studied shares bought a few days after IPO showing that stocks purchased under-perform the market by ~ 25% over 14 months following purchase

Excess-returns from stocks sold beat those purchased post-transaction

Stocks purchased were those that rose sharply relative to the market 2 years before

Stocks sold were those that also rose, esp. after a period of underperformance. Most didn't sell stocks that under-performed (ie. held their losers hoping they would improve)

Gap between bought and sold small, as stocks purchased are mostly those sold by other investors (ie. trades within this large discount broker' universe mirror the market)

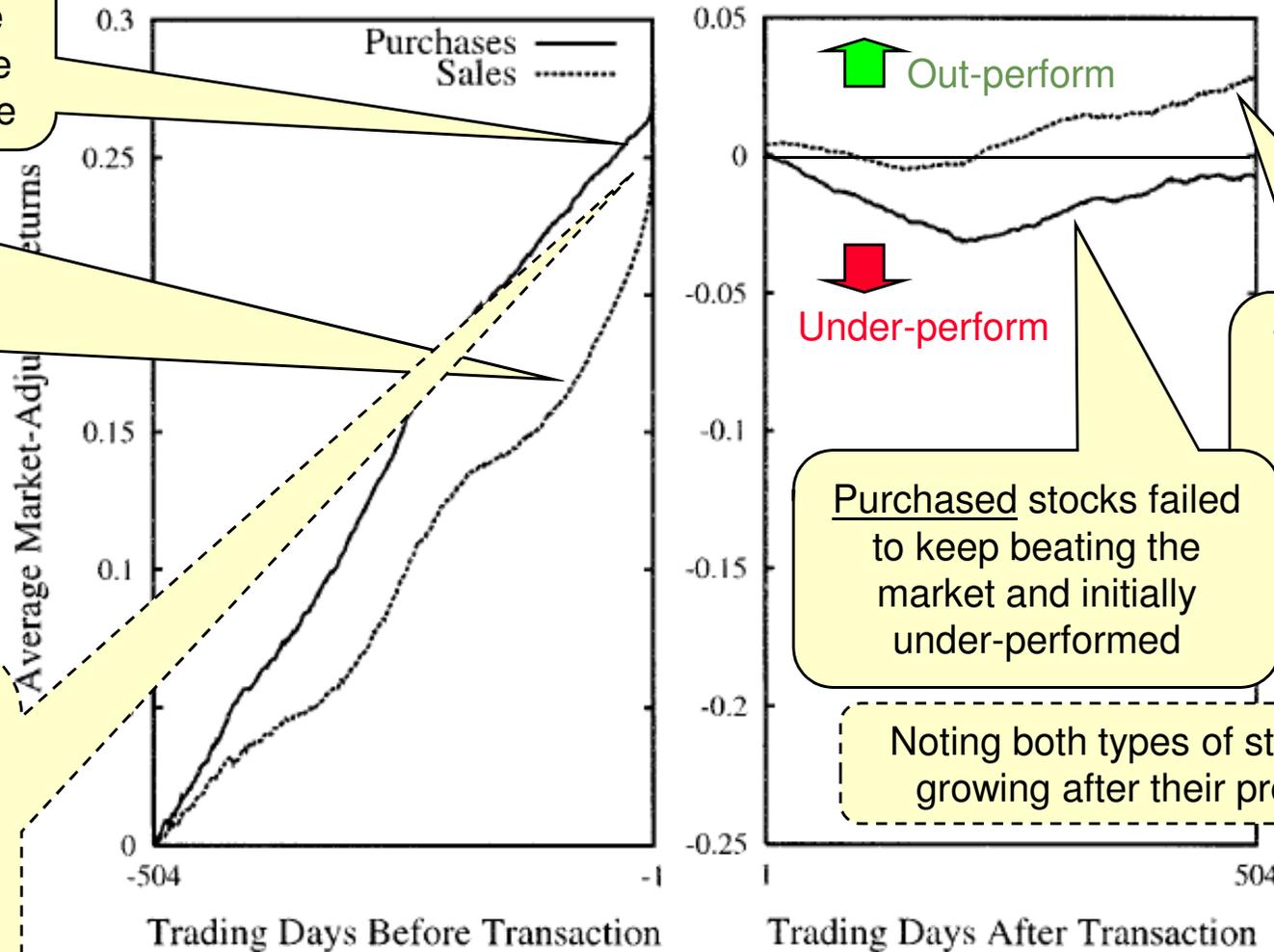


FIGURE 1. AVERAGE RETURNS IN EXCESS OF THE CRSP VALUE-WEIGHTED INDEX FOR ALL SECURITIES BOUGHT AND SOLD

Note: 46,830 bought; 44,265 sold.

