Chapter 36 Social Interactions and Investing

1. If a group of investors tends to buy and sell together, are these investors “herding”? Explain why or why not.

   Based on Hirshleifer and Teoh (2003) taxonomy of herding shown in Figure 36.1, the group of investors can be said to be “herding”. Unfortunately, the reason the investors tend to buy and sell together is unknown. They may be influenced by observing others, learning. or be part of an information cascade. There may be network externalities and/or reputational concerns. Observing a group of investors buying and selling together is interesting, but calls for further investigation.

2. How can financial economists measure information diffusion among investors?

   Measuring information diffusion is very complicated because financial economists cannot view investors’ information sets. One needs to measure changes in people’s information sets as the information diffuses through a population. Two directions future research might follow are laboratory experiments and natural experiments. The former is potentially expensive, while the latter requires innovation. Devising ways to measure information diffusion is an open area of research.

3. Why do so few papers combine the fields of sociology and finance when studying social interactions and investing?

   This is currently an unanswered question. Ethnographic studies in sociology typically rely on interviews and in-depth case studies. While case studies are a popular teaching tool in business schools, top finance journals do not publish many papers based on case studies.

4. If a group of investors tends to buy and sell together, should financial economists study their behavior if there is no correlation between the net trades and contemporaneous returns? Explain why or why not.

Just because net trades (buys-minus-sells) are not correlated with contemporaneous returns, one should not forget to check whether the trades are correlated with lagged and/or future returns. Correlation with future returns is especially interesting to financial economists. A positive correlation between net trades and future returns might indication that the investors have value-relevant information. They buy before prices increase and sell before prices decrease.

One could ask why there is no correlation with contemporaneous returns. Are frictions low? Or, one could ask why the investors are trading together. Is there a utility gain based on trading in the same directions as one's peers? Finally, checking what percentage of trades that investors initiate may be worthwhile. If the majority of trades are initiated and the investors trade in the same direction, this might provide insights into how the investors process information and how they choose which stocks to buy.