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Investigating the Disposition Effect among Young Investors: An Integrative Literature Review on Cognitive Biases

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Abstrak

Kajian ini menjelaskan *disposition effect* pada investor muda. *Disposition effect* adalah bias perilaku yang menyebabkan investor menjual aset terlalu awal dan dalam saat yang bersamaan mempertahankan aset yang menurun nilainya. Dalam dunia keuangan yang berkembang, yang ditandai oleh aliran masuk investor muda, pemahaman terkait bias kognitif yang mempengaruhi keputusan investasi kelompok tersebut perlu untuk diperdalam. Studi ini meneliti faktor-faktor yang mempengaruhi dan penelitian yang berkembang terkait bias kognitif *disposition effect* dalam berinvestasi pada kelompok investor muda. Telah ditemukan dari berbagai kajian bahwa *disposition effect* sangat umum di antara investor muda dan pemula dibandingkan dengan investor yang lebih senior. Meski banyak studi tentang topik ini, masih ada kekosongan penelitian mengenai efek disposisi di antara investor muda di pasar berkembang dan di berbagai kelas aset. Penelitian di masa depan harus bertujuan untuk menjembatani kesenjangan ini untuk membentuk generasi investor muda yang kompeten dan berpengetahuan. Tinjauan ini menyoroti kebutuhan akan program edukasi keuangan yang efektif yang disesuaikan dengan ciri khas dan perilaku investor muda, membantu dalam pengambilan keputusan investasi yang lebih baik dan berkontribusi pada kesehatan dan stabilitas pasar keuangan.

Kata Kunci : Efek disposisi; Investor muda; Perilaku keuangan; Pengambilan keputusan investasi; Literasi keuangan.

Abstract

This literature review elucidates the disposition effect, a pervasive behavioral bias causing investors to prematurely sell appreciating assets while retaining depreciating ones, within the context of young investors. In the evolving financial landscape, characterized by an increasing influx of young, often less experienced market participants, understanding the cognitive biases influencing their investment decisions is imperative. This study examines influencing factors and a growing body of research regarding cognitive bias in investing among young investors especially disposition effect. It has been found from various literature that disposition effect is prevalent among young and novice investors compared to their counterpart. Despite numerous studies on this topic, research gaps remain regarding the disposition effect among young investors in emerging markets and across different asset classes. Future research should aim to bridge these gaps to foster a generation of competent and informed young investors. This review highlights the need for effective financial education programs tailored to the unique traits and behaviors of young investors, aiding in better investment decision-making and contributing to the health and stability of financial markets.

Keywords: Disposition effect; Young investor; Behavioral finance, Investment-decision making; Financial literacy.

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Background

Behavioral finance provides pivotal insights into the idiosyncratic decision-making patterns exhibited by investors, elucidating numerous cognitive biases that can distort investment outcomes (Yu & Yuan, 2011). An especially pervasive bias known as the disposition effect (Joshipura, 2023), encapsulates the tendency of investors to prematurely dispose of assets that have appreciated, whilst retaining assets that have depreciated in value (Mayur, 2018; Odean, 1998). This behavioral pattern contradicts the normative investment strategy of 'cut losses short and let profits run’ (Kajol, Biswas, Singh, Moid, & Das, 2020; Trejos, Deemen, Rodríguez, & Gómez, 2019).

The salience of the disposition effect has amplified in the contemporary investment environment, characterized by an influx of young, often less-experienced market participants (Kesuma, Ekaputra, & Chalid, 2021). With these novice investors shaping the trajectory of financial markets and simultaneously sculpting their personal financial futures, understanding the cognitive biases that permeate their investment decisions is an imperative.

The disposition effect has notable implications for the investment portfolio performance and overall financial health of young investors (Breitmayer, Hasso, & Pelster, 2019). Retaining losing investments may precipitate more substantial losses over time, while prematurely liquidating profitable investments may lead to foregone gains (Acharya, Shin, & Yorulmazer, 2013). Additionally, this bias can instigate excessive trading, culminating in elevated transaction costs and eroded investment returns.

Further, certain determinants may exacerbate the disposition effect among young investors, such as limited investment experience, overconfidence and susceptibility to trending investment behaviors propagated via social media platforms. These digital platforms can catalyze peer influence and information dissemination, engendering collective bias and reinforcing the disposition effect.

