Rational and Heuristic-Driven Trading Panics in an Experimental Asset Market

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Abstract

In financial markets, potential adverse price movements may induce traders to rush to trade as soon as possible, forgoing time-consuming research that produces better asset value information. I theoretically derive conditions under which equilibrium forces cause traders to rationally panic, simultaneously attempting to front-run each other. In a laboratory test of the model, robust, rational panics occur, resulting in poor information aggregation. Panics inconsistent with equilibrium behavior are also frequent, and lead to trade clustering and positive short-term correlation in returns. These real-world phenomena result from about 40% of traders relying on a simple trading heuristic that experience does not eliminate.

1 Introduction

In financial markets, traders decide how much information to acquire before trading an asset. Obtaining better information leads to higher expected profits and more informative asset prices. However, when information can only be acquired over time, it comes at a cost: if others trade, prices move towards fundamental value in expectation, reducing one’s potential trading profit. This fear of adverse price movements can cause a rational panic - defined

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as a trading episode in which traders simultaneously rush to trade before acquiring full information. In a rational panic, asset values poorly aggregate information to the detriment of the long-term informational efficiency of the market, which both theoretical and empirical work have shown to be important for the real economy (Bond, Edmans, and Goldstein (2012)). This paper develops a model of panics and then tests it in a laboratory setting to study actual behavior and its associated informational consequences.\footnote{Panics’ defined in this way are distinct from ‘crashes’ and ‘frenzies’. In the same way that a panic in a crowded theater may or may not lead to people being trampled to death, a panic may or may not lead to a price crash. That is, panics are caused by actions taken out of fear (in this case of adverse price movements), and may produce different consequences. A price crash is one such consequence, but informational losses are another. For a concrete example of a panic that does not lead to a price crash, consider the fact that earnings announcements generate spikes in volume (Frazzini and Lamont (2006)), but not necessarily large price movements. For papers that study (theoretically) how rational panics can lead to crashes, see Romer (1993), Bulow and Klemperer (1994), Smith (1997), Lee (1998), Barlevy and Veronesi (2003), Brunnermeier and Pedersen (2005), and Pedersen (2009).}

Why study market panics in a laboratory environment? Real-world evidence is difficult to interpret because we do not typically observe the information traders acquire nor when they acquire it, making it difficult to understand how they trade off information and forgone profits.\footnote{Methods of inferring information from trades do exist. For example, Hasbrouck (1991) uses the persistence of price impacts and Easley et al. (1996) construct a structural model based on the arrival of news. Kendall (2016a) discusses the observable implications of traders rushing to trade on weak information.} By overcoming these issues, a laboratory experiment can provide insight into two main questions of interest. First, how do subjects evaluate this trade-off— are panics consistent with equilibrium behavior or do they result from other rules-of-thumb? Second, how do panics (rational or otherwise) affect the informational content of prices?

I introduce a novel model of trading with two important features. First, traders receive private information over time. Specifically, they receive initial (poor quality) information when they arrive to the market (simultaneously), and are then given several opportunities to trade before receiving additional information just prior to the final trading period.\footnote{Alternatively, as in Kendall (2016a), one could have subjects receive only weak information immediately or better information after waiting, which makes a single trade natural. The trade-off is very similar in this case, but here I opt for providing initial information and restricting to a single trade because traders can then condition their timing decision on the private information they obtain upon arrival which allows for a better understanding of what drives behavior.} Second, although each trader in the model has the opportunity to trade in many trading periods, I restrict them to a single trade. This restriction imposes the trade-off between acquiring better information and the desire to trade before others in a particularly stark way, but allows me to develop benchmark theoretical predictions, and, unlike models in which multiple trades are allowed, allows me to easily identify panics (simultaneous trades).

The common-value asset and signals in the model are binary. Risk-neutral traders trade with a market maker who posts a single price equal to the expected value of the asset.
conditional on all public information. As is standard, traders can profit by trading according to their private information: buying with favorable information and selling otherwise.

In the main theoretical contribution, I provide precise predictions about when trades occur in equilibrium. I provide a pair of sufficient conditions, one of which ensures that the equilibrium prediction is a rational panic (all traders trade in the first period), and the other of which ensures that the prediction is for traders to instead wait for better information (trade in the final period). As one may expect, the main driver of whether one should panic or wait is the difference between initial and final signal qualities. When this difference is large, waiting intuitively becomes more valuable. However, the signal qualities also affect the information revealed by trades and therefore the cost side of the trade-off (prices move more when others have better information).

How do subjects actually trade off better information and forgone profits? On the one hand, subjects may place too much value on private information (Weizsäcker (2010), Eliaz and Schotter (2010)), waiting more than is rational. On the other hand, in equilibrium, prices, and specifically trends in prices, are irrelevant for decisions. However, a natural intuition is that as prices rise indicating that the asset is valuable, one may be tempted to buy the asset immediately, reasoning that buying is more likely to produce a profit and waiting simply results in paying a higher price. While partially correct, this intuition fails because an asset that is more likely to be valuable is already priced to account for this fact so that buying is only optimal if one has favorable information that the market does not. By allowing for many trading periods so that price trends may form, I designed the model such that this faulty intuition, if used, is observable in the data.

In the experiment, I conduct two treatments with parameters such that rational panics should occur in the first, but not in the second. In the treatment in which panics are rational,

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4 The model is in the spirit of Glosten and Milgrom (1985), but I abstract from the adverse selection problem between the market maker and the informed traders. Here, the market maker provides liquidity so that noise traders are not necessary. As shown in Kendall (2016a), incorporating adverse selection by having the market maker post separate bid and ask prices complicates the analysis, but doesn’t affect the main trade-off between better information and costly price moves.

5 Precise theoretical predictions are mostly absent in experimental studies of markets with endogenous trade timing. Park and Sgroi (2012), in the most closely related paper, provide qualitative predictions guided by theory in an endogenous timing setting. Shachat and Srinivasan (2011) study trading with sequential arrival of information, but in an environment in which a no trade theorem applies. Bloomfield et al. (2005) study the choice between market and limit orders in the absence of theoretical predictions. Several papers consider timing decisions in environments in which prices are fixed and theoretical predictions are known. See, for example, Sgroi (2003) and Ziegelmeier et al. (2005) who each implement the irreversible investment model of Chamley and Gale (1994). Ivanov et al. (2009, 2013) and Çelen and Hyndham (2012) study similar environments. Incentives to wait are quite different in these papers as observing others’ decisions can be beneficial when their information is not incorporated into prices. Finally, Brunnermeier and Morgan (2010) study timing decisions theoretically and experimentally in a game related to both preemption and war of attrition games.
they always occur, providing the first available laboratory evidence that subjects rationally rush to trade to avoid adverse price movements and suggesting that theory can be a useful guide to predicting panics in the field. Subjects forgo acquiring perfect information about the asset value 99.7% of the time, instead rationally choosing to trade immediately on lower quality information.

In the treatment in which subjects should rationally wait for additional information, they instead are much more likely to follow a heuristic similar to the intuition I described previously. The heuristic produces non-equilibrium panics (trade clustering) that result in informational losses not predicted by theory. It also produces short-term positive correlations in returns due to the fact that traders chase price trends. Chasing price trends can lead to informational herding (trading against one’s private information), but perhaps surprisingly, the positive correlation in returns is *not* driven primarily by herding. Instead, the correlation is driven by traders with different private information choosing to trade at different times. Given that above one third of subjects follow the heuristic, and the emergence of positive correlations in returns and trade clustering - two well known features of real markets - it is plausible that the heuristic is relevant outside of the laboratory.

To study the heuristic predictions in greater detail and determine its robustness, I develop a second model - the Diagnostic model. One difficulty with interpreting the data of the main model is that selection issues arise: subjects that trade early on exit the sample so that one cannot observe what they would have done at other price levels. To overcome this issue, in the Diagnostic model, traders arrive sequentially and make simple, binary timing decisions. Subjects trade in an overlapping sequence such that an additional trader arrives before one’s second trading opportunity. I again construct a pair of treatments and show theoretically that in one it is rational to rush to trade upon arrival to the market, but in the other it is rational to wait for more information. Instead I find behavior that confirms use of the heuristic: subjects that arrive at times when the price is high are more likely to rush to buy.

In addition to explaining phenomena in real markets, the heuristic provides a potential

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6The literature on informational herding began with the papers of Banerjee (1992) and Bikhchandani, Hirshleifer, and Welch (1992). Various definitions of herding and its counterpart, contrarianism, are present in the literature. I follow the definitions of Avery and Zemsky (1998) and the subsequent experimental literature that tests their model (Cipriani and Guarino (2005) and Drehmann et al. (2005)). See Section 3.3 for the formal definitions. For a survey on herding in financial markets, see Devenow and Welch (1996). Herding has has long been considered an explanation for correlation in returns. See Hirshleifer and Teoh (2003) for an extensive review.

7Dufour and Engle (2000) provide empirical evidence of trade clustering. Positive short-term correlation in returns is often attributed to underreaction and has received considerable attention both theoretically and empirically. For theoretical explanations, see Barberis et al. (1998), Daniel et al. (1998), and Hong and Stein (1999). For a review of empirical evidence, see Daniel et al. (1998). Kirchler (2009) demonstrates underreaction in an experimental double-auction environment in which asset values follow a stochastic process.
explanation for herding observed in past sequential trading laboratory experiments (Cipriani and Guarino (2005) and Drehmann et al. (2005)). It suggests subjects herd as a function of their beliefs about the asset value, not due to conformity or beliefs about mistakes by others.\footnote{Cipriani and Guarino (2005) consider and reject the idea that herding is due to beliefs about mistakes by previous traders. Drehmann et al. (2005) consider and reject conformity.} Because trade timing is exogenous in this literature, it is more difficult to identify the heuristic.\footnote{Park and Sgroi (2012) also relate herding to trade timing, but in an environment with three states and signals where rational herd behavior is predicted. While they do not have precise theoretical timing predictions, they argue (and observe) that those who have signals that are more likely to herd move later than those with monotonic signals. In contrast, subjects that herd move earlier here.}

An important issue in assessing the external validity of heuristic behavior is to identify its source. I demonstrate numerically that prospect theory preferences (Kahneman and Tversky (1979,1992)) are a promising candidate for explaining this behavior and argue informally that the heuristic is inconsistent with several other common behavioral explanations for experimental data.

The paper is organized as follows. In Section 2, I consider the main model. I derive theoretical predictions, outline the experimental treatments, and provide results. I then investigate non-equilibrium behavior in more detail, developing a heuristic to explain it. Section 3 develops and tests the Diagnostic model. Section 4 discusses potential implications of the discovered heuristic for actual markets and how it can potentially explain behavior observed in related experimental work. There, I also discuss how prospect theory generates behavior consistent with the heuristic. Section 5 concludes.

