Social Trading: When do Signal Providers Gamble?

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All remaining errors are our own.

\section*{Extended Abstract}

\textbf{Purpose:}

The distinction between signal providers and signal followers is the defining feature of social trading. Regarding signal provider trading activities, social trading platforms ensure visibility and traceability. Based on the published information, signal followers can copy one or several signal providers, i.e. delegate their investment decisions (e.g., Döring et al. (2015), Oehler et al. (2016)).

Previous studies on social trading assess the performance of signal providers and signal followers (e.g., Dorfleitner et al. (2018), Oehler et al. (2016)), as well as certain behavioral phenomena like the disposition effect (e.g., Gemayel and Preda (2018b), Glaser and Risius (2018), Pelster and Hofmann (2018)), herding (e.g., Gemayel and Preda (2018a), attention from peers (e.g., Pelster and Breitmayer (2019), and the establishment of trust (Wohlgemuth et al. (2016)). Pelster and Breitmayer (2019) relate social trading to research on private investor (stock) trading driven by excitement (e.g., Dorn and Sengmueller (2009), Taffler (2018)) as well as the desire to gamble (e.g., Dorn et al. (2015), Goa and Lin (2015), Kumar (2009)).

Signal provider gambling behavior has not been addressed by previous research. As described, signal providers are (mostly private) traders, who administer the funds of their respective followers. When the administered portfolio performs well, signal providers are compensated, i.e. become eligible for receiving funds in the form of performance fees. On the other hand, when their administered portfolio fails, there are barley any consequences (see below). This inherent asymmetry might induce signal providers to gamble. In this context, we
analyse signal provider gambling behavior with regard to the past performance of their administered portfolio.

The social trading platform considered in our analysis is subject to several peculiarities:

- Administered signal provider portfolios are purely virtual, i.e. signal providers do not actually hold the corresponding assets.
- Signal providers are compensated via performance fees which are self-imposed when creating a portfolio. Performance fees are calculated depending on the high watermark principle, i.e. signal providers may only receive remuneration if a corresponding portfolio reaches a new high.
- Signal providers may simultaneously administer several portfolios which can be closed, and potentially replaced, at any time.

The described design peculiarities create a unique environment for traders. Examining signal provider gambling behavior adds another aspect to a relatively new research area. In the context of social trading, we are the first to our knowledge to explicitly analyse signal provider gambling with stocks (e.g., Bali et al. (2011), Kumar (2009)).

**Design/methodology/approach:**

We employ a comprehensive dataset containing the return and transaction data of 30,279 signal provider portfolios from December 2011 to February 2019.

The incentive structure stems from the social trading platform’s established remuneration scheme. Signal provider compensation depends on the success of the administered portfolio. Therefore, we set past portfolio performance as the main independent variable. The portfolio return of the previous month, as well as the average monthly portfolio return over the previous two, three, four, five, and six months, are employed as past performance measures. For each of the six performance measures, each portfolio is then assigned a number from one to ten, indicating its according relative monthly performance ranking.

We start by assessing whether the monthly transaction volume generated by a signal provider within an administered portfolio, as well as the respective number of transactions, depends on the corresponding portfolio's relative past performance. The according relevant dependent variables are the monthly volume / number of assets purchased, as well as the monthly volume / number of assets sold, within each portfolio.
Subsequently, we examine whether relative past portfolio performance has an impact on signal provider gambling as depicted by the relative monthly share of transactions involving lottery-like stocks (e.g., Bali et al. (2011), Kumar (2009)). We set the monthly relative volume / number of lottery-like stocks purchased, as well as the monthly relative volume / number of lottery-like stocks sold, within each portfolio, as the according dependent variable. We conduct panel regressions including a number of control variables obtained from the social trading platform. As a panel regression specification, we compute standard errors clustered by month and portfolio (e.g., Petersen (2009)).

**Findings:**

We provide evidence that signal providers increase their trading activity with regard to a corresponding portfolio when they have performed well relative to their peers. Our results vastly confirm those of Pelster and Breitmayer (2019). We further relate our results to literature on overconfidence – attributable to good past performance – and the respective impact on trading activity (e.g., Gervais and Odean (2001), Odean (1999), and Statman et al. (2006)). Moreover, we follow Pelster and Breitmayer (2019) and argue that excitement (e.g., Taffler (2018), Dorn and Sengmueller (2009)) – increased by good past performance – may be a suitable explanation for the surge in signal provider trading activity. Furthermore, we provide evidence that signal providers trade lottery-like stocks more frequently when their past performance was comparatively good. To be more precise, our results indicate that signal providers tend to increase the traded relative share of lottery-like stocks within an administered portfolio when the portfolio has performed well relative to its peers. In order to explain the observed results, we once more refer to an increase in overconfidence due to good relative past performance (e.g., Gervais and Odean (2001), Odean (1999), Statman et al. (2006)) which causes an increased appetite for risk (e.g., Barber and Odean (2001), Broihanne et al. (2014), De Long et al. (1991), and Odean (1999)). However, since signal providers increase the share purchased as well as the share sold of lottery-like stocks, we are not able to make a statement about the net exposure towards risk. Furthermore, overconfident signal providers might vastly overestimate the precision of their information (e.g., Benos (1998), Daniel et al. (1998), Odean (1998, 1999)), and therefore assume that they can make profits by timing the market. When in believe of having (precise) information, signal providers may increase trading with regard to stocks where major
(positive) price movements are more likely, i.e. stocks exhibiting high idiosyncratic volatility and high idiosyncratic skewness (e.g. Kumar (2009)). Finally, we remark that the peculiarities of the social trading platform, especially the applied signal provider remuneration scheme, may have a substantial impact on signal provider gambling behavior.

**Originality/value:**

Regarding social trading, we are the first to our knowledge to explicitly analyse signal provider gambling (e.g., Bali et al. (2011), Kumar (2009)). Social trading platforms create a unique environment for traders. Due to the described design peculiarities of the considered social trading platform, signal providers are remunerated when exhibiting good performance. However, when administered portfolios fail, there are barley any consequences. In this context, signal provider gambling is a highly relevant issue.

Our results have major implications for social trading platforms. In order to protect signal followers and their respective investments, social trading platforms should establish an incentive scheme which doesn’t facilitate signal provider gambling.
References


Gemayel, Roland, and Alex Preda, 2018a, Does a scopic regime produce conformism? Herding behavior among trade leaders on social trading platforms, *European Journal of Finance* 24, 1144–1175.