Hence, examining the disposition effect among young investors extends beyond mere academic interest; it is a prerequisite for the creation of efficacious financial literacy programs and investment tools. Mitigating this bias can assist young investors in making judicious investment decisions and contribute to the dynamism and robustness of financial markets. Therefore, a comprehensive literature review elucidating this phenomenon is instrumental in navigating the future course of action.

Literature Review

Young Investor Characteristic

Investors in their youth exhibit distinct traits that shape their investment choices. They often display an assertive demeanor, which can significantly sway their investment decisions (Evanthi, Wikartika, & Suwaidi, 2023). Moreover, these young investors are susceptible to the phenomenon of FOMO (Fear of Missing Out), which is typically incited by a volatile market, risk-averse investors, and the perception of market efficiency (Bo, 2023). Psychological attributes, including overconfidence, trait anger, and trait anxiety, also play a pivotal role in comprehending the investment decisions of young investors (Usriyono, 2023). Despite these traits, the growing cohort of young investors plays a vital role in bolstering the economy (Halim, Matoati, Viana, & Suryawati, 2022).

Several factors, including financial literacy, investment knowledge, and perceptions of risk and return, also influence young investors. For instance, financial literacy and investment knowledge positively impact students' inclination towards becoming young investors (Gayatri & Gayatri, 2022). Furthermore, the research conducted by Jonathan and Sumani (2021) revealed that factors such as financial literacy, perceptions of risk and return, financial technology, family background, and income significantly shape the investment decisions of millennial investors.

Behavioral biases also exert a substantial influence on the investment decisions of young investors. Young investors are prone to demonstrating herding behavior, overreaction behavior, and availability bias (Memarista & Puspita, 2021; Theressa & Armansyah, 2022). Furthermore, these behavioral biases considerably shape individual investors' perceptions during investment (Khurshid, 2023), potentially leading to less-than-optimal investment decisions and adversely affecting the financial outcomes of young investors.

Lastly, young investors are increasingly leveraging social media platforms to guide their investment decisions (Memarista & Puspita, 2021). This trend underscores the importance of understanding the role of social media in molding the investment decisions of young investors.

In summary, young investors possess unique traits that shape their investment decisions, and comprehending these traits is of paramount importance for policymakers, financial practitioners, and the investors themselves.

Disposition Effect

The disposition effect has been the subject of rigorous academic scrutiny, with numerous theoretical frameworks proposed to elucidate this behavior.

Prospect theory, one of the earliest and most influential frameworks, offers a compelling explanation for the disposition effect(Mayur, 2018). This theory posits that investors assess gains and losses relative to a reference point, typically the purchase price of the investment. The theory suggests that investors display risk aversion in the context of gains and risk-seeking behavior in the context of losses. Consequently, investors are prone to sell appreciated investments to secure gains and retain depreciated investments to avoid realizing losses (Meng & Weng, 2018). Prospect theory has been extensively employed to elucidate the disposition effect across various financial markets (Li, Yu, & Sun, 2018).

The mean reversion bias is another theoretical construct posited to account for the disposition effect (Lucchesi, Yoshinaga, & Castro, 2015). This theory suggests that investors anticipate asset prices reverting to their mean values over time. Consequently, investors are inclined to retain losing investments, hoping for a price appreciation that aligns with the mean value. This behavior is deemed irrational as it disregards the potential for continued price depreciation (Lucchesi et al., 2015).

Several other theoretical frameworks, including regret aversion, self-control, and mental accounting, have been proposed to elucidate the disposition effect (Meng & Weng, 2018). Regret aversion theory suggests that investors eschew decisions that may engender future regret, causing them to retain losing investments. Self-control theory posits that investors, due to a lack of self-control, retain losing investments in the hope of recouping losses. Mental accounting theory suggests that investors segregate funds into distinct mental categories, causing them to treat gains and losses differently.

Despite the extensive body of research on the disposition effect, several research gaps persist. For instance, there is a dearth of research on the disposition effect in emerging markets. While most studies have been conducted in developed markets, it is crucial to investigate the occurrence of the disposition effect in emerging markets and assess whether existing theories can elucidate its manifestation in these markets.

Additionally, research on the disposition effect in the context of different asset classes, such as bonds and commodities, is warranted (Zahera & Bansal, 2019). Most studies have focused on equities, necessitating an investigation into the occurrence of the disposition effect in other asset classes and the applicability of existing theories to these asset classes (Zahera & Bansal, 2019).

Method

This study employs a qualitative research methodology, utilizing a descriptive approach to delve into and comprehend the phenomenon under investigation, as outlined by Sugiyono (2018). The primary objective of this research is to understand the influence of disposition effect in young investors investment decisions. The study was conducted in May 2023.