2 Model and Theory

2.1 Terminology

I distinguish between two related concepts: rushing and panics. Rushing refers to a trader who trades prior to receiving all possible private information. A panic occurs when multiple traders rush to trade simultaneously. In the main model, both rushing and panics are possible, whereas in the Diagnostic model, only rushing is possible because traders trade one at a time.

2.2 Model

Time is discrete with $t = 1, 2, \ldots, T$ trading periods. In each trading period, each of $n$ risk-neutral trader may trade a single, common-value asset, $V \in \{0, 1\}$, at a price established by
a market maker. The initial prior that the asset is worth $V = 1$ is $p_1$. When the asset value is realized at $T$, those who purchased the asset receive a payoff of $V - p$ and those who sold (short) receive a payoff of $p - V$. There is no discounting.

Each trader, identified by $i \in n$, receives a private signal before the first trading period, $s_i \in \{0, 1\}$, which has a correct realization with probability $q = \Pr(s_i = 1|V = 1) = \Pr(s_i = 0|V = 0) \in (\frac{1}{2}, 1)$. Each trader may trade only once in any of the $T$ trading periods. If a trader waits until time $T$ to trade, she receives an additional private signal, $\bar{s}_i \in \{0, 1\}$, immediately prior to $T$, which has a correct realization with probability $\bar{q} = \Pr(\bar{s}_i = 1|V = 1) = \Pr(\bar{s}_i = 0|V = 0) \in (\frac{1}{2}, 1]$. Note that I allow for the second private signal to reveal the true asset value perfectly, and I assume $\bar{q} > q$.

Between each pair of trading periods, a binary public signal, $s_{P,t} \in \{0, 1\}$, is released that has a correct realization with probability $q_P = \Pr(s_{P,t} = 1|V = 1) = \Pr(s_{P,t} = 0|V = 0) \in (\frac{1}{2}, 1)$. A single price, $p_t = E[V|H_t] = \Pr[V = 1|H_t]$, equal to the expected value of the asset conditional on all publicly available information, $H_t$, is set by a market maker prior to each trading period.$^{10}$ $H_t$ includes all prior trades, timing decisions, and prices.

This model may be thought of as a simplified version of the situation arising around a firm’s earnings announcement. At the time of announcement, traders receive independent (low quality) private information about the revision in the firm’s valuation. After the announcement, public information slowly becomes available through a series of public signals and, finally, some time later (perhaps at the filing of the firm’s 10-K), more information about the firm’s revised valuation becomes publicly known.$^{11, 12}$

2.3 Theoretical Predictions

The solution concept is sequential equilibrium and I focus on Markov strategies that depend only upon the payoff-relevant state (see part A of the online Appendix for further details). Proposition 1 states the standard result that traders optimally buy when their private belief is greater than the public belief (which is equal to the price), and sell otherwise. For a risk-neutral trader, this strategy leads to a positive expected profit, while doing the opposite would lead to an expected loss. All proofs are given in Part A of the online Appendix.

$^{10}$Incorporating a bid-ask spread would make interpretation of the experimental data much more difficult because optimal timing strategies involve mixing (see Kendall (2016a)).

$^{11}$The slow release of public information, while not unreasonable, has the additional benefit of facilitating unique equilibrium predictions.

$^{12}$Although earnings announcements are typically thought of as public information, private information can arise if traders have heterogeneous abilities to process information or have different models of a firm’s dividend-generating process (Kandel and Pearson (1995)).
Proposition 1: In any equilibrium:
1. traders who trade prior to period $T$ buy if $s_i = 1$ and sell if $s_i = 0$.
2. traders who trade in period $T$ buy if $s_i = 1$ and sell if $s_i = 0$.

Due to the richness of the strategy space, a complete characterization of all equilibria for general parameters is tedious to derive. However, sufficient conditions exist (that include the particular sets of parameter values used in the two treatments, R and W, provided in Table 1) to ensure equilibria involve either all traders rushing or all traders waiting. Proposition 2 states the result.

Proposition 2: Equilibrium trading (buy or sell) strategies are given by Proposition 1. For the timing strategies:
1. there exists an open set of the parameter space, $(q, q_P, \bar{q}, p_1, T,)$ which includes the parameter set of treatment R $(q = \frac{3}{4}, q_P = \frac{17}{24}, \bar{q} = 1, p_1 = \frac{1}{2}, T = 8)$ such that, in any equilibrium, all trades occur in the first trading period.
2. there exists an open set of the parameter space, $(q, q_P, \bar{q}, p_1, T,)$ which includes the parameter set of treatment W $(q = \frac{13}{24}, q_P = \frac{17}{24}, \bar{q} = 1, p_1 = \frac{1}{2}, T = 8)$, such that, in the unique equilibrium, all trades occur in the final trading period.

Although the model is simple to describe, its analysis is complicated by the fact that the strategy space of a trader, even when restricted to a single trade, is large: strategies depend upon a player’s initial signal, the price, and the number of traders that have traded prior to her. The proof of Proposition 2 first establishes that traders with different initial signals must follow the same strategy, simplifying the analysis greatly. I then establish a pair of sufficient conditions to ensure that traders trade at either $t = 1$ or $t = T$.

Intuitively, the main trade-off is between obtaining better private information by waiting and the fact that, when information becomes public (either through others’ trades or through public signals), it reduces a trader’s potential profit because it moves prices towards the true asset value in expectation. The difference between treatments R and W lies solely in the initial signal quality. In R, the better quality initial signal increases the profit from trading immediately. The proof of Proposition 2 establishes that, even if all other traders wait to trade until $t = T$, the price impacts of the public signals alone are sufficiently costly to ensure a trader must trade at $t = 1$. When combined with the relatively large price impacts

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13 Part 1 of Proposition 2 does not specify the off-equilibrium timing strategies, but the proof ensures that all trades occur immediately independent of these strategies.

14 More generally, the game is a coordination game in which multiple equilibria may exist. It may be interesting to study how traders behave in this coordination game, but studying behavior under environments with unique equilibrium predictions seems like a logical first step.
of others’ trades, one may anticipate a robust rational panic in which all traders rush to trade at \( t = 1 \).

In \( W \), the initial signal quality is so poor that it rationally pays to wait to learn the asset value in the final period before trading. Even if all other traders trade before \( t = T \), their trades produce so little price impact that it is rational to wait. The equilibrium prediction aside, one may expect trends in prices to prove tempting for traders that use the intuition I described in the Introduction, given the many opportunities to trade before they receive additional information.

Proposition 2 provides point predictions about subject behavior, but subjects are unlikely to behave rationally 100% of the time. A weaker hypothesis is that subjects rush more often in \( R \) than in \( W \). I formally state this comparative static result as Corollary 1 which follows immediately from Proposition 2.

**Corollary 1:** Subjects trade earlier in \( R \) than \( W \).

### 2.4 Experimental Design

All subjects were recruited from the University of British Columbia student population using the experimental recruitment package Orsee (Greiner (2004)). Subjects came from a variety of majors and no subject participated in more than one session. I conducted four sessions of each treatment, for a total sample of 64 subjects (\( n = 8 \) subjects in each session). New randomizations were performed for each session’s asset values and signals in order to avoid the possibility of a particular set of draws influencing the results. In each session, subjects first signed consent forms and then the instructions (provided in part B of the Online Appendix) were read aloud. Subjects were encouraged to ask questions while the instructions were read and then completed a short quiz. All quiz questions had to be answered correctly by each subject before the experiment began, and this policy was common knowledge. Once the experiment began, no communication of any kind between subjects was permitted.\(^{15}\)

In each session, 30 paid trials, preceded by two practice trials, were run. In each trial, subjects made their trading decisions via computerized interfaces, an example of which is provided in the instructions. Past prices and trades were available on an intuitive graphical display. Software was developed using the Redwood package (Pettit and Oprea (2013)) which uses HTML5 to allow for rapid updating of the computer interface. This feature allows for many more trials than would have been possible otherwise, which is important for learning

\(^{15}\)Subjects were separated by physical barriers so that they could not observe each others’ private information or decisions.
in this relatively complex environment. An additional benefit of a large number of trials is that it provides a sufficient number of observations to study individual behavior.\footnote{Cipriani and Guarino (2009) use a semi-strategy method in a related experiment as alternative way of obtaining many individual observations.}

The trading environments were framed as such: subjects were told that they would trade a stock with the computer. It was emphasized that they could only trade once and that they must trade (in each trial).\footnote{Both Cipriani and Guarino (2005) and Drehmann et al. (2005) allow subjects to not trade in some treatments, finding that a considerable fraction do so. Given that not trading is never optimal and the additional complexity of the environment here, I chose to require subjects to trade in order to eliminate one potential source of noise.} Asset values were represented visually as bins containing different numbers of colored balls, with signals corresponding to draws from the appropriate bin.

Subjects earned a payoff in each trial as described in Section 2.2. The asset value, $V$, and prices were scaled by a factor of 100 currency units. Subjects were endowed with 100 units with which to trade prior to each trial, for a maximum possible earning of 200 currency units per trial. In order to induce risk-neutrality, each currency unit represented a lottery ticket with a $1/200$ chance to earn $1.00$ Canadian (see Roth and Malouf (1979)). After all trials were completed, a computerized lottery was conducted for each paid trial and subjects were paid according to the results of the lotteries. In addition, each subject was paid $5.00 as a show-up fee. Average earnings were $21.53$ (minimum $12.00$, maximum $30.00$) with a corresponding wage rate over an hour and a half of $14.35$/hour.

Ex-ante assumptions about behavior must be made in order to set prices in the experiment. I assume that no information is revealed by the decision to wait, as is the case in equilibrium (see part A of the online Appendix). Therefore, if no trade occurs, the price is updated due to the information contained in the public signal only. After a trade, the price is updated according to Bayes’ rule, assuming that traders follow equilibrium buy and sell strategies. In the case of a trade that occurs after an off-equilibrium timing decision, the price is set assuming traders make the optimal buy or sell decision according to their private information after the deviation.\footnote{As shown in Section 2.5, this assumption is valid the vast majority of the time, but the assumption that a wait decision reveals no information is violated frequently in the data. In Section 4, I discuss the consequences of traders understanding that other traders may not be making optimal trading or timing decisions.} Subjects were told that prices reflect the mathematical expected value of the value of the asset, conditional on all public information. They were also explicitly told that prices would increase after buy decisions and favorable public signals, and conversely for sell decisions and unfavorable public signals. The exact amount of each increase or decrease was not communicated, but subjects participated in many trials so that they had an opportunity to
learn about price movements over time.

2.5 Results

In all reported results, I focus on the last third of trials (10 trials). Because the trading environment is relatively complex, focusing on the latter third of trials eliminates much of the noise associated with early behavior as subjects have had time to learn about the environment. Evidence of this learning is provided in part A of the Appendix.

