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A stock broker monitoring the latest share prices during a trading session at the Pakistan Stock Exchange. The rise of low-cost trading applications has made it easier and faster for investors to execute their own trades. However, the writers say the simplification and gamification of such trading platforms may not be beneficial for investors. PHOTO:EPA-EFE

The costs of doing your own trades

There is risk from opportunity cost and danger of behaving more like a gambler

Ben Charoenwong and Tan Zong Ting

The global pandemic was the spark that accelerated two trends in financial market participation: technology-enabled, lower-cost trading and the rising cost of attention.

Having more people take part in the economic and financial market growth is a democratic way for the entire population to grow their wealth. But, on the other hand, uninformed amateur stock trading may also result in exposing one's life savings to risks.

INVESTMENT OPPORTUNITIES

For every investment we make, we forgo a whole range of other possibilities. Therefore, in chasing after one popular stock, we may miss out on the opportunity to invest in another company that may actually be a long-term winner.

In addition, we may decide to hold securities which have lost money for a longer period in hopes of recouping losses. We may also decide to take more risk following gains from an investment, thinking that at least we have broken even and that perhaps the positive returns may continue.

But these behaviours miss a key fundamental lesson that finance professors teach: Money has an opportunity cost. Expecting simply to break even for a risky investment is a pretty low bar. You should be paid for taking on risk.

Remember that there is an opportunity cost for that money. It is fungible and could have been used for a variety of other things, from treating yourself to a nice dinner to investing in another security which may have provided a better return.

The concept of opportunity cost is arguably the most important concept from all of economics, and in fact motivates the next hidden cost as well: your attention.

ATTENTION AND MINDSHARE

Trading platforms compete for your attention. Gone are the clunky trading platforms of old where a single login into the trading account requires the consultation of a physical card for a security key before a heavy application filled with hundreds of obscure moving numbers pops up on a screen.

Now, a clean application loads up with intuitive buttons, concise descriptions of various actions and securities, and large buttons for buying and selling.

However, simplification and gamification may not be beneficial for investors. Academic research has found that simultaneously showing cross-market data helps investors attain better trading prices. So more may be better than less here.

Trading nowadays is easy and fast. We can react to any news developments much faster than before. But having such a wealth of information is a double-edged sword from a human perspective. Just as it becomes easier for us to access news from all around the world and act on the information, it also raises the opportunity cost for all the other activities we do, be it family time, meeting friends, or date night with a significant other.

ADDICTION

Low-cost trading applications such as Robinhood have fuelled the rise of novice traders who behave more like gamblers rather than investors. Robinhood's interface simplified trading substantially. Features like falling confetti and emoji-filled phone notifications make it feel like a game. A quick glimpse at the interface shows that it is reminiscent of the machines sitting in a casino.

The Institute of Mental Health here in Singapore defines addiction as a "chronic, progressive and relapse-prone illness that affects a person both physically and psychologically", and is characterised by continuing the addictive behaviour despite the consequences; the frequency or intensity of the behaviour increases over time, and when stopped, the person experiences unpleasant emotions.

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Stock trading has similar features: It comes with promises of opulence as huge winners are covered by the news media; it is high-paced; and thanks to discount brokers, it is also easily done and does not actually require a trip to the casino.

Arguably, because the probabilities of winning or losing in the financial markets are not known (unlike in a casino), it can be even more exhilarating.

TWO TIPS FOR TRADERS

1. Maintain a trading log. Keep a trading log which documents your opinions and bets.

Then you should periodically review your trading log, for example when you close a trade.

This review provides a point-in-time perspective of your thoughts. This allows you to learn from past mistakes, if any. Academic research finds cognitive reflection helps traders avoid behavioural biases.

Unfortunately, without writing it down, we tend to overwrite the past with our perspective of the past, or "memory bias". In fact, academic research finds evidence that inexperienced investors are unable to provide a reasonable assessment of their own realised trading returns. Unfortunately, the most robustly documented effect is a positive memory bias, meaning that we tend to remember the winners and forget the losers.

2. Write down pre-specified rules.

You can try to set well-defined rules for yourself in terms of a trading horizon, the maximum trade size, and the frequency at which you will check the trade. But unfortunately, we humans are notoriously bad at following our own rules, and whenever our behaviours do not coincide with our beliefs, we simply tend to change our beliefs rather than our actions (this is known as "cognitive dissonance").

This inability to commit to following rules is where machines have a clear advantage. Quantitative algorithmic trading can reduce the attention cost on the investors. Unfortunately, implementing such a rules-based system also requires some level of technical sophistication.

Alternatively, you can delegate someone else to trade on your behalf, such as trading into a fund. Segregating core long-term investment assets from a gambling/speculation/play trading account can also help to improve the discipline.

In conclusion, only by being aware of both the full suites of benefits and costs of day trading can we make informed decisions. In a fast-paced world where so many things compete for our attention, we need to slow down at times, so that we can make more conscious and deliberate decisions in investing wisely for the long term.

For some whose opportunity costs of time are high, the wisest decision may be not to day-trade at all. In that case, they can still participate in financial markets through other means such as financial advisers or investing in funds that require less day-to-day attention.

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