Abstract

We investigate the effect of house money on individual investors. Our empirical evidence suggests that house money effect shows up in real-world financial markets, not just in artificial laboratory experiments.

The results reveal a strong house money effect and show that investors tend to buy up trend stocks once they have experienced a prior gain. Only when a significant gain is being considered, does an individual become more inclined to take a risk. When the influence of a significant gain gradually depreciates over time, the greater tendency to take risk also diminishes. We find that individual investors exhibit the disposition effect— reluctant to realize losses and more willing to realize gains. They frequently realize small gains and less frequently take large losses, such a behavior may hurt their wealth because their gains are lower than their losses.

Analyses of portfolio holdings reveal that individual investors hold relatively few different stocks and focus on a small number of stocks with which they are familiar. Their investment choice is driven by familiarity bias which diminishes the strength of the house money effect. When evaluate an investment gain, investors' reference points adapt over time and the currently-salient reference point is the highest stock price attained some time ago.