To categorize trading directions, I formally define four possible trade behaviors.

Definition 1: A subject’s trade is classified as:

1. ‘Rational’ if she trades in the direction indicated by her private information (Proposition 1).
2. ‘Herding’ if she buys at a price greater than 0.5 with private information indicating that she should rationally sell, or sells at a price less than 0.5 with private information indicating that she should rationally buy.
3. ‘Contrarian’ if she sells at a price greater than 0.5 with private information indicating that she should rationally buy, or buys at a price less than 0.5 with private information indicating that she should rationally sell.
4. 'Irrational', if at a price of 0.5, she buys with private information indicating that she should rationally sell, or sells with private information indicating that she should rationally buy.

Table 2 reports the trading results of the model. About 85% of behavior is rational which suggests that, at least along this dimension, traders have a good understanding of their environment. In treatment W, more herding trades are observed, which is the first indication that something other than rational behavior is present in this treatment.

To compare timing behavior across the R and W treatments, Figure 1 plots the empirical cumulative distribution functions (CDFs) of the fraction of trades that occur in periods $t \leq t'$ as a function of $t' \in 1\ldots8$. The rational prediction is that all trades occur at $t = 1$ in the R treatment and at $t = 8$ in the W treatment, corresponding to step functions that transition from 0 to 1 at $t' = 1$ and $t' = 8$, respectively. Figure 1 provides clear evidence that trades occur earlier in treatment R than in treatment W. The median trading periods in the four sessions of R and W are $\{1, 1, 1, 1\}$ and $\{2, 3, 3.5, 4\}$, respectively. Applying a non-parametric Mann-Whitney U test, one rejects the null of equal median trading periods (test statistic = 0, p-value = 0.05), supporting Corollary E1.$^{19}$ I summarize the trading and timing results

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$^{19}$A Kolmogorov-Smirnov test also rejects the null of equal empirical cumulative distributions (p-value =
in the following two findings.

**Finding 1** *(Proposition 1)* In treatments R and W, approximately 85% of subjects rationally reveal their private information through their trades.

**Finding 2** *(Corollary 1)* Subjects trade earlier in the treatment for which the equilibrium prediction is to trade at \( t = 1 \) (R) than in the treatment for which the prediction is to trade at \( t = 8 \) (W).

Behavior in the R treatment provides a vivid demonstration of predictable, rational panics and their consequences. Traders trade in the first period almost 75% of the time, and over 90% of trades occur in the first two trading periods. Extreme clustering of trades is observed as subjects scramble to be the first to trade in all four sessions of the treatment. Rational rushing produces informational losses due to traders acting on low quality information: when a trader rushes to be the first to trade, she trades with information that is correct only 75% of the time, forgoing the opportunity to obtain perfect information. In fact, only one subject in one trial (out of 320 subject-trials) ever waits to obtain the asset value at \( t = 8 \), so that prices reflect the true asset value perfectly only 0.3% of the time.

Unlike behavior in the R treatment, behavior in the W treatment clearly departs from the rational prediction. Before delving into this behavior in the following section, I first note an immediate consequence: informational losses are greater than predicted. Even though the asset value should be revealed for certain, trials exist in which none of the eight subjects waits to learn it and therefore prices differ from the true asset value after the game ends. I provide more formal evidence of informational losses produced by non-equilibrium behavior in part B of the Appendix. Both too frequent rushing and trading against one’s private information contribute to these additional losses. Finding 3 summarizes the results related to informational losses.

**Finding 3:** Rational panics result in considerable information losses, as predicted (R). Non-equilibrium panics and trade directions exacerbate these losses, even after subjects acquire substantial experience.

### 2.5.1 Heuristic-Driven Behavior (Treatment W)

I now provide an explanation for the non-equilibrium behavior observed in treatment W. As suggested as a possibility in the Introduction, it appears that a large proportion of subjects make decisions based upon maximizing their chances of making a positive profit (buying 0.01).
good assets and selling bad), rather than maximizing their expected profit. With private information, these criteria do not necessarily lead to the same trading decisions. To take a simple example, consider the case in which the price has risen to 0.9 but one’s belief is 0.8 because one has unfavorable private information. Buying results in correctly purchasing a valuable asset 80% of the time, while selling results in correctly selling a worthless asset only 20% of the time, so that one buys if maximizing the probability of obtaining a positive profit. However, if one accounts for the sizes of the potential gains from trade, one should sell to maximize expected profit. Traders that want to maximize their chances of making a profit buy at beliefs greater than one half and sell otherwise.

Extending this intuition, if one wants to maximize the probability of a positive profit, one will value public information that provides additional certainty about the asset value (even though it is fully reflected in prices). Therefore, one may be willing to wait to observe others’ trades until sufficiently certain about the asset value, even if no additional private information is received. In treatment W, 62% of trading decisions occur in the intermediate periods, \( t = 2, 3, \ldots, 6 \), suggesting that subjects do in fact place value on public information.

To formalize a description of how subjects behave, I define what I refer to as the \( \tau \)-herding heuristic. \( \tau \) is the belief threshold above which a subject immediately buys. The heuristic is labeled with the term ‘herding’ because, as in the previous example, subjects that buy at high beliefs may herd, trading against their private information. In the following definition, and throughout the analysis of timing decisions, I assume subjects treat the asset values of 1 and 0 symmetrically.\(^{20}\) Under this assumption, the price range can be transformed to \( p' \in [0.5, 1] \) where \( p' \equiv \max(p, 1 - p) \), and similarly for beliefs. For convenience, I often to refer to prices and beliefs transformed in this manner simply as prices and beliefs.

**Definition 2:** A trader uses the \( \tau \)-herding heuristic if she has a threshold private belief, \( \tau \in [0.5, 1) \), and uses the following strategy:

1. With a private belief, \( b \in [1 - \tau, \tau] \), always wait for more information, if possible.
   If not possible, trade according to private information.

2. With a private belief \( b > \tau \), buy immediately. With a private belief, \( b < 1 - \tau \), sell immediately.

Use of the heuristic, while non-optimal, implies that subjects are reacting to their envi-

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\(^{20}\)Given the neutral framing of their environment, I would not expect subjects to favor trading in one direction over the other. Formally, I assume symmetric behavior around \( p = 0.5 \): a trader facing a price, \( p \), with private information, \( I \), makes the same decision as a trader facing price, \( 1 - p \), and complementary private information, \( I^C \). To test this assumption, I partition trials into those in which \( V = 1 \) and those in which \( V = 0 \). If there were an asymmetry between rising and falling prices, one would expect the determinants of rushed trades to be different in these two samples. However, the interaction terms are insignificant if one interacts a dummy for \( V = 1 \) with the other covariates in the regression of Table 3 that follows.
ronment in a sophisticated and predictable way such that formal tests of the behavior are possible. In developing the predictions, I make no assumption about the distribution of \( \tau \) values in the population: qualitative predictions are possible without any such an assumption. On the other hand, I later show that it is possible to estimate \( \tau \) on an individual basis.

If subjects follow the \( \tau \)-herding heuristic, we expect to see trading at intermediate periods when beliefs cross traders’ threshold beliefs, as observed. However, we can’t predict a simple relationship between beliefs and the probability of trade at a particular price (or period) because of selection issues: traders with low threshold beliefs exit earlier in time. Instead, the prediction is that when beliefs exceed a particular level for the first time, we should observe all traders with threshold beliefs below that level trade, if they haven’t already. I use the exogenous public signals, which drive most of the changes in prices (and therefore beliefs), as a coarse predictor of when belief thresholds are crossed. Specifically, I construct a set of indicator variables, each of which is set to one when the absolute value of the difference in public signals reaches a new value for the first time in the period prior to the trading period of interest (and is zero otherwise). I denote these dummy variables PubDiff1 through PubDiff6 (6 being the largest absolute difference in public signals arising in the data). One expects to see a higher probability of trade in the period immediately after a new level is reached, as long as there are traders with threshold beliefs between adjacent levels.

Table 3 reports the results of a logit regression of the probability of trade on the public signal difference indicator variables described above. I exclude \( t = 8 \) because traders must trade in this period if they haven’t traded previously. I also control for subject and trial fixed effects, the price, whether a trader’s signal makes their beliefs more or less extreme (i.e. a favorable signal makes beliefs more extreme when \( p \geq 0.5 \), but makes beliefs less extreme when \( p < 0.5 \)), and a linear time trend (i.e. trading period). Results are also reported when the subsample is restricted to only subjects identified as \( \tau \)-herding types, as discussed later in this section.

Table 3 shows that when public signals first push prices to about 0.7 (PubDiff1) and about 0.85 (PubDiff2), the probability of trade jumps, suggesting that subjects with \( \tau \) values below \( \approx 0.7 \) and between \( \approx 0.7 \) and \( \approx 0.85 \) both exist in the data. The indicator variables corresponding to public signal differences of three or more are not significantly positive and

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one is in fact (marginally) significantly negative. But, because higher public signal differences are reached less often in the data, statistical power is low in these cases. For this reason, I cannot rule out the existence of $\tau$-herding traders with threshold beliefs beyond 0.85.

The fact that a signal that makes one’s belief more extreme does not increase the probability of trade is surprising, although it is positive as one would expect. The positive coefficient on the time trend shows that traders are more likely to trade in later periods, all else equal.

I have provided timing evidence consistent with the heuristic’s prediction, but it also predicts trade directions: subjects trade in the direction of the price trend. Because I have sufficient individual observations, I explore this dimension of behavior at the individual level, providing a more detailed picture than an aggregate analysis. I attempt to classify each individual into one of four possible types: rational, $\tau$-herding, $\tau$-contrarian, and simplistic. A trader is $\tau$-contrarian if she follows a strategy identical to that of a $\tau$-herding type except that she trades against her belief, rather than with it. In classifying an individual as $\tau$-herding or $\tau$-contrarian, I only require that their behavior be consistent with some value of $\tau < 1$. Specifically, a rushed trade may occur in any period prior to the final trading period, but must be in the direction prescribed by the heuristic. Simplistic types always rush and follow their signal when they trade.

To classify subjects, I impose a rather stringent criterion: both their trading and timing decisions must be consistent with those of a particular type in nine of the last ten trials. I allow subjects to be classified into more than type in order to get a sense of the robustness of the classification, but I also assign a unique type based upon the following prioritization scheme (high to low): rational, simplistic, $\tau$-herding, and $\tau$-contrarian. Table 4 provides the resulting classifications for each treatment, including the percentages of exact matches and subjects that have ambiguous types. Given that types must match behavior along two dimensions, the classification scheme is quite successful: 84.4% of subjects are able to be classified.

About one third of subjects are classified as $\tau$-herding types, which is more than five times as many than are classified as rational. Only the simplistic types are (slightly) more common, but a subjective evaluation of these types suggests that most are likely $\tau$-herding.

