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The psychology of overtrading

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One of the oldest findings in behavioural finance is that investors often trade more than they should and lose money by doing so. What's not so clear is why they do this. One possibility is that they are overconfident; they simply overestimate their ability to beat the market. Another is that they get a buzz from trading, as they might from gambling. Two new pieces of research, however, suggest some other motives - one rational, one not.

To see the irrational one, imagine that a stranger gave you and a third stranger an envelope each, both containing some money. He tells both of you that one envelope contains twice as much as the other, and then asks whether you'd like to swap.

One obvious line of reasoning is that you should. Doing so gives you a 50 per cent chance of doubling your money and a 50 per cent chance of halving it. The expected value of this is obviously positive.

However, this same reasoning tells you that once you've swapped, you should swap again. And again, and again. And your co-recipient has the same motivation. Both of you might therefore trade a lot, even though it's obvious that doing doesn't create wealth - and, indeed, if the donor asks you to pay to swap, it might even destroy wealth.

Something, then, is wrong. But what? The answer, says David Navon at the University of Haifa, is that expected value thinking misdescribes the problem. It looks at the question only from the point of view of one person; he calls this the egocentric framing error. But there's another frame - what he calls the acentric one. This says there are two possible states: one in which you have twice as much as your partner, and one in which he has twice as much as you. These states are equally likely, so there's no point swapping.

He shows experimentally that many people fall into the egocentric framing error - by, for example, swapping between things with equal payoffs because their individual position warps their perceptions of randomness.

Thinking acentrically can protect us from trading too much. If we asked in the envelope problem 'why is the other guy so keen to swap?' our desire to trade would vanish. Similarly, our desire to buy a stock might wane if we wondered why others want to sell. The acentric mode reminds us that the information we have might be only a subset of all relevant information.

However, there might be a more benign reason why some of us trade. It's that we take pride in controlling our investments. Christophe Merkle of the University of Mannheim and Daniel Egan and Greg Davies at Barclays surveyed clients of Barclays Stockbrokers and found that "successful trading contributes to happiness, even after controlling for the returns generated". This, they say, "suggests that personal involvement in trading and investing has a positive effect on happiness beyond monetary outcomes".

What's going on here might be more than just ego gratification at the thought of beating the market. It's consistent with a finding by economists at the University of Zurich, that the self-employed are happier than employees. Taking control of our destiny gives us satisfaction in itself.

You might wonder whether this is offset by the misery that unsuccessful traders feel. Not necessarily. Such people can reasonably blame bad luck or, less reasonably, use self-serving biases and attribute their failings to others.

Perhaps, then, trading a lot on one's own account isn't always irrational. The key thing for investors here is to be aware of why you're doing so. If you think you know better than others, or if you're using egocentric framing (the two are similar), then you should pause. If, however, you're the sort of person who likes to be in control, then such trading, at least in moderation, is no bad thing. Introspection is often a bad idea, but perhaps in this case we need it.

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