

Andreas Krause



Speculation

Speculation and investment

- ▶ Speculation is the exploitation of price differences over time
- ▶ Speculation seeks to generate these profits within short time periods
- ▶ Obtaining the benefits of the asset, such as dividends, is of little interest
- ▶ Investment seeks to obtain these benefits and is focussed on long-term gains

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Negative views on speculation

- ▶ Speculation is commonly seen negatively as detrimental to investors and destabilising markets
- ▶ Speculators are often accused of ignoring the fundamental value and driving asset prices up
- ▶ We will look at the impact speculation has on the market and the emergence of trading, which ignores information

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- ▶ We will look at the impact speculation has on the market and on the environment
- ▶ Speculation is not always a bad thing

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Speculation and volatility

- ▶ Market prices fluctuate due to information becoming available or to spurious trading behaviour of investors
- ▶ Speculators try to take advantage of these fluctuations, especially those that are not information based
- ▶ If they trade against the trend, they can reduce asset volatility
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Stabilizing and destabilizing speculation

Benefits of speculation

- ▶ If speculators anticipate future price movements correctly and speculation is limited, it reduces price volatility
- ▶ Destabilising speculation reduces overall welfare. But investors stabilise as benefit from speculation
- ? Why might the welfare gains to investors from destabilising volatility be more limited than in this model?
 - ▶ Investors are risk averse and the increased volatility will negatively affect their utility from holding the asset, this will reduce the overall welfare or make it even negative

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Copying other traders' decisions

- ▶ Herding is a situation where traders make the same decisions and this decision is not based on information but traders copying each other's decisions
- ▶ Traders ignoring information is often seen as irrational and unprofitable
- ▶ There is significant evidence that herding in financial markets exists
- ▶ We will show that herding can be rational and profitable

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Profitable herding

- ▶ Herding can be profitable if it dominates the market and in this case informed traders might find it optimal to ignore their information
- ▶ The existence of herding can be seen as information and following the herd as acting on that information
- ? If you observe that many traders make the same decision, is this a sure sign of herding?
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Summary of key results

- ▶ Speculation can be beneficial if its extent is limited as it then reduces asset volatility
- ▶ Excessive amount of speculation reduces overall welfare as speculators make a loss
- ▶ If speculation occurs to such an extent that it dominates the market, it can start a trend that becomes self-fulfilling
- ▶ If traders can coordinate to generate such a trend, herding can be optimal and generate larger profits than informed traders can generate

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