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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

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 high
- We will look at the impact speculation has on the market and at the emergence of herding, which ignores information

Speculation and volatility

- Market prices fluctuate due to information becoming available or exogenous 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
- If they misjudge future trading behaviour, they can increase asset volatility
- We will see how such behaviour emerges and what its consequences are

Stabilizing and destabilizing speculation

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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 nevertheless 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

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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Herding

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?

! Traders could have received information that induced the same behaviour, it is only herding if it is not based on information about the value of the asset

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 extend 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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