What Drives the Disposition Effect?  
An Analysis of a Long-Standing Preference-Based Explanation

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Abstract
One of the most striking portfolio puzzles is the “disposition effect”: the tendency of individuals to sell stocks in their portfolios that have risen in value since purchase, rather than fallen in value. Perhaps the most prominent explanation for this puzzle is based on prospect theory. Despite its prominence, this explanation has received little formal scrutiny. We take up this task, and analyze the trading behavior of investors with prospect theory preferences. We find that, at least for the simplest implementation of prospect theory, the link between these preferences and the disposition effect is not as obvious as previously thought: in some cases, prospect theory does indeed predict a disposition effect, but in others, it predicts the opposite. We provide intuition for these results, and identify the conditions under which the disposition effect holds or fails. We also discuss the implications of our results for other disposition-type effects that have been documented in settings such as the housing market, futures trading, and executive stock options.