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23 Here, the effect of one’s signal is averaged across cases in which a new public signal difference level is reached and when it is not. In Table 6, we see that when we consider its effect conditional on reaching the first threshold, it is significant.

24 If one of these types trades at $t = T$, I require that their trade direction be consistent with either the price trend or their private information. As such, all rational subjects are also classified as $\tau$-herding. For this reason, I prioritize rational types over $\tau$-herding types in assigning the final classification. If I were to instead require $\tau$-herding types to never wait, I would not be able to identify those that use relatively high belief thresholds.
types who made a single mistake too many to be classified as such. Supporting this assertion, in the Diagnostic treatments that follow, simplistic types mostly disappear such that across all treatments with substantial non-equilibrium behavior, \( \tau \)-herding types are by far the most common.

I perform three additional checks that those individuals classified as \( \tau \)-herding types actually follow the heuristic. First, the average belief at which these types trade should be higher than the average belief at which they wait. This criterion is satisfied for 81.8\% of these subjects. Second, returning to the determinants of rushing in Table 3, for the eleven subjects that match \( \tau \)-herding types we see that the increased probabilities of trade at the new public signal difference levels are more than double those in the aggregate regression. Although not significant, even the third public signal difference level has a large, positive coefficient. In this regression, a subject’s signal now has a significant positive effect, indicating that traders with signals that make their beliefs more extreme are significantly more likely to trade, a finding I return to in Section 2.5.2. Lastly, following a procedure outlined in Appendix C, I estimate the individual belief thresholds, \( \tau_i \), for each of these individuals using only their timing decisions. 45.5\% of them have thresholds significantly less than one, with thresholds ranging from 0.62 to 0.74. Most of the remaining subjects use higher thresholds that do not differ significantly from one, but subjects who do not appear to use a stable threshold exist. Together these results suggest that a fairly heterogeneous mix of belief thresholds are used among those identified as \( \tau \)-herding types. Finding 4 summarizes the evidence thus far.

Finding 4: Subjects exhibit considerable heterogeneity in their strategies. About one third of subjects can be described as \( \tau \)-herding, which is more than five times the percentage of subjects that can be described as rational or \( \tau \)-contrarian.

One may wonder why heuristic behavior is completely absent in treatment R. In early trials of the R treatment, evidence in fact exists that subjects use the heuristic (results available upon request). But, the fact that its use is costly causes it to die out in later trials.\(^{25}\) So, while most subjects naturally tend to follow the heuristic, if its use proves costly enough, they do learn their way out of it. Note, however, that they only learn their way out of it when panics are rational: little evidence exists that they learn to wait in treatment W even though one may think that learning the asset value perfectly provides a very salient reason to wait.

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\(^{25}\)When all others are trading at \( t = 1 \), if one delays one’s trade by even one period, the price (at \( t = 2 \)) is likely to be very close to the true asset value, so that trading produces almost no gain over one’s endowment of $1.00 (100 currency units). Trading immediately instead results in an expected profit of \( 0.75 \times \$1.50 + 0.25 \times \$0.50 = \$1.25 \).
2.5.2 Implications of Heuristic Behavior

This section studies two implications of heuristic behavior: non-equilibrium panics (trade clustering) and positive serial correlations in returns.

The increased probability of trade when new levels of public signal differences are reached provides indirect evidence of non-equilibrium panics, defined as clustered trades. As further evidence, consider the trading period \(t = 2\) after the first public signal is revealed (corresponding to PubDiff1), where the increase in trade probability is the largest. \(81/320 = 25.3\%\) of all trades occur in this second trading period even though it makes up only 12.5% of all trading periods. Put another way, there are an average of 2.03 trades at \(t = 2\). If the eight traders were randomly choosing to trade in one of the eight periods, the expected number of trades at \(t = 2\) would be given by a binomial distribution, so that we’d expect only \(8 \times 0.125 = 1\) trade, on average. Under the binomial distribution, the probability of observing more than 2.03 trades is only 6.25%. Thus, we see statistical evidence that non-equilibrium panics occur in a predictable manner.

When \(\tau\)-herding subjects rush to trade, they trade in the direction of their private belief, producing positive correlation in returns. To study this correlation, I continue to focus on the second trading period just after the first public signal is revealed. At this time, 85% of trades are in the direction of the first public signal (and therefore in the direction of the trader’s belief). Table 5 provides the Spearman correlation coefficients between the return due to the first public signal and that due to trades in each of the first seven trading periods, excluding the last where the asset value is known.\(^{26}\) We observe a very strong positive short-term correlation between the return due to the first public signal and that due to the trades in the following trading period. Were traders simply rushing and trading according to their signals, prices would form a martingale and such a correlation would be statistically improbable. This finding provides solid evidence of trades being not only clustered, but also occurring in the same direction.\(^{27}\) Finding 5 summarizes the clustering and correlation results.

Finding 5: Use of the \(\tau\)-herding heuristic produces non-equilibrium panics (clustered trades) and positive short-term correlation in returns.

I investigate further the source of the correlation at \(t = 2\), providing two pieces of evidence to show that it is primarily driven by traders with different private information

\(^{26}\)The results are very similar if the Pearson correlation coefficient is used, but there is no a priori reason to expect the correlations to be linear.

\(^{27}\)One may expect negative correlation in later trading periods, should those with signals that did not agree with the first public signal delay their trades and later trade in the opposite direction. However, any such negative correlation would be spread over the remaining trading periods as there is no salient time at which to trade. In addition, some of these traders may delay until \(t = 8\) when they learn the true asset value.
choosing to trade at different times, and *not* by herding. Although herding has long been considered to be a source of correlation (Hirshleifer and Teoh (2003)), this finding suggests a different explanation.

First, of the 81 trades that occur at $t = 2$, 65% are by those whose signal agrees with the public signal even though only 51% have such signals. This fact is consistent with $\tau$-herding behavior because traders whose signals agree with the public signal have more extreme beliefs so that their critical threshold for trading is more likely to be exceeded. Furthermore, 100% of those whose signals agree with the public signal trade in the direction of their beliefs, while only 57% of the others do (i.e. 57% herd). Therefore, on average, the herding trades contribute little to the price change.

As a second piece of evidence, I show that the increased probabilities of trade at new public signal levels are driven by those whose signals make their beliefs more extreme than the current price. To do so, I interact each of the public signal indicator variables in Table 3 with a dummy that indicates a trader’s signal makes her belief more extreme. The results of Table 6, show that the increased probability of trade after the first public signal is solely due to traders whose signals make their beliefs more extreme.\(^{28}\) The coefficient on the first public signal indicator, which now represents those with signals whose beliefs are less extreme than the price, is a fairly precise zero, indicating that there is no increased probability of a trade that could result in herding.

In summary, we have evidence that correlation in returns arises because traders choose when to trade based upon their private information. This finding provides a new explanation for the empirical puzzle of correlation in stock returns, specifically post-earnings-announcement drift, in which returns drift in the direction of the earnings surprise (here, the first public signal).\(^{29}\)

### 3 Diagnostic Model and Theory

In the main model, the strategy space of subjects is large, so that one may conjecture that complexity leads to non-equilibrium behavior. Also, selection issues complicate the heuristic predictions. For these reasons, I also study a simpler model in which traders make binary timing decisions and trade one at a time. Although panics are precluded in the model, it serves as a useful diagnostic tool.

\[^{28}\text{For brevity, I do not report the coefficients on all variables. The price coefficient remains insignificant and the period coefficient remains positive and significant.}\]

\[^{29}\text{See Daniel et al. (1998) for a list of papers providing evidence of post-earnings-announcement drift.}\]
3.1 Diagnostic Model

The asset structure, common prior, and payoffs are identical to the main model. In each period $t = 1, 2, \ldots, T$, a single new, risk-neutral trader arrives to the market and may trade the asset of unknown value.

Upon arrival, each trader receives a private, binary signal, $s_t \in \{0, 1\}$, which has a correct realization with probability $q \in (\frac{1}{2}, 1)$. The trader may either buy or sell immediately in the period she arrives or wait (not trade) and trade in the following period. Each trader may trade only once. If a trader waits, she receives an additional private signal before she trades, $s_t \in \{0, 1\}$, which has a correct realization with probability $\bar{q} \in (\frac{1}{2}, 1)$. All signals are independent conditional on $V$. Here, I don’t impose the restriction $\bar{q} > q$.

Should a trader choose to wait, her next trading opportunity is immediately after the next trader arrives to the market, as shown in Figure 2. As indicated by the highlighted (second) trader in Figure 2, all traders (except the first and last) face up to two intervening trades: one from trader $t - 1$ (if she chose to wait) and one from trader $t + 1$ (if she chooses to rush). The complete history of trades, timing decisions, and prices (denoted $H_t$ in the subperiod of a new arrival and $\overline{H}_t$ in the subperiod reached after a trader waits) are observed by all traders. Traders may buy or sell at a single price equal to the expected value based upon all public information, $p_t = E[V|H_t] = Pr[V = 1|H_t]$ or $\overline{p}_t = E[V|\overline{H}_t] = Pr[V = 1|\overline{H}_t]$. $p_t$ plays a more prominent role, so I generally refer to at as ‘the’ price and denote it $p_t$, unless a distinction is necessary.

In addition to having traders make simpler decisions, the diagnostic model differs from the main model in that all information is generated by trades - there are no public signals. Similarly, the cost of waiting is generated by others’ trades. For these reasons, the diagnostic model structure may be of theoretical interest on its own. In reality, others’ trades are the more likely source of price movements and therefore the more likely source of information revelation and the cost of waiting.

In designing the two treatments for the Diagnostic model, Diagnostic Rush (DR) and Diagnostic Wait (DW), the goal is to provide a strong comparative static test across treatments: subjects should rush in one, but wait in the other. To achieve this, I chose the parameters for the two treatments specified in Table 7. For both treatments, the initial prior, $p_1$, is set to $\frac{1}{2}$. The two treatments differ mainly in the quality of the initial information received, being higher in Diagnostic Rush than Diagnostic Wait. I set $T = 6$ so that there are 6 subjects in each session of each treatment.

The experimental protocol for the Diagnostic treatments is virtually identical to that of the main treatments discussed in Section 2.4. I ran four sessions of each treatment, for a total sample of 48 subjects. Each session consisted of 42 trials plus two practice trials. Subject
orderings were randomized in each trial. Average earnings were $28.67 (minimum $22.00, maximum $35.00) with a corresponding wage rate over an hour and a half of $19.11/hour. The instructions and an example of the trading interface are provided in part B of the online Appendix. Prices are set as in the main model.

