Can We Exploit Behavioral Biases?

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Abstract

In this paper we test whether investors have behavioral biases such as tendency to be caught by attention-grabbing events, a combination of overconfidence and self-attribution, representative ness or conservatism, and loss-aversion. Employing a Cox proportional competing risk model and using a trading data of Japanese online investors, we show that they have tendency to be attention-grabbed, conservatism and loss aversion. We also test whether strategy to exploit behavioral biases yields us profits or not. Dividing our sample period into two halves, the former of which is used in measuring the degree of behavioral biases and the latter of which is used in testing, we long in stocks behavioral biased investors sold and short in stocks they purchased. Our results show that strategy based on loss aversion and conservatism generate strongly significant returns, about annually 9-10 percent in 3-6 months. But strategy based on tendency to be attention-grabbed show insignificant return. These results imply that we can make profits if we ride on behavioral biases which we can't know without using a trading data. Even if we try to exploit biases which are easier to find such as attention-grabbed bias, we can't get any rewards. Information contained in a trading data seems to be left unused by any market participants.

Keyword: Behavioral Bias, Individual Investor