



**The Disposition to Sell Winners Too Early and Ride Losers Too Long:
Theory and Evidence: Discussion**

George M. Constantinides

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DISCUSSION

GEORGE M. CONSTANTINIDES*: The paper by Shefrin and Statman (S-S) outlines four behavioral theories of decision making and applies them to the problem of the realization of capital gains and losses. These theories are: prospect theory; mental accounting; regret aversion; and self-control. The behavioral theories are at odds with the neoclassical model of utility maximization by rational investors. Many economists, including myself, while recognizing the imperfections of the economic theory, find no compelling theoretical or empirical reason to abandon the neoclassical model in favor of these behavioral theories. Specifically, the empirical evidence cited in the S-S paper does not reject the predictions of the neoclassical model in favor of the predictions of the behavioral theories. Nevertheless, the discussion of the behavioral theories is both interesting and challenging.

The first contribution of the S-S paper is in the observed increased realization of capital losses at year-end. S-S argue that there should be no special significance to December as a month in which realized capital losses result in an immediate tax rebate: if a capital loss is realized in (say) January, the investor can obtain an immediate tax rebate in the form of lower tax withholding by changing the number of exemptions. Yet they continue: "We conjecture that tax planning in general, and loss realization in particular, is disagreeable and requires self-control. Should this be the case, then it is reasonable to expect that it is easier to motivate oneself in December than other months because of its perceived deadline characteristic." On the one hand, the investor is sufficiently sophisticated to change frequently the number of exemptions; on the other hand, the investor has to discipline himself to act rationally only occasionally by imposing on himself imaginary deadlines, such as the end of the calendar year.

In their second contribution, S-S argue that the behavioral theories prescribe that the investor should realize capital gains early and defer the realization of capital losses. By contrast, the rational theory, in the absence of transaction costs, prescribes that the investor should realize losses, short term if possible, defer short-term gains, and realize or defer long-term gains, depending on the differential marginal tax rate between short-term losses and long-term gains.

In their Table I, S-S present empirical evidence by Schlarbaum et al. [2] to the effect that the fraction of transactions in which a gain is realized, is independent of the assets' holding period. This evidence rejects neither the rational model nor the behavior theories in favor of the other. In their Table II, S-S present their own empirical evidence based on mutual fund redemptions in months in which the market went up and months in which the market fell. The evidence is interesting in its own right, but again rejects neither the rational model nor the behavioral model in favor of the other. IRS data or the database available through the NBER may provide more powerful tests in comparing these theories. Feldstein and Yitzhaki [1], among others, provide convincing empirical evidence that investors are quite sensitive to tax consideration in their decisions to sell common stock.

* University of Chicago.

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