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Is Talk Cheap Online:  
Strategic Interaction in A Stock Trading Chat Room

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Abstract:
We consider a model of an internet chat room with free entry but secure identity. Traders exchange messages in real time of both a fundamental and non-fundamental nature. We explore conditions under which traders post truthful information and make trading decisions. We also describe an equilibrium in which momentum and hybrid traders profit from their exposure to informed traders in the chat room. The model generates a number of empirical predictions: (1) traders with middle skill level communicate most often; (2) All but the most informed traders learn from public information about prices, and they optimally follow informed traders; (3) Traders follow informed traders more often. We test and affirm all three predictions using a unique data set of chat room logs from the Activetrader Financial Chat Room.

Keywords: chat room; strategic information; individual traders; behavioral finance;

JEL Codes: G14;

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1. **Introduction**

Wall Street has a lot in common with Madison Avenue. There is a great deal of information disseminated to influence portfolio selection. There are numerous communications among professionals and here comes out the questions: will trader A take positions in a stock after trader B says he has loaded up? When will trader B tell the truth and when will he lie? There is no effective way to study the real time effects of such informal communications among professional investors. However, we now can study similar interactions among individual traders when stock trading chat rooms come out. This paper studies the influence of communications among individual day traders on their trading decisions. And we take advantage of a unique data set of the chat room posts of more than 1,000 individual day traders and studied their interaction and transactions in time series.

There are two advantages that individual day traders are good objectives to study the effect of informal communications in trading decision making: (1) unlike professionals, they do not have any trading rules or trading guidelines forced on them, which make their trades more personal-decision drive; (2) unlike professionals, they do not have enough capital to verify others’ news/rumors/ideas by testing market liquidity, which makes the influence of the real-time interaction on their trading decisions more easily to study.

There is now an established literature on the performance of individual traders. Odean (1999) documents poor returns in a sample of more than 35,000 households. He attributes the underperformance to both overtrading and the disposition effect, the tendency to sell winners and hold losers.

Some recent papers, including Coval, Hirshleifer, and Shumway (2005) and Niccolosi, Peng, and Zhu (2003), have suggested that traders might gain experience that improves their performance over time. Mizrach and Weerts (2007) show that skill may be stock specific. As far as we know, the literature has not looked at the real-time interactions between individual traders, perhaps because of data limitations.

We model individual day traders’ interactions as a dynamic game and study several basic questions: Who communicates the most? When do they communicate? And why? The model establishes three strong empirical predictions: (1) Neither the most informed nor the most uninformed traders communicate most often; (2) All but the most informed traders learn from public information about prices, and they optimally follow informed traders; (3) Traders follow the most
informed traders, instead of the most active ones, more often.

We typically don’t observe the message traffic between traders and their brokers. And we also don’t see trading decisions linked directly to their posts. Antweiler and Frank (2004) study Internet bulletin board posts, but these are not observed in real time.

This paper takes advantage of a unique data set of the chat room posts of more than 1,000 individual traders, with which we confirm the three main empirical predictions of our model.

The paper is organized as follows: Section 2 describes the equilibrium if traders cannot communicate; Section 3 describes the equilibrium with an informal communication group and the empirical implications. Section 4 introduces the data; Section 5 presents our empirical results; Section 6 concludes and speculates about the generalizability of the results.

2. Model

2.1 Model Settings

2.1.1 Environment

There is a risky asset $V$ with initial value $v_0$. Information is released at time $t = \Gamma$ which changes the risky asset’s value to $\tilde{v}$. The value of $\tilde{v}$ depends on the state of the world, which takes three values from the set $\tilde{\omega} = \Omega = \{\omega^-, \omega^0, \omega^+\}$. $\tilde{v} = v_0 + \tilde{v}$ in state $\omega^+$, $\tilde{v} = v_0$ in state $\omega^0$ and $\tilde{v} = v_0 - \tilde{v}$ in state $\omega^-$. The prior probability of each state $\{\omega^+, \omega^0, \omega^-\}$ is $\{p, 1 - 2p, p\}$.

We divide $[0, \Gamma]$ into 3 periods and $\tilde{v}$ is revealed as information is released at the end of period 3 and no order is allowed to submit one period before information is released, i.e. at period 2. The time-discount factor is denoted as $\beta$.

2.1.2 Traders and Signals

There are three kinds of individual traders in the market: informed traders $S_I$, hybrid traders $S_H$ and momentum traders $S_M$.

Each trader $i$ receives a signal $\theta_i \in \Theta = \{\theta^1, \theta^2, \theta^3, \theta^4, \theta^5, \theta^6\}$, where $\theta^1 = \{0, +\}$, $\theta^2 = \{0, -\}$, $\theta^3 = \{+\}$, $\theta^4 = \{-\}$, $\theta^5 = \{0\}$, $\theta^6 = \{+, 0, -\}$. Signal $+$ indicates state $\omega^+$, signal $-$ indicates state $\omega^-$, and signal 0 indicates state $\omega^0$.