### 3.2 Theoretical Predictions: Diagnostic Model

Although a full equilibrium characterization for general signal qualities, $q$ and $\overline{q}$, is possible, here I instead focus on establishing sufficient conditions to guarantee either all traders rush or all traders wait in equilibrium, as in the main model. I present the results and intuition, leaving the details to Part A of the online Appendix.

The optimal trading strategies for the Diagnostic model are provided in Proposition D1.\(^{30}\)

**Proposition D1:** In the Diagnostic model,

1. traders who rush and traders who wait with $\overline{q} < q$ buy if $\overline{s}_t = 1$ and sell if $\overline{s}_t = 0$.
2. traders who wait with $\overline{q} \geq q$ buy if $\overline{s}_t = 1$ and sell if $\overline{s}_t = 0$

As in the main model, the trading strategies of Proposition D1 are optimal because they ensure one buys when one’s private belief is greater than the public belief (which is equal to the price), and sells otherwise. If one has contradictory signals, one trades according to the one with higher quality.

Proposition D2 provides sufficient conditions, including the parameters of the experiment, to ensure a unique equilibrium (up to the indifference of trader $T$ when all other traders rush).

**Proposition D2:** In the Diagnostic model, equilibrium trading strategies are given by Proposition D1. For the timing strategies:

1. there exists an open set of the parameter space, $(q, \overline{q}, p_1, T)$ which includes the parameter set of treatment $R$, $(q = \frac{17}{24}, \overline{q} = \frac{16}{24}, p_1 = \frac{1}{2}, T = 6)$, such that, in any equilibrium, all traders rush at every history, except trader $T$, who is indifferent when trader $T - 1$ rushes.
2. there exists an open set of the parameter space, $(q, \overline{q}, p_1, T)$ which includes the parameter set of treatment $W$, $(q = \frac{13}{24}, \overline{q} = \frac{17}{24}, p_1 = \frac{1}{2}, T = 6)$, such that, in the unique equilibrium, all traders wait at every history.

In the DR treatment, rushing is intuitively optimal because the second signal never changes one’s trading decision: if the two signals contradict one another, trades are made according to the one with higher quality.

\(^{30}\)For concreteness, I assume traders trade according to their second period signal if they wait and their two signals are of equal quality. To break this indifference in the experiment, I don’t use $q = \overline{q}$. 

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according to the first, better quality, signal. Thus, there is no benefit from waiting, but there is a cost due to others’ trades. The final trader is an exception in that she is indifferent between rushing and waiting when $T - 1$ rushed, due to the fact that no intervening trades are possible. In the DW treatment, a strictly positive benefit from waiting exists for all $p_t$, independent of whether or not $t - 1$ and $t + 1$ rush or wait, making the optimal timing strategy to wait. Here, the much better quality information obtained by waiting dominates the cost of any potential trades.

As in the main model, a weaker comparative static prediction follows directly from Proposition D2.

**Corollary D1:** Subjects rush more often in DR than in DW.

In contrast to the equilibrium predictions of Proposition D2, a simple heuristic prediction is available in this environment. If subjects follow the $\tau$-herding heuristic and, as found in the main results, use heterogeneous threshold beliefs, then in the aggregate, the decision to rush or wait should increase with a subject’s belief upon arrival. In having subjects make only a single timing decision, selection issues are avoided. This prediction is independent of the treatment, but as observed in the previous results, we may expect the heuristic to be moderated by the cost of its use.

### 3.3 Results: Diagnostic Model

As with the main results, I report data from only the last third of trials (14 trials) in order to focus on behavior after subjects have gained experience.

Table 8 first demonstrates that trading behavior in the Diagnostic model is highly rational, as in the main model. Finding 6 summarizes the trading behavior.\(^{31}\)

**Finding 6** *(Proposition D1)* In the Diagnostic treatments, almost 85% of subjects’ trade directions are rational, revealing their private information.

Turning to the timing decisions, Table 9 provides the percentage of rush decisions observed in each treatment, aggregated across sessions. In the DR treatment, I omit the timing observations of the final trader when the previous trader rushed, leaving 309 observations.\(^{32}\) A t-test comparing the average frequency of rushing across treatment rejects the null of equal

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\(^{31}\)One might expect a lower degree of rational behavior when a subject’s two signals conflict. In Diagnostic Rush, this conjecture is correct, with subjects acting rationally only 60% of the time when they receive conflicting signals. In Diagnostic Wait, subjects rationally follow the better quality signal 90% of the time.

\(^{32}\)When the final trader knows the previous trader rushed, she is indifferent. Of the 27 times traders are indifferent, they wait 66.7% of the time.
means at the 5% level (p-value = 0.046), supporting Corollary D1. Subjects respond to the difference in equilibrium forces across treatments in a predictable manner. Interestingly, behavior is not statistically different across treatments in the first third of trials (difference in means is 9.0%, p-value = 0.24), indicating that subjects learn to avoid adverse prices movements as they acquire experience. I summarize this comparative static result in Finding 7.

**Finding 7 (Corollary D1)** In the Diagnostic treatments, subjects rush more often in the treatment in which it is the equilibrium prediction (DR).

Although subjects respond as predicted by Corollary D1, behavior is clearly not perfectly rational. In particular, subjects both wait too much (DR) and rush too much (DW) which is suggestive of the heuristic prediction that subjects wait at prices near one half, but rush as prices become more extreme.

To provide an overall view of the aggregate timing decisions, I plot the proportion of rushed trades as a function of price (Figure 3). I bin the data according to the number of trades that reveal better quality information (late trades in DW and any trade in DR) because these trades are the main determinants of prices. I also provide 95% confidence intervals, assuming that the decision to rush is binomially distributed. Note the clear upward trend in treatment DW: the probability of rushing increases with the price. Such a trend occurs in treatment DR as well, although it is notably noisier. These upward trends are not predicted by rational behavior and provide a first indication of heuristic behavior.

Table 10 presents the results of a logit regression of the probability of a rushed trade on a trader’s private belief for each treatment. In the regressions, subject and trial fixed effects are included (not reported), as is an indicator dummy that indicates whether or not the previous trader has rushed.\textsuperscript{33} Results are also shown for the subsample of individuals classified as \(\tau\)-herding types later in this section.

In Table 10, we see that, consistent with the heuristic prediction, the probability of a rushed trade increases with a trader’s belief. This effect is statistically and economically significant in the DW treatment: moving from complete uncertainty (belief is 0.5) to completely certainty (belief is 1), the probability of rushing increases by almost 0.85, a very large effect. In the DR treatment, we also observe a positive coefficient on a trader’s belief but it is not statistically significant. Table 10 also shows that the probability of rushing, although not significant, is reduced when the previous trader rushed, as is expected because there can be no price impact from the previous trader in this case.

\textsuperscript{33}I again choose to report heteroskedastic robust standard errors rather than standard errors clustered at the session level. The significance of results remains unchanged with clustered standard errors.
Behavior in the DR treatment is not as well captured by the heuristic for a good reason: using the heuristic is more costly in this treatment. The cost from deviating from the rational strategy is largest at prices near one half where trading profits are the largest. Conversely, at prices near certainty, payoffs are flatter because trading profits are smaller. Thus, in treatment DR, following the heuristic by waiting at prices near one half is very costly: strong payoff incentives and the heuristic oppose each other. Conversely, in DW, at prices near one half, the heuristic and payoff incentives reinforce each other because both induce one to wait. One would then expect behavior to be more noisy in treatment DR than in treatment DW, as we observe. The fact that the heuristic is moderated or strengthened by the cost of its implementation here and in the main results, suggests that it is not itself driven by changes in payoff incentives but is instead an innate tendency that subjects bring to the lab.

As in the main results, I classify subjects in each of the Diagnostic treatments into one of four types. In the resulting classifications, \( \tau \)-herding types are the most common type in both treatments, making up 40.0% of the population overall and 67.9% of subjects that can be classified. Rational types are second most common making up only 12.5% of the population. Simplistic types are almost non-existent. Demonstrating the robustness of the heuristic, \( \tau \)-herding types are frequent in both treatments, even in DR where payoff incentives work against the heuristic. The classification scheme works much better in DW, where 79.2% can be classified. This fact is again consistent with heuristic behavior and payoff incentives reinforcing each other to produce less noise in the DW treatment.

As I did in the W treatment, I perform three additional checks to ensure that \( \tau \)-herding types’ behavior is consistent with the heuristic. First, if a subject uses a consistent threshold, \( \tau \), then the beliefs at which they rush to trade should be higher on average than the beliefs at which they wait. This criterion is satisfied for 84.2% of the \( \tau \)-herding types. Second, I return to the regression results in Table 10 for the subsample of subjects classified as \( \tau \)-herding. The previous relationship between the probability of rushing and one’s belief is now stronger and significant even in treatment DR. Finally, for those subjects classified as \( \tau \)-herding types, I estimate their individual threshold, \( \tau_i \). Of these types, 42.1% have thresholds estimated to be significantly less than one. Even among the thresholds that are significant, substantial heterogeneity exists, with point estimates of \( \tau_i \) between 0.65 and 0.89. Given the overall evidence that subjects use the \( \tau \)-herding heuristic, we have Finding 8.

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34 As in the W treatment, simplistic types in DW always rush and trade according to their initial signal. Simplistic types in DR always wait and trade according to their private information.
Finding 8: Across all three treatments in which non-equilibrium behavior is observed, 37.5% of subjects use the $\tau$-herding heuristic, making it the most frequent mode of behavior. By comparison, only 10.0% of subjects are classified as rational across these three treatments.

4 Discussion

A critical question facing any laboratory study of markets is the degree to which the environment and behavior can be extrapolated to real-world financial settings. In terms of the environment, by restricting to a single trade, I have deliberately generated the trade-off between acquiring better information and adverse price movements in an admittedly stark way. This abstraction allows for theoretical predictions and a relatively simple environment to explain to subjects. In more realistic environments, after trading, traders of course have the option to acquire more information and then to adjust their positions. However, note that the tradeoff is still present: after taking an initial position, one again faces a situation of having to decide how much information to acquire before changing one’s position. Developing theoretical predictions in such an environment is non-trivial, but I hope future work proceeds in this direction.

In terms of rational behavior, Kendall (2016a) provides empirical evidence that is consistent with the fact that traders rationally rush to trade. Data from the laboratory backs up this evidence by providing a clear demonstration of rational panics in the R treatment, where subjects clearly understand that waiting to trade can be extremely costly. Although individually rational, the resulting rational panic is severely costly for the market as a whole due to large informational losses. It also produces acute trade clustering, which, interpreted in terms of an earnings announcement, is consistent with the fact that volumes spike around these announcements (Frazzini and Lamont (2006)). The laboratory data can also provide insight as to when rational panics are more likely to occur in actual financial markets. The data suggests that panics are more likely when there are many other informed traders present in the market (treatment R) than when there are relatively few (treatment DR). Finally, note that experience in the environments where rushing is optimal drives behavior towards rational panics. Given that equilibrium behavior involves preempting other traders, it seems likely that experienced professionals understand the benefit of acting quickly, and do so.