The research methodology is grounded in the structured literature review approach proposed by Webster and Watson (2002), which involves the following steps: (i) conducting a search using pertinent keywords on reputable journal and news websites; (ii) selecting publications or data that meet the established criteria; (iii) conducting a preliminary review of the selected publications or articles by examining their titles, abstracts, and content relevant to the research problem; and (iv) conducting a detailed study and analysis of the chosen publications or articles.

Upon identifying the relevant literature, it is then classified into appropriate categories: (i) literature reviews concerning young investors; (ii) information pertaining to disposition effect; and (iii) literature and information in examining interactions of disposition effect and young investors. Subsequently, the pertinent information is synthesized to address the research question.

Result

Interaction between the Disposition Effect and Young Investor

Numerous scholarly works have scrutinized the complex relationship between the disposition effect-a pervasive cognitive bias in finance-and nascent market participants, often referred to as young investors. Kesuma et al. (2021) discovered an intriguing association between individual investors' alertness to stock split phenomena and a subsequent diminution in their disposition effect bias (Kesuma et al., 2021). Extrapolating from this, it can be posited that young market actors who maintain a heightened vigilance towards stock split proclamations might exhibit a decreased susceptibility to the disposition effect.

Another significant contributor to this discussion is that investor sophistication has a measurable influence on the manifestation of the disposition effect (Dhar & Zhu, 2006). This finding can be interpreted to imply that budding investors who possess a higher degree of sophistication may exhibit a reduced propensity towards the disposition effect. Furthermore, demographic factors such as age, gender, and market exposure significantly alter the incidence of the disposition effect (Zahera & Bansal, 2019). Based on this, one might infer that novice investors might be more susceptible to the disposition effect due to their limited experience in the financial market.

Disparity Between Seasoned and Novice Investors

An abundance of empirical research has dissected the divergences in the disposition bias amongst individuals. Aramrueng and Tangtammaruk (2021) made the compelling finding that veteran investors usually exhibited a lesser degree of susceptibility to the disposition effect compared to their novice counterparts. Building upon this discovery, it can be surmised that novice, particularly younger, investors may display an increased susceptibility to the disposition effect. Li (2018) conducted an insightful analysis of the manifestation of the disposition effect within the sphere of securities investment funds in China. Drawing from this, one might propose that younger investors engaging in securities investment funds might exhibit an increased disposition effect.

Despite the voluminous research on the disposition effect, a lacuna persists in comprehending the intricate relationship between this cognitive bias and novice market participants. Yulianto (2023) made the noteworthy observation that the academic discourse on the disposition effect in relation to the education of fledgling investors is still scant. This finding signifies a critical demand for additional scholarly pursuits focused on the interplay between the disposition effect and younger investors.

Conclusion

This comprehensive literature review illuminates the multidimensional and complex nature of the disposition effect, especially in the context of young investors. A salient finding from the review is the confirmation of the pervasiveness of the disposition effect among novice and young investors, underscored by a multitude of factors including limited investment experience, overconfidence, and susceptibility to trending behaviors in the digital sphere.

Distinct behavioral traits, as well as the influence of social media platforms and collective biases, also shape the investment decisions of young investors. Additionally, the role of financial literacy, investment knowledge, perceptions of risk and return, as well as the effect of certain psychological attributes, can't be overlooked in shaping the investment behaviors of this cohort.

From a theoretical perspective, various frameworks including prospect theory, mean reversion bias, regret aversion theory, self-control theory, and mental accounting theory provide valuable insights into the disposition effect. Nonetheless, our understanding of the disposition effect among young investors remains incomplete due to research gaps in the context of emerging markets, different asset classes, and the influence of digital platforms on investment behaviors.

Despite the extensive body of research dedicated to the disposition effect, it is evident that more work needs to be done to fill these research gaps. Particularly, the dynamics of the disposition effect among young investors in emerging markets and across different asset classes merit further exploration. Future studies might also delve deeper into the role of digital platforms in shaping investment decisions and exacerbating the disposition effect among young investors.

Given the increasing influence of young investors in financial markets, understanding the disposition effect among this cohort is not only academically interesting but also practically significant. Mitigating the disposition effect among young investors can foster more rational and effective investment decisions, thereby contributing to the health and stability of financial markets. This review underscores the pressing need for effective financial education programs tailored to the unique traits and behaviors of young investors, thereby fostering a generation of competent and informed market participants.

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