Chapter 5

Conclusion

Despite strong psychological foundations and the extensive experimental evidence that people exhibit house money effect, there exists very few empirical studies because the limitation of the data. The database is, to our knowledge, the first comprehensive data source on trading records of a stock market in the world. This study use this unique data to testing for the house money effect by directly examining the relation between prior investment gains and the change of risk taking in individual investors. We demonstrate that the historical price change of stock will significantly correlated with the investment gain in the previous sale period if individual investors increase their risk taking when they just experience a successful investment (the house money effect).

Our findings clearly support the theory and experimental results in Thaler and Johnson (1990) that individual investors increasing their risk taking in a security investment is strongly related to the prior gains. Analyses across size and time suggest that the gain should be large enough to be perceived as the house's money and the influence of a significant gain gradually depreciates over time, the greater tendency to take risk also gradually diminishes.

We also investigate two important issues in behavior finance on familiarity bias and reference point effect. We find evidence that individual investors'

investment choice is driven by familiarity bias which diminishes the strength of the house money effect. Moreover, we demonstrate the strong house money effect, no matter what types of reference point we use. Analyses across different reference points reveal that the maximum stock price is a more effective reference point than the purchase price. Investors' reference points adapt over time and the currently-salient reference point is the highest stock price attained some time ago.

Our descriptive analysis provides two additional conclusions that are noteworthy. 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 not good for their wealth because their gains (return of gains) is lower than their losses (return of losses). Second, individual investors hold relatively few stocks. They focus on a small number of stocks with which they are familiar. Both the mean and median in our sample of individuals are below 8 different stocks. And the mode is 1 or 2 different stocks.