Although heuristics found in the laboratory should generally be cautiously exported to the field, there are several reasons to suspect the $\tau$-herding heuristic operates in real-world markets. First, the heuristic, although not optimal, is far from irrational behavior: it demon-
strates a reasonable level of understanding of one’s environment. Second, the percentage of \( \tau \)-herding types in the data actually increases over time. From the first third of trials to the last third, the changes are from 12.5\% to 34.3\%, 25.0\% to 50.0\%, and 12.5\% to 29.1\%, in treatments W, DW, and DR, respectively. As in the case of rational panics, this finding suggests that traders may actually learn over time that prices move against them in expectation, causing them to (rationally or heuristically) panic. Finally, the fact that such behavior generates the well-known phenomena of short-term positive correlation in returns and trade clustering in the laboratory data suggests that it is a good candidate explanation for these findings.\(^{35}\)

As further suggestive evidence that traders may exhibit \( \tau \)-herding behavior in actual markets, consider the fact that one of the pillars of technical analysis is momentum trading: wait until prices appear to be moving in a particular direction and then trade in that direction.\(^{36}\) In the absence of private information, momentum trading and \( \tau \)-herding are identical, so, at least among those that subscribe to technical analysis, something akin to \( \tau \)-herding strategies is natural.\(^{37}\) Furthermore, \( \tau \)-herding strategies can potentially generate positive-feedback trading (De Long et al. (1990)). As initial traders cause a trend in prices, those with more extreme threshold beliefs are encouraged to join in, reinforcing the trend and setting off further trading.

Uncovering the \( \tau \)-herding heuristic by endogenizing trade timing also suggests an explanation for behavior in past experiments in which use of the heuristic was not easily identifiable. Cipriani and Guarino (2005) and Drehmann et al. (2005) study trading behavior in an exogenous timing version of the Diagnostic model. Both papers document herding and contrarian trades, but neither puts forth an explanation backed by the data. Cipriani and Guarino (2005) consider the possibility that subjects believe previous subjects made mistakes, but

\(^{35}\)Although not detectable in the laboratory data, given that traders with signals that oppose the price trend delay their trades, it is not inconceivable that \( \tau \)-herding behavior could also be responsible for the longer-term negative correlation in returns (overreaction) observed in real markets (see Appendix A of Daniel et al. (1998) for a review of papers finding such evidence).

\(^{36}\)For a description of momentum trading, see http://www.investopedia.com/articles/trading/02/090302.asp.

\(^{37}\)Note, however, that there is a subtle difference between \( \tau \)-herding strategies and momentum strategies. In a momentum trading strategy, traders that observe a positive price change (or series of positive price changes) purchase the stock regardless of their private information, so there is no predicted relationship between traders’ signals and when they choose to trade. Instead, through the use of a threshold belief, \( \tau \)-herding behavior allows for differences in trade timing precisely because traders with different signals have different beliefs. As shown in Section 2.5.1, the correlation in returns in the data is primarily driven by differences in timing strategies and not by herding. If momentum strategies were instead the correct explanation, herding would be a more significant contributor to return correlation in the laboratory data. Several behavioral finance papers posit that traders follow momentum strategies in order to explain post-earnings-announcement drift (see De Long et al. (1990) and Hong and Stein (1999)). The \( \tau \)-herding behavior observed here provides an alternative explanation.
show that this explanation can only explain contrarian trades.\textsuperscript{38} Drehmann et al. (2005) instead consider, but reject, conformity: subjects trade in the direction of previous subjects, regardless of their signals or beliefs.\textsuperscript{39} The $\tau$-herding heuristic suggests an explanation for herding: subjects herd when their beliefs become extreme.

Previous literature (De Long et al. (1990) and Cipriani and Guarino (2005)) points out that contrarian trades tend to stabilize markets by causing prices to become less extreme, while herding trades do the opposite. Thus, the finding that $\tau$-herding types are much more frequent than $\tau$-contrarian types suggests that behavioral types may tend to destabilize markets overall. This conclusion stands in contrast to Cipriani and Guarino (2005) who, based upon a higher frequency of contrarian trades in their data (Drehmann et al. (2005) find the same), conclude that contrarianism is more frequent. I suggest two reasons previous data may have led to a different conclusion. First, in the data here, the overall frequency of contrarian trades declines over time, from 13.1\% in the first third of trials to only 5.3\% in the last third. As the two previous studies did not allow for as many learning opportunities, they picked up behavior only in non-experienced subjects. Second, part of the reason contrarian trades may be more frequent is that there are more opportunities to act contrarian: signals are more likely to go in the direction of the price trend rather than against it. Conditioning on the opportunity for herding or contrarian behavior, I find much higher rates of herding behavior than contrarian behavior (47\% vs. 12\% in the main treatments and 21\% vs. 14\% in the Diagnostic treatments).

Given the explanatory power of the heuristic, two additional questions naturally arise. Do subjects understand that others use the heuristic? And, what is the underlying behavioral force that generates its use? On the first question, the data is not consistent with subjects understanding that others use the heuristic. If subjects were to always trade according to their signals, the parameters in all treatments are such that the equilibrium timing strategy is dominant.\textsuperscript{40} However, prices are set in the experiment assuming that observing a trader wait reveals no information and that traders always trade according to their private information. $\tau$-herding behavior causes violations of both of these assumptions so that prices are seen to be too extreme ex post.\textsuperscript{41} If traders understand this fact and the mispricing is severe enough,

\textsuperscript{38}I similarly reject this explanation as a source of herding in the data here (see footnote 43).

\textsuperscript{39}I also reject conformity by looking for evidence in the W treatment where $\tau$-herding and conformity have distinct predictions because past trades have relatively little effect on one’s beliefs. Of the 51 herding decisions observed in this treatment, 42 coincide with new public signal difference levels, meaning traders generally herd \textit{at the same time}, not after others have traded in a particular direction.

\textsuperscript{40}In treatment DR, one is indifferent if one’s predecessor rushed and one expects one’s successor to wait, but there is never a strict incentive to wait.

\textsuperscript{41}For example, consider the case in which the price trend is upwards. A decision to wait reveals that a trader is more likely to have had an unfavorable signal. Furthermore, a buy decision may be taken by a trader with an unfavorable signal. In both cases, the resulting price is too high.
then it may in fact to be optimal to rush in a treatment where the equilibrium is to wait. But, a trader would then have act contrarian, trading against the price trend regardless of her signal, which is rare in the data. Therefore, it seems either that the majority of traders do not understand others are τ-herding types, or that the drive to follow the τ-herding strategy is strong enough that traders follow it even after accounting for mispricing.42

Can τ-herding behavior be generated by common behavioral game theoretical models or alternative preferences? Unfortunately, given the complexity of the models considered here, a full equilibrium characterization for any particular theory is extremely difficult. However, I argue that prospect theory offers the best chance of being at the root of the behavior. Most common behavioral theoretic models build upon the idea that subjects make mistakes, but if subjects make mistakes, then prices are generally too extreme. As argued above, subjects that account for mistakes, would then trade in a contrarian manner, but would never herd.43

Turning to preference-based explanations, note that risk aversion is incapable of producing heuristic behavior. Intuitively, risk-averse individuals prefer to wait to learn about the asset value, potentially even through public information, which is consistent with one aspect of the heuristic.44 However, it can not generate rushing when the risk-neutral prediction is to wait, nor herding, and therefore fails to produce the other two aspects.

The prospect theory preferences of Kahneman and Tversky (1979,1992), on the other hand, can in fact produce τ-herding behavior if one is willing to accept that possibility that subjects exhibit preferences different from those induced (risk-neutrality).45 In fact, prospect theory’s S-shaped utility function can produce all three characteristics of the heuristic: wait-

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42This argument suggests we’d expect to see the same behavior in the R and W treatments if run as individual decision tasks. However, one would not be able to observe panics in this case.

43Behavioral game theory has developed several theories that have proven successful at describing experimental behavior: quantal response equilibrium (McKelvey and Palfrey (1995,1998)), level k reasoning (Stahl and Wilson (1994) and Nagel (1995)), cognitive hierarchy (Camerer et al. (2004)), and cursed equilibrium (Eyster and Rabin (2005)). These theories are based upon models of subjects’ beliefs about other subjects behavior. Intuitively, they all lead to contrarian behavior. Quantal response equilibrium assumes that subjects probabilistically take actions in proportion to the payoff of each action, and that this behavior is common knowledge. While there is some evidence that mistakes are proportional to payoff differences (see the discussion in Section 3.3), if subjects believe others make such mistakes, then they would believe prices are too extreme. In this case, contrarian behavior would be prescribed. In level k and cognitive hierarchy, subjects believe other subjects are boundedly rational and best respond to this behavior. The lowest level of rationality is typically assumed to be random behavior, but this would again lead to prices being too extreme and contrarian behavior. Finally, in cursed equilibrium, subjects correctly predict the frequencies of actions, but believe that actions are not connected to underlying signals. Again, this belief leads to believing prices are too extreme and contrarian behavior.

44Assuming power utility, numerical simulations suggest though that no value of risk aversion can produce non-equilibrium waiting at prices near one half in treatment DR where it is observed.

45It may be natural for subjects to attempt to maximize their number of lottery tickets in which case we can think of standard utility functions over lottery tickets instead of wealth. In considering prospect theory as an explanation, I take this approach.
ing at uncertain prices, rushing at more certain prices, and trading in the direction of the price trend. To demonstrate this possibility, I numerically simulated subject’s timing and trading decisions in both trading models, making several simplifying assumptions. First, I assume that other subjects follow rational strategies. Although clearly not the case in the data, an equilibrium characterization is very difficult. In treatment W at least, this assumption is not critical because prices are mainly determined by the public signals. Second, I assume subjects evaluate gains and losses relative to a reference point equal to their endowment. Other reference points, such as one’s expected profits (Koszegi and Rabin (2006,2007)), are possible, but the endowment reference point is simple and seems natural in this environment. Third, I assume subjects’ utility functions are S-shaped and governed by power utility

\[ u(x) = \begin{cases} 
(x - 1)^{\alpha} & x > 1 \\
-(1 - x)^{\alpha} & x < 1 
\end{cases} \]

where the value, 1, is a subject’s normalized endowment.

