Special Session Summary  Advances in the Psychology of Consumer Investment
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SESSION OVERVIEW

Consumers make important investment decisions throughout their lives. While such decisions were once thought the exclusive province of finance and economics, they also deserve great attention from consumer researchers. First, consumption is intimately related to wealth: consumption requires money, and money is for consumption. No theory of consumption can be complete without an understanding of how consumers manage their wealth. Second, investment decisions typically entail substantial financial stakes and can have important influences on consumers’ welfare. Finally, investment decisions are theoretically interesting in their own right. Although one might be tempted to regard them as a special kind of consumption decisions—decisions about financial products as opposed to traditional consumables—it is not clear that investment decisions respond to the same principles as those governing more traditional product decisions. However, despite their importance, surprisingly little consumer research has focused on such investment decisions.

This special session is an attempt to address this void. In the first presentation, Dhar and Kumar (see Dhar and Kumar 2004) analyze individual-level trading data from a brokerage house to investigate how investors’ decisions to buy and sell stocks are influenced by short-term past price trends. They used Monte-Carlo simulation to classify individuals in their dataset as “momentum investors” (those who expect continuations of past price increase or decrease) or “contrarian investors” (those who expect reversals of trends). They observed that the two segments showed different responses to reference points such as recent highs and lows in stock prices. They also found that the two segments exhibited differences in term of the disposition effect—a well-established phenomenon whereby investors tend to realize gains too quickly but are reluctant to realize losses. Analyzing the differences in portfolio and trading characteristics of the two segments, they additionally found that momentum investors held less diversified and riskier portfolios and traded more actively than contrarian investors do. They concluded that, overall, contrarian investors appear to be relatively more sophisticated.

In the second presentation, Zhou and Pham examined consumers’ investment decisions across different types of financial products from a self-regulation perspective. They argued that investment decisions are largely driven by regulatory systems known as promotion and prevention. Promotion and prevention-focused self-regulation, though both essential to successful investment management, tend to be pursued separately through distinct mental accounts. Furthermore, different financial products are posted to separate mental accounts set up around a promotion versus prevention focus. This in turn leads to systematic differences in the way consumers make decisions about these products. They reported results from four experiments showing that (a) investors are asymmetrically sensitive to potential gains versus potential losses; (b) investors are differentially risk-seeking with money mentally associated with different financial accounts; and more importantly (3) these effects occurred because investors categorized different financial products in terms of distinct self-regulatory focuses.

At the conclusion of the presentations, John Gourville led the discussion. Besides summarizing the papers and highlighting the common learning, he put forward interesting questions and issues and offered suggestions on directions of future research in this area.

“Non-Random Walk Down the Main Street: Impact of Price Trends on Trading Decisions of Individual Investors”
Ravi Dhar, Yale University
Alok Kumar, Cornell University

Recent research has examined the systematic deviations from traditional models of rationality to better understand investor behavior in financial markets. Relatively little is known about the psychological motivations that determine decisions about buying and selling stocks for individual investors. In this paper, we analyze the impact of price trends on trading decisions of more than 40,000 households with accounts at a major discount brokerage house and find that buying and selling decisions of investors in our sample are influenced by short-term (less than 3 months) past price trends. Investors that trade on trends can be broadly classified as momentum (positive feedback traders) or contrarian (negative feedback traders). Ceteris paribus, momentum investors expect price continuations and hence they buy on an upward trend and sell on a downward trend. Contrarians, on the other hand, expect price reversals and thus they buy on a downward price trend and sell on an upward trend. By comparing the observed distributions of average trend before buys and average trend before sells with the average trend distributions (obtained using Monte Carlo simulations) when investors trade randomly, the null of non-trend motivated random trading is easily rejected (p-value<0.002). Using Monte Carlo simulations again, we examine investor heterogeneity in trading based on prior returns and classify investors into (i) momentum buy (MB), (ii) momentum sell (MS), (iii) contrarian buy (CB) or (iv) contrarian sell (CS) category. The trading behavior of these investor segments shows systematic differences that are persistent across time periods. We find variations in the response of these investor segments to reference points such as recent high and low prices for the traded stock.

Previous research suggests that investors may be reluctant to realize losses (disposition effect or DE) on their investments due to various psychological factors including mental accounting (reluctance to close a mental account at a loss) and regret aversion (reluctance to accept mistakes). The reluctance to realize losses can also result from different expectations about the future prices. Contrarian investors expect trend reversals and so the propensity to hold on to the losers is likely to be stronger for them. Momentum investors, on the other hand, are more likely to realize their losses since they believe that a downward price trend is likely to continue. This suggests that the disposition to hold on to a losing investment is likely to vary across investor segments due to the differences in their expectations about the future price movements. Consistent with differences in expectations, we find that the disposition effect varies across the investor segments. All four investor segments are reluctant to sell losers but the effect is the strongest for contrarian sell investors who expect price reversals and hence show a greater tendency to hold on to the losers. The effect is very weak for momentum sell investors who believe that a downward price trend is likely to continue and hence are more likely to realize their losses. The presence of DE even among momentum investors who expect trend continuation suggests that loss aversion is an important
determinant of disposition effect. However, the variation of DE across momentum and contrarian investor segments suggests that in addition to loss aversion, contrarian expectation is an important determinant of investors’ reluctance to sell losers. Analyzing the differences in portfolio and trading characteristics of investor segments, we find that momentum investors hold less diversified and riskier portfolios and they trade more actively. Consequently, they earn lower risk-adjusted portfolio returns in comparison to the contrarian investor segment. The relatively stronger performance of contrarian investors can also be attributed to their “value” focus. Overall, our results suggest that relatively more sophisticated investors exhibit contrarian trading behavior.