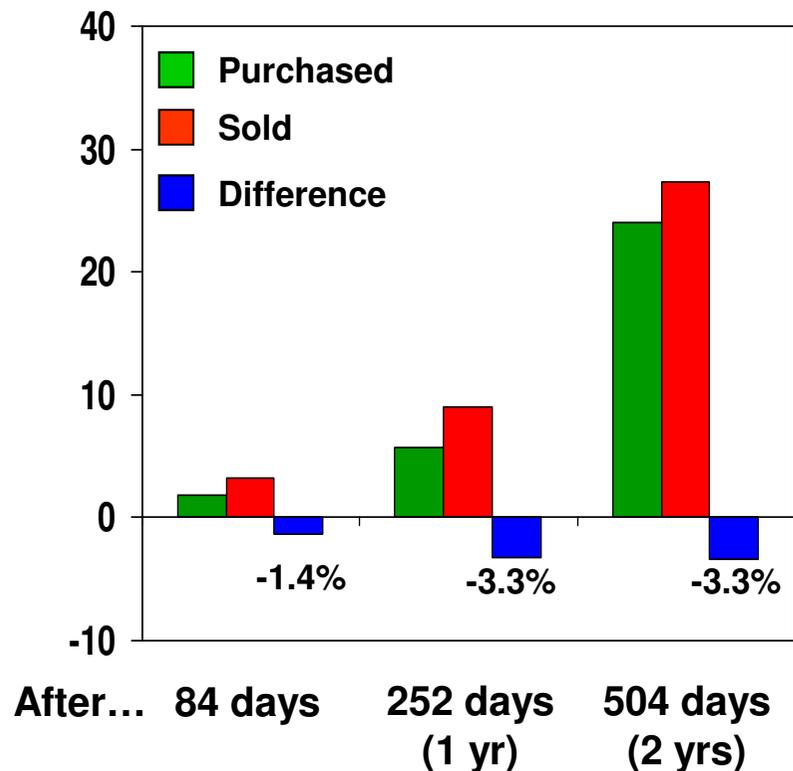
Purchased stocks failed to keep beating the market and initially under-performed

Stocks sold did better than stocks purchased, slightly outperforming the overall market

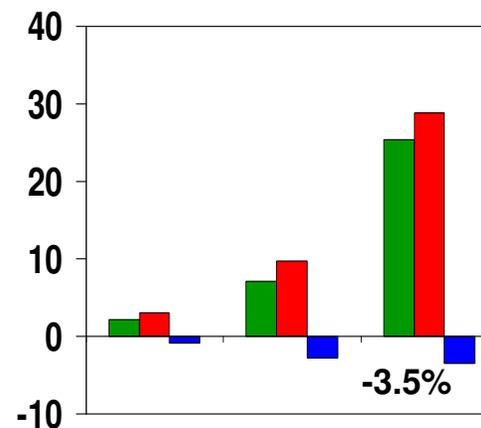
Noting both types of stocks failed to keep growing after their pre-t/x growth spurt

No matter how you cut it, sold stocks appreciated more than new stocks purchased

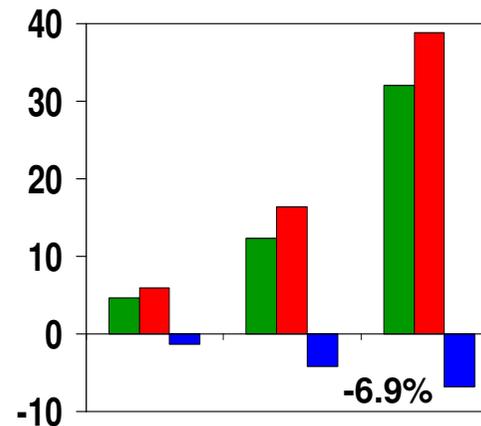
Investment Return (%) post- transaction of stocks ...



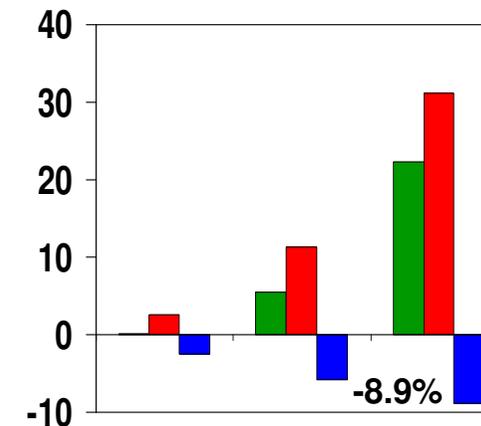
All transactions for all 10,000 investors from 1987-1993



For top 10% of investors who traded the most
(interestingly, returns from this active group slightly exceeded returns from others, owing possibly to better stock selection)



Over 2nd half of time period from 1990-1993
(further analysis suggests under-performance is from poor stock picking not poor market timing)



For transactions excluding those that might be associated with re-balancing (partial sales), to realise a tax loss (ie. sell loser), for liquidity (ie. not followed by a purchase), etc...

Epilogue

Odean and another researcher Brad Barber later studied 1607 discount brokerage customers trading from Feb 1991 to Dec 1996

They studied a group of “investors” who recently switched to online trading from phone based trading and compared them to a control group of traders who remained phone based traders

The group that switched were mainly high income/Net Worth males who as group had previously enjoyed investment returns of 4.2% above the market (vs. 2.2% for control group)

After going online their portfolio turnover rose to 120% pa in the first month then settled to a high 96% pa (ie. they sold about every stock in their portfolio each year)

- **Was previously 70% and 50% for the control group**

Returns from the online traders over the next five years were (-1.2%) compared to the market, before costs, and (-3.5%) after costs.

- **In summary, they performed worse for their extra effort**
- **“Trigger happy traders are prone to shooting themselves in the foot”**

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