For each of the three environments in which heuristic behavior is observed, numerical simulations show that for \( \alpha \) sufficiently small, heuristic behavior is produced. To understand the intuition, consider an individual with no initial private information facing a high price, \( p > \frac{1}{2} \). Buying provides a lottery in which one obtains a gain of \( 1 - p \) with probability \( p \), and a loss of \( p \) with probability \( 1 - p \). Selling instead provides a gain of \( p \) with probability \( 1 - p \) and a loss of \( p \) with probability \( 1 - p \). Compare first the possible gains. Due to risk aversion over gains, obtaining a smaller amount, \( 1 - p \), with a larger probability, \( p \), is preferred to the converse, even though the expectation is the same. Due to risk-seeking over losses, the converse is true: one prefers the smaller probability, \( 1 - p \), of a larger loss, \( p \). Therefore, both in terms of gains and losses, a subject with prospect theory preferences strictly prefers to buy at any \( p > \frac{1}{2} \), while a risk-neutral subject is indifferent. Similarly, at \( p < \frac{1}{2} \), a subject with prospect theory preferences strictly prefers to sell. To see that prospect theory preferences induce waiting at uncertain prices, note that the utility of such a subject is zero at \( p = \frac{1}{2} \), but strictly positive away from \( p = \frac{1}{2} \). Therefore, a subject initially waits to allow others to trade, buying if they buy, and selling if they sell, just as the heuristic prescribes. Finally, for prices sufficiently close to 0 or 1, an incentive to wait no longer exists because a trader

\[^{46}\text{I also included the probability weighting and loss aversion aspects of prospect theory in the numerical simulations, but omit them from the exposition. Loss aversion appears to do little to change behavior. Probability weighting actually works against the heuristic, so that if a subject distorts probabilities, they must have more pronounced utility curvature to exhibit heuristic behavior (see Kendall (2016b)). Probability weighting complicates the analysis because it induces time-inconsistencies in behavior (see Barberis (2012)). In fact, the main model is very similar to the casino gambling model of Barberis (2012), and so is computationally intensive to solve when there are many trading periods, as he shows.}\]
knows future price movements are unlikely to change the direction of her trade. Adding in private information complicates the analysis, but the basic intuition remains unchanged.

Although prospect theory is a promising candidate to explain heuristic behavior, a caveat is in order. Numerical simulations show that the utility curvature must be very pronounced to produce herding even at extreme prices, and no amount of curvature can produce herding at the more intermediate prices at which it is observed in the experiment. Therefore, prospect theory as an explanation remains speculative. That said, Kendall (2016b) provides convincing evidence that prospect theory is the main driving force behind herding and contrarian behavior in a closely related environment in which subjects do not make trade timing decisions (as in Cipriani and Guarino (2005) and Drehmann et. al. (2005)), suggesting that it is very likely to be at least a partial explanation for the heuristic observed here.

5 Conclusion

This paper investigates the sources and consequences of trading panics in a laboratory setting in which precise theoretical predictions are derived. Traders may rationally rush to trade in order to avoid adverse price movements that reduce their profits, leaving substantial information on the table. Theoretical results successfully predict the relative frequency of rational panics and allow non-equilibrium panics to be identified. Non-equilibrium panics result from a simple heuristic and exacerbate informational losses. The heuristic reconciles findings in previous experimental studies with related environments and puts forth a new explanation for the trade clustering and positive short-term correlation in returns observed in real financial markets.

A clear direction for future experimental research is to understand in more detail the trading heuristic used by almost half of traders. Of particular interest may be to determine whether or not it is truly generated by prospect theory preferences, which is the direction taken in Kendall (2016b), and whether or not subjects exist that try to exploit such behavior to their advantage. For example, in settings in which multiple trades are possible, rational traders may buy in an attempt to induce heuristic traders to buy. If successful, they can then profitably sell at a higher price. In this way, the heuristic may help to explain price bubbles, both in the field and in laboratory experiments (e.g. Smith et al. (1988)).

The trading heuristic has additional implications outside of the laboratory. In particular, it suggests that short-term correlation in returns should be more dramatic after earnings announcements that generate disagreement among traders, as opposed to those that are unambiguous in their implications. In the former case, there is more scope for traders with different beliefs to choose to trade at different times. Similarly, return correlations should
be more pronounced in stocks with higher informed trader arrival rates, where increased fears of adverse price movements cause traders to rush to trade on lower quality information. Given these predictions, future empirical studies may be able to detect the use of the trading heuristic even without being able to observe traders’ private information.

References


**Figures**

Figure 1: Cumulative Distribution of Trades Occurring at $t \leq t'$ in Main Treatments
Figure 2: Trade Timing in the Diagnostic Model

Note: Arrows reflect the two periods in which each trader may trade. The second trader is highlighted for exposition.

Figure 3: Proportion of Rushed Trades In Diagnostic Treatments
# Tables

Table 1: Main Model Treatment Parameters

<table>
<thead>
<tr>
<th>Treatment Name</th>
<th>$q$</th>
<th>$\bar{q}$</th>
<th>$q_P$</th>
<th>Subjects</th>
<th>Periods</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rush (R)</td>
<td>$\frac{3}{4}$</td>
<td>1</td>
<td>$\frac{17}{21}$</td>
<td>$n = 8$</td>
<td>$T = 8$</td>
</tr>
<tr>
<td>Wait (W)</td>
<td>$\frac{1}{2}$</td>
<td>1</td>
<td>$\frac{1}{2}$</td>
<td>$n = 8$</td>
<td>$T = 8$</td>
</tr>
</tbody>
</table>

Table 2: Main Model Trading Results

<table>
<thead>
<tr>
<th>Treatment</th>
<th>Rational</th>
<th>Herding</th>
<th>Contrarian</th>
<th>Irrational</th>
</tr>
</thead>
<tbody>
<tr>
<td>R</td>
<td>93.8% (300)</td>
<td>3.4% (11)</td>
<td>1.9% (6)</td>
<td>0.9% (3)</td>
</tr>
<tr>
<td>W</td>
<td>77.2% (247)</td>
<td>15.9% (51)</td>
<td>5.9% (19)</td>
<td>0.9% (3)</td>
</tr>
</tbody>
</table>

Notes: Results reported for last 10 trials. Number of observations in parentheses: 320 total observations per treatment.
Table 3: Determinants of Rushed Trades in the Wait Treatment

<table>
<thead>
<tr>
<th></th>
<th>Wait (τ-herding types)</th>
<th>Wait (τ-herding types)</th>
</tr>
</thead>
<tbody>
<tr>
<td>PubDiff1</td>
<td>0.14***</td>
<td>0.35***</td>
</tr>
<tr>
<td></td>
<td>[0.05]</td>
<td>[0.11]</td>
</tr>
<tr>
<td>PubDiff2</td>
<td>0.12*</td>
<td>0.30</td>
</tr>
<tr>
<td></td>
<td>[0.07]</td>
<td>[0.19]</td>
</tr>
<tr>
<td>PubDiff3</td>
<td>0.02</td>
<td>0.24</td>
</tr>
<tr>
<td></td>
<td>[0.07]</td>
<td>[0.23]</td>
</tr>
<tr>
<td>PubDiff4</td>
<td>-0.08*</td>
<td>-0.03</td>
</tr>
<tr>
<td></td>
<td>[0.04]</td>
<td>[0.10]</td>
</tr>
<tr>
<td>PubDiff5</td>
<td>-0.01</td>
<td>0.14</td>
</tr>
<tr>
<td></td>
<td>[0.12]</td>
<td>[0.35]</td>
</tr>
<tr>
<td>PubDiff6</td>
<td>-0.06</td>
<td>0.05</td>
</tr>
<tr>
<td></td>
<td>[0.09]</td>
<td>[0.20]</td>
</tr>
<tr>
<td>Price ($p'$)</td>
<td>0.02</td>
<td>0.01</td>
</tr>
<tr>
<td></td>
<td>[0.15]</td>
<td>[0.37]</td>
</tr>
<tr>
<td>Extreme Signal</td>
<td>0.03</td>
<td>0.10**</td>
</tr>
<tr>
<td></td>
<td>[0.03]</td>
<td>[0.04]</td>
</tr>
<tr>
<td>Period</td>
<td>0.08***</td>
<td>0.08***</td>
</tr>
<tr>
<td></td>
<td>[0.01]</td>
<td>[0.03]</td>
</tr>
</tbody>
</table>

Notes: Dependent variable is a dummy variable: 1 indicates a rushed trade. 1077 observations (361 when restricted to τ-herding types). Logit marginal effects reported. Subject and trial fixed effects are included. Robust standard errors in brackets. Significance at the 10% level is represented by *, at the 5% level by **, and at the 1% level by ***.

Table 4: Frequency of Subjects of Each Type In the Wait Treatment

<table>
<thead>
<tr>
<th>Type</th>
<th>Percent of Subjects (multiple)</th>
<th>Percent of Subjects (prioritized)</th>
</tr>
</thead>
<tbody>
<tr>
<td>% Rational</td>
<td>0.0-6.3%</td>
<td>6.3%</td>
</tr>
<tr>
<td>% Simplistic</td>
<td>21.9-37.5%</td>
<td>37.5%</td>
</tr>
<tr>
<td>% τ-Herding</td>
<td>34.4-56.3%</td>
<td>34.4%</td>
</tr>
<tr>
<td>% τ-Contrarian</td>
<td>6.3-12.5%</td>
<td>6.3%</td>
</tr>
<tr>
<td>% Unclassified</td>
<td>15.6%</td>
<td>15.6%</td>
</tr>
<tr>
<td>% Exact</td>
<td>53.1%</td>
<td></td>
</tr>
<tr>
<td>% Ambiguous</td>
<td>21.9%</td>
<td></td>
</tr>
</tbody>
</table>

Notes: 32 subjects total. Subjects may match multiple types because I allow for one mistake. Results of assigning a single type through a prioritization scheme are shown in bold.
Table 5: Correlation of Trading Returns in the Wait Treatment

<table>
<thead>
<tr>
<th>Trading Period</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Spearman Correlation Coefficient</td>
<td>0.13</td>
<td>0.73***</td>
<td>0.05</td>
<td>0.27</td>
<td>-0.13</td>
<td>-0.03</td>
<td>0.15</td>
</tr>
<tr>
<td>[0.42]</td>
<td>[0.00]</td>
<td>[0.74]</td>
<td>[0.09]</td>
<td>[0.44]</td>
<td>[0.87]</td>
<td>[0.35]</td>
<td></td>
</tr>
</tbody>
</table>

Notes: Correlation is with respect to return due to first public signal. p-value of two-tailed t-test included in brackets. Each correlation is over 40 trials (last 10 trials of each of 4 sessions).

