INVESTMENT POLICY AND PORTFOLIO MANAGEMENT

Are Investors Reluctant to Realize Their Losses?

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The author examines the behavior of individual investors and finds that they realize their profitable stock investments at a much higher rate than their unprofitable ones, except in December. He also finds that tax-motivated selling is most evident in December.

Shefrin and Statman (*Journal of Finance*, 1985) have called the tendency of investors to hold losing positions too long and sell winning positions too soon the disposition effect. For taxable investments, the disposition effect predicts that investors will behave quite differently from how they would if they paid attention to tax consequences. The author uses market data to examine whether investors with discount brokerage accounts sell winners more readily than losers. He also examines tax-motivated trading in December.

Kahneman and Tversky (*Econometrica*, 1979) explain that according to prospect theory, when people are faced with choices involving simple two- or three-outcome lotteries, they behave as if maximizing an S-shaped value function. This value function is defined by gains and losses and is steeper for losses than for gains, which implies that people are generally risk averse. The status quo is taken as the reference point. In this study, the author views the purchase price as the reference point for investors.

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Investors might choose to hold their losers and sell their winners not because they are reluctant to realize losses but because they believe that today's losers will soon outperform today's winners. In experimental settings, Andreassen (*Organizational Behavior and Human Decision Processes*, 1988) finds that investors buy and sell stocks as if they expect short-term mean reversion. Constantinides (*Journal of Financial Economics*, 1984) shows that when there are transaction costs, and no distinction is made between the short-term and long-term tax rates, investors should gradually increase their tax-loss selling from January to December.

The data for this study are provided by a discount broker. The period covered is January 1987 through December 1993. By going through each account's trading records, the author sets up for each date a portfolio of securities for which the purchase date and price are available. Each stock that is in a portfolio at the beginning of a day but is not sold is considered to be a paper (unrealized) gain or loss (or neither). If the stock's daily high and low are above its average purchase price, it is counted as a paper gain; if the daily high and low are below its average purchase price, it is counted as a paper loss; if its average purchase price lies between the high and the low, neither a gain nor a loss is counted.

The author's finding that investors are reluctant to sell their losers and prefer to sell winners is not influenced by the inclusion or exclusion of commissions or dividends. Through its impact on supply, the disposition effect may also contribute to market stability near prices at which substantial trading has previously taken place. Odean finds that individual investors demonstrate a significant preference for selling winners and holding losers, except in December when tax-motivated selling prevails. This investor behavior does not appear to be influenced by a desire to reconfigure portfolios or by a reluctance to bear the higher trading costs of low-priced stocks. Subsequent portfolio performance does not justify this behavior either. In fact, this aberrant behavior by investors leads to lower returns, particularly for taxable accounts.