“Financial Self-Regulation across Mental Accounts: Implications for Consumer Investment Decisions”
Rongrong Zhou, HKUST
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We propose that consumers’ investment decisions can be usefully studied from a self-regulation perspective (e.g., Carver and Scheier 1998). In particular, consumers’ investment decisions are largely driven by generic regulatory systems known as promotion and prevention (Higgins 1998). The promotion system regulates nurturance needs and those motives related to aspiration and accomplishment (i.e., ideals). The prevention system regulates security needs and those motives related to safety and responsibilities (i.e., oughts). Since promotion and prevention-oriented financial self-regulation is difficult to achieve simultaneously, investors tend to perform the two types of self-regulation using separate “mental accounts” (a promotion focus account and a prevention focus account). In addition, consumers post various financial products to these two accounts according to these products’ representativeness to the motives and goals defining these accounts (see Brendl et al. 1998). Financial products such as individual stocks and trading accounts tend to be associated with a promotion focus, which emphasizes growth and aspirations. In contrast, financial products such as mutual funds and retirement accounts tend to be associated with a prevention focus, which emphasizes security and protection. This association in turn leads to systematic differences in the way consumers make decisions about these products.

A major correlate of promotion versus prevention is a differential sensitivity to positive versus negative outcomes. The promotion system tends to be more sensitive to positive outcomes (e.g., gains), and the prevention system tends to be more sensitive to negative outcomes (e.g., losses). Therefore, we predict that investment decisions involving financial products tagged with a prevention focus will exhibit a relatively greater sensitivity to potential losses than to potential gains. However, investment decisions involving products tagged with a promotion focus will exhibit a relatively greater sensitivity to potential gains than to potential losses. This prediction is tested in Experiment 1. Results from Experiment 1 reveal that consumer investors evaluating an individual stock held in a trading account were found to be very sensitive to upside potential, but curiously oblivious to downside potential. In contrast, investors evaluating a mutual fund held in a retirement account were found to be very sensitive to downside potential, but oddly insensitive to upside potential.

Another major correlate of promotion versus prevention self-regulation is a different propensity toward risk. In most situations, promotion-focused regulation entails greater risk-taking, whereas prevention-focused regulation entails greater risk aversion. Therefore, we argue that in decisions involving financial products tagged with a promotion focus, consumers should exhibit greater risk-seeking than in decisions involving financial products tagged with a prevention focus. We predict that this difference in risk propensity will hold even for money that bears only a mental association with promotion versus prevention-focused financial products. In particular, we predict that money to be withdrawn from a prevention-tagged account will be invested more conservatively than money to be withdrawn from a promotion-tagged account. Furthermore, this effect will be amplified when consumers’ self-regulation concerns are heightened. These predictions are tested in Experiment 2. Results reveal that respondents whose money was to be withdrawn from a trading account were much more willing to invest in a risky business venture than respondents whose money was to be withdrawn from a retirement account. These differences in risk propensities were accentuated when respondents were encouraged to reflect on their goals, that is, when their self-regulation systems were actively engaged.

Experiments 1 and 2 provided input-output evidence of a relation between certain financial products and investment behavior (in terms of sensitivity to gains and losses and risk propensity). Experiments 3 and 4 provide more process-level evidence that this relation could be due a mental association between certain financial products and distinct regulatory focuses. In experiment 3, it was found that making decisions involving different types of financial products resulted in subsequent unrelated decisions being carried out with distinctive promotion versus prevention orientations. Specifically, respondents who had made decisions about individual stocks in trading accounts were later found to prefer consumer products with promotion-related benefits and favor approach strategies in friendship. In contrast, respondents who had made decisions about mutual funds in retirement accounts were found to prefer products with prevention-related benefits and favor avoidance strategies in friendship. In experiment 4, it was found that the mere priming of a promotion versus prevention focus through tasks that have little to do with financial decision making produced distinct patterns of allocation of money across types of accounts and across types of assets. Specifically, when the unrelated tasks (proofreading and anagrams) were framed in terms of avoiding misses, thus priming a prevention focus, respondents’ allocations tended to shift (a) toward the IRA (as opposed to the online trading account) and (b) toward the mutual fund (as opposed to the individual stock). In contrast, when the unrelated tasks were framed in terms of maximizing hits, thus priming a promotion focus, respondents’ allocations tended to shift (a) toward the online trading account (as opposed to the IRA) and (b) toward the individual stock (as opposed to the mutual fund).

Taken together, the results show that (a) investors are asymmetrically sensitive to potential gains versus potential losses across financial products; (b) investors are differentially risk-seeking with money mentally associated with different financial accounts; and more importantly (3) these effects occur because investors associate different financial products with distinct self-regulatory focuses. Overall, the findings are consistent with the view that promotion and prevention self-regulation are pursued through separate mental accounts and that consumers post different financial products to these mental accounts set up around different regulatory focuses. As a result, decisions involving these products are carried out with a distinct promotion or prevention orientation.

REFERENCES
