Retail traders lost Rs5,584 crore a year due to bad calls
Adventurism in stock markets can have serious consequences for wealth accumulation
Prasanna Tantri

There is a problem known as the disposition effect. Disposition effect is a tendency to close a profitable hold on to a losing position longer, hoping that price artificial reference price, which is usually one’s purchase, this behaviour.

Researchers working at the Centre For Analytical Finance School of Business, after examining terabytes of data trading behaviour of retail and institutional investors trading done by behaviourally biased and short-term traders leads to wealth transfer from individuals to institutions. Although I use the words ‘investor’ and ‘trader’ interchangeably, the real focus is on short-term trading done by individuals who don’t indulge in speculative trading.

There is a debate in academic finance regarding the impact of retail traders in the market. Retail investors are noise traders, who adversely impact the price efficiency of the market. Some have argued that such excessive short-term trading scuttles the functioning of arbitrage mechanism by increases market efficiency. However, others have argued that presence of retail investors provides liquidity hence, is useful. The recent spurt in behaviour finance research has led to a careful examination of consequences of short-term trading done by individuals.

One of the findings that has emerged is that excessive retail trading leads to transfer of significant amounts of wealth from individuals to institutions. One of the findings that has emerged is that excessive retail trading leads to transfer of significant amount of wealth from individuals to institutions. The recent spurt in behaviour finance research has led to a careful examination of consequences of short-term trading done by individuals.

Sankar De, Naveen R. Gondhi and Subrata Sarkar, in a paper titled Behavioral Biases, Investor Performance, and Wealth Transfer in Indian Investor Groups, investigate the impact of trading on a retail investor’s portfolio in India. Specifically, they tested if there is wealth transfer from individuals to institutions. For the purpose of this study, the researchers used tick-by-tick trading data given to them by exchanges. In total, they examined 1,346 million trades done by 2.5 million traders/investors. The monetary value of trades examined was about `37 trillion. Retail investors were involved in 831.5 million trades that they studied.

The purpose of the above description is to show that these results have come forth through a careful analysis of a very large dataset based on casual observation of a few wise men. The study covers a period of 18 months between January 2005 and June 2006 period is relevant currently because the market was in a bullish mode ever since then. In fact, the CNX Nifty recorded positive returns in 18 of the 20 months that were studied.

It was found that when an investor with low degree of expected bias (read, mostly institutions) trades with an investor with high expected bias (read, mostly individuals), then the price of the stock traded moves in favour of the former. In other words, price usually goes down after retail traders buy it from informed institutions, and vice versa. Interestingly, such a pattern is not visible in the other side of their trade. Financial institutions seem to be more informed than other institutional investors such as commodity traders.

The economic magnitude of the losses experienced by Indian retail traders is large. The researchers estimated that, in their study, Rs5,584 crore a year due to bad calls - Print View - Livemint

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18 months, retail traders lost `8,376 crore, a run rate of `5,584 crore a year. They also estimated that the loss due to wealth tr
0.77% of India’s savings during 2005-06. It is important to note that the above figure only includes trading losses. If other exp
commissions, taxes and so on are added, then the total loss easily exceeds 1% of the savings. The paper also indicated that
shown by individuals in India is much higher than the same for developed countries.

This is not to say that retail investors should not invest in stocks. Careful research has clearly established that disciplined val,
generates positive abnormal returns. Such studies have also shown that equities tend to outperform other asset classes signi
long run. However, very few retail investors sustainably follow this approach. Many of them get attracted to short-term specul
end up losing money even when it’s a bull market.

The findings of the above mentioned paper has two clear messages for the retail investors in India. First, it is futile to try to ou
money in the short term. When buying a stock sold by institutions, it is important to investigate the reasons for such a sale. Se
vestors who do not have time and energy to do such an investigation are likely to do better if they chose to invest systemati
professionally managed fund or simply a passive index. Adventurism in stock markets can have serious consequences for we
accumulation.

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