Table 6: Private Signals and Rushed Trades in the Wait Treatment

<table>
<thead>
<tr>
<th></th>
<th>Wait</th>
</tr>
</thead>
<tbody>
<tr>
<td>PubDiff1</td>
<td>-0.00</td>
</tr>
<tr>
<td>[0.05]</td>
<td></td>
</tr>
<tr>
<td>PubDiff2</td>
<td>0.10</td>
</tr>
<tr>
<td>[0.08]</td>
<td></td>
</tr>
<tr>
<td>PubDiff3</td>
<td>-0.01</td>
</tr>
<tr>
<td>[0.08]</td>
<td></td>
</tr>
<tr>
<td>PubDiff4</td>
<td>-0.10**</td>
</tr>
<tr>
<td>[0.04]</td>
<td></td>
</tr>
<tr>
<td>PubDiff1 * Extreme Signal</td>
<td>0.26**</td>
</tr>
<tr>
<td>[0.10]</td>
<td></td>
</tr>
<tr>
<td>PubDiff2 * Extreme Signal</td>
<td>-0.01</td>
</tr>
<tr>
<td>[0.07]</td>
<td></td>
</tr>
<tr>
<td>PubDiff3 * Extreme Signal</td>
<td>0.07</td>
</tr>
<tr>
<td>[0.14]</td>
<td></td>
</tr>
<tr>
<td>PubDiff4 * Extreme Signal</td>
<td>0.12</td>
</tr>
<tr>
<td>[0.20]</td>
<td></td>
</tr>
<tr>
<td>Extreme Signal</td>
<td>-0.05</td>
</tr>
<tr>
<td>[0.05]</td>
<td></td>
</tr>
</tbody>
</table>

Notes: Dependent variable is a dummy variable: 1 indicates a rushed trade. 1077 observations. Logit marginal effects reported. Subject and trial fixed effects are included. Robust standard errors in brackets. Significance at the 10% level is represented by *, at the 5% level by **, and at the 1% level by ***.

Table 7: Diagnostic Model Treatment Parameters

<table>
<thead>
<tr>
<th>Treatment Name</th>
<th>q</th>
<th>q</th>
<th>Subjects</th>
<th>Periods</th>
</tr>
</thead>
<tbody>
<tr>
<td>Diagnostic Rush (DR)</td>
<td>17</td>
<td>16</td>
<td>n = 6</td>
<td>T = 6</td>
</tr>
<tr>
<td>Diagnostic Wait (DW)</td>
<td>13</td>
<td>14</td>
<td>n = 6</td>
<td>T = 6</td>
</tr>
</tbody>
</table>

37
Table 8: Diagnostic Treatment Trading Results

<table>
<thead>
<tr>
<th>Treatment</th>
<th>Rational</th>
<th>Herding</th>
<th>Contrarian</th>
<th>Irrational</th>
</tr>
</thead>
<tbody>
<tr>
<td>Diagnostic Rush (DR)</td>
<td>84.5% (284)</td>
<td>5.7% (19)</td>
<td>6.5% (22)</td>
<td>3.3% (11)</td>
</tr>
<tr>
<td>Diagnostic Wait (DW)</td>
<td>83.9% (282)</td>
<td>6.3% (21)</td>
<td>6.9% (23)</td>
<td>3.0% (10)</td>
</tr>
</tbody>
</table>

Notes: Results reported for last 14 trials. Number of observations in parentheses: 336 total observations per treatment.

Table 9: Diagnostic Model Timing Results

<table>
<thead>
<tr>
<th>Treatment</th>
<th>Frequency of Rush</th>
</tr>
</thead>
<tbody>
<tr>
<td>Diagnostic Rush (DR)</td>
<td>47.6% (147)</td>
</tr>
<tr>
<td>Diagnostic Wait (DW)</td>
<td>31.3% (105)</td>
</tr>
</tbody>
</table>

Notes: Results reported for last 14 trials. Number of observations in parentheses: 309 (336) total observations in DR (DW). Rushing corresponds to rational behavior in DR, but not in DW.

Table 10: Determinants of Rushed Trades in the Diagnostic Treatments

<table>
<thead>
<tr>
<th></th>
<th>Diagnostic Rush</th>
<th>Diagnostic Wait</th>
<th>Diagnostic Rush (τ-herding types)</th>
<th>Diagnostic Wait (τ-herding types)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private Belief</td>
<td>0.30</td>
<td>1.69***</td>
<td>1.13**</td>
<td>1.71***</td>
</tr>
<tr>
<td></td>
<td>[0.27]</td>
<td>[0.25]</td>
<td>[0.47]</td>
<td>[0.35]</td>
</tr>
<tr>
<td>Previous Rushed</td>
<td>-0.12</td>
<td>-0.04</td>
<td>-0.04</td>
<td>-0.10</td>
</tr>
<tr>
<td></td>
<td>[0.07]</td>
<td>[0.07]</td>
<td>[0.07]</td>
<td>[0.06]</td>
</tr>
</tbody>
</table>

Notes: Dependent variable is a dummy variable: 1 indicates a rushed trade. 308 (294) observations in DW (DR). 132 (84) observations when restricted to τ-herding types. Logit marginal effects reported. Subject and trial fixed effects are included. Robust standard errors in brackets. Significance at the 10% level is represented by *, at the 5% level by **, and at the 1% level by ***.
Table 11: Frequency of Subjects of Each Type in the Diagnostic Treatments

<table>
<thead>
<tr>
<th>Type</th>
<th>Diagnostic Rush (multiple)</th>
<th>Diagnostic Rush (prioritized)</th>
<th>Diagnostic Wait (multiple)</th>
<th>Diagnostic Wait (prioritized)</th>
</tr>
</thead>
<tbody>
<tr>
<td>% Rational</td>
<td>8.3%</td>
<td>8.3%</td>
<td>0-16.7%</td>
<td>16.7%</td>
</tr>
<tr>
<td>% Simplistic</td>
<td>0.0%</td>
<td>0.0%</td>
<td>4.2%</td>
<td>4.2%</td>
</tr>
<tr>
<td>% τ-Herding</td>
<td>29.1%</td>
<td>29.1%</td>
<td>50-66.7%</td>
<td>50.0%</td>
</tr>
<tr>
<td>% τ-Contrarian</td>
<td>8.3%</td>
<td>8.3%</td>
<td>8.3-33.3%</td>
<td>8.3%</td>
</tr>
<tr>
<td>% Unclassified</td>
<td>54.1%</td>
<td>54.1%</td>
<td>20.8%</td>
<td>20.8%</td>
</tr>
<tr>
<td>% Exact</td>
<td>29.1%</td>
<td></td>
<td>54.1%</td>
<td></td>
</tr>
<tr>
<td>% Ambiguous</td>
<td>0.0%</td>
<td></td>
<td>25.0%</td>
<td></td>
</tr>
</tbody>
</table>

Notes: 32 subjects for each of DR and DW. Subjects may match multiple types because I allow for one mistake. Results of assigning a single type through the prioritization scheme are shown in bold.

Appendix

A. Learning

Figure A1 plots the evolution of rational timing decisions in each treatment. The clearest evidence of learning is observed in the R treatment, where robust convergence to a rational panic is observed. In the DW treatment, learning is also evident: subjects learn that an additional signal is valuable. On the other hand, they do not appear to learn this same lesson in the W treatment. It may be that the large number of opportunities to trade makes learning more difficult: if one never experiments with waiting until the final period, one doesn’t observe its benefit. Finally, in the DR treatment, learning is particularly difficult because waiting is only costly if either the previous trader waited or the subsequent trader rushes and the trade(s) move prices adversely. If one’s successors mostly wait, it may take time to learn that prices on average move adversely. Learning may have perhaps been easier had subjects maintained the same position in the sequence in treatments DR and DW, but the concern in this case is that subjects would be learning about a particular subject’s behavior rather than about their environments.

B. Non-equilibrium Informational Losses

Non-equilibrium behavior exacerbates the informational losses predicted by rational theory in all four treatments. I measure informational losses by comparing final prices in each trial to actual asset values. Figure B1 plots the empirical CDF of the absolute value of the difference in these two values for each of the four treatments. In each case, the difference between the asset value and the theoretical final price, had all traders acted rationally, is compared to the difference between the asset value and the actual final price in the data.
Figure A1: Proportion of Rational Timing Decisions as Trials Progress
In the two treatments in which rushing is optimal, R and DR, we see that the theoretical and actual losses are very similar: differences are mostly due to trades not revealing private information. Therefore, when rushing is rational, almost all information losses are due to rational behavior.\textsuperscript{47} Importantly, non-equilibrium waiting does not cause additional information to be aggregated because, in DR, waiting to obtain an additional signal does not reveal additional information and in R, only one subject in one trial waited long enough to obtain this information.

In the treatments in which waiting is optimal, we observe large informational losses due to non-equilibrium behavior. In treatment W, where all traders should obtain perfect information, informational losses are particularly surprising because, should any one of the eight traders wait to obtain perfect information, the final price would reflect the true asset value. Thus, in the trials in which information is lost, no trader waited. In treatment DW, where traders determine all information aggregation, we observe the largest losses due to non-equilibrium behavior. On average, the observed final price differs from the theoretical by 9.6%. Average differences in the other three treatments are: R (2.6%), W (6.8%), and DR (3.5%).

\textsuperscript{47}In treatment R, final prices are generally very close to the true asset value even though traders forgo perfect information, because final prices also reflect the information contained in the public signals.
C. Estimation of Individual Thresholds

The $\tau$-herding heuristic posits an individual belief threshold, $\tau_i$. If behavior is perfectly consistent with the heuristic, then we expect to observe waiting at all beliefs between $1 - \tau_i$ and $\tau_i$, and rushing for beliefs outside this range. Focusing on a belief, $b_{i,t} > \frac{1}{2}$, the probability of observing a rush decision is given by

$$Pr(R) = Pr(b_{i,t} + \varepsilon_{i,t} > \tau_i)$$

$$\iff Pr(R) = Pr(\varepsilon_{i,t} > \tau_i - b_{i,t})$$ (1)

where $\varepsilon_{i,t}$ captures any observed component that contributes to the decision to rush. Equation (1) assumes errors are small so that if a rush decision is observed for $b_{i,t} > \frac{1}{2}$, it is due to the upper threshold, $\tau_i$, being surpassed (as opposed to the lower threshold, $1 - \tau_i$). It suggests a simple logit model:

$$Pr(R) = \gamma_i(\tau_i - b_{i,t}) + \varepsilon_{i,t}$$

where the heuristic prediction is that $\gamma_i \to -\infty$ and $\tau_i < 1$. $\gamma_i \to -\infty$ occurs if an individual uses a precise threshold but, given the discrete nature of possible beliefs in the data, the threshold can not be pinned down exactly. We therefore expect only for $\gamma_i$ to be large and negative. Assuming symmetric behavior around $b_{i,t} = \frac{1}{2}$, I obtain the individual $\tau_i$ estimates using

$$Pr(R) = \gamma_i(\tau_i - \max\{b_{i,t}, 1 - b_{i,t}\}) + \varepsilon_{i,t}$$

where the regression is run for each individual using observations from the last 10 (14 in the Diagnostic treatments) trials. Using the entire set of trials produces similar results in terms of the number of individuals with thresholds significantly less than one.