[Insert Table 1 Here]
A trader’s type and signal are private information to her. Suppose the number of traders $S_i$, $S_H$ and $S_M$ in the market are $QQ_i$, $QQ_H$ and $QQ_M$.

### 2.1.3 Price Path and Market Impact

At each period, all orders are submitted to market maker and will be executed at next period. The price $P_t$ is decided by the market aggregate demand/supply of risky asset, plus noise $\varepsilon_t$ where $\varepsilon_t \sim N(0, \sigma_e^2)$. Specifically, $P_t$ equals to the asset’s true value plus the realizations of noise, where the asset’s true value at this period equals to the asset’s true value at the last period plus the market impact from the overall order flows submitted at the last period.

Assume each unit of order flow has the same market impact $\lambda$ on price.

### 2.1.4 Actions

We assume each trader can only hold 1 unit (long position), $-1$ unit (short position) and 0 unit of risky asset. The changes of their positions generate the order flow.

At period $s$, trader $i$’s action is denoted as $a_i^s \in \Lambda_1 = \{-1, 0, 1\}$, where $\{-1, 0, 1\}$ is the action set, 1 means holding 1 unit (long position) of risky asset, $S$ means holding $-1$ unit (short position), and 0 means holding 0 unit. And trader $i$’s strategy at period $s = 0, 1$ is $a^i = \{a_i^1, a_i^2\}$.

### 2.2 Equilibrium without Communications

Without communications with each others, traders use their private signals and the price path, which is public information, to make their trading decisions.

**Lemma 1**: Informed traders $S_i$ trade only on their signals and enter the market at the very beginning if the market is not neutral. And their optimal strategy is

- $a^I (\{+\}) = \{a_0^I = 1, a_1^I = 1\};$
- $a^I (\{-\}) = \{a_0^I = -1, a_1^I = -1\};$
- $a^I (\{0\}, P_1 > v_0) = \{a_0^I = 0, a_1^I = -1\};$
- $a^I (\{0\}, P_1 < v_0) = \{a_0^I = 0, a_1^I = 1\}.$

Proof: See Appendix A.

Please note that all the strategies are traders’ actions, and the order they send may not be executed because they send limit orders.

**Intuition**: Informed traders $S_i$ receive perfect information about $\bar{v}$ and their optimal strategy
is to benefit from their signals immediately, i.e. to long at period 0 as soon as possible if receiving a positive signal and short as soon as possible if receiving a negative signal.

But after they receive a neutral signal and observe price $P_1$ at period 1, they may trade against those uninformed traders to make profits.

**Lemma 2**: Hybrid traders $S_H$ trade not only on their signals but also on the price path. They enter the market at the very beginning and decide whether to exit or not after they observe the price at period 1. And their optimal strategy is

$$a^H(\{+, 0\}, P_1 \geq v_0 + P_1^*) = \{a_0^H = 1, a_1^H = 1\};$$
$$a^H(\{+, 0\}, P_1 < v_0 + P_1^*) = \{a_0^H = 1, a_1^H = 0\};$$
$$a^H(\{-, 0\}, P_1 \leq v_0 - P_1^*) = \{a_0^H = -1, a_1^H = -1\};$$
$$a^H(\{-, 0\}, P_1 > v_0 - P_1^*) = \{a_0^H = -1, a_1^H = 0\}.$$

Proof: See Appendix A.

**Intuition**: Hybrid traders $S_H$ depend not only on their signals but also on the price path to make trading decisions.

Signal $\{+, 0\}$ excludes state $\omega^-$ which occurs with the possibility $p$ and signal $\{-, 0\}$ excludes state $\omega^+$ which also occurs with the possibility $p$. Thus, without trading costs, hybrid traders enter the market at the very beginning, as informed traders $S_I$. After observing the price at period 1, $S_H$ infer $S_I$’s action from the price path and decide whether to exit their positions or not.

**Lemma 3**: Momentum traders $S_M$ trade only on the price path. They enter market later than informed traders $S_I$ and hybrid traders $S_H$.

$$a^M(P_1 > v_0 + P_1^{**}) = \{a_0^M = 0, a_1^M = 1\};$$
$$a^M(P_1 < v_0 - P_1^{**}) = \{a_0^M = 0, a_1^M = -1\};$$
$$a^M(v_0 - P_1^{**} \leq P_1 \leq v_0 + P_1^{**}) = \{a_0^M = 0, a_1^M = 0\},$$
where $P_1^{**} > P_1^*$.

Proof: See Appendix A.

**Intuition**: Momentum traders $S_M$ rely on the price path to make trading decisions.

$S_M$ never trade at the very beginning because they only have uninformative signals. They infer informed traders $S_I$’s and hybrid traders $S_H$’s actions from the price path and make their trading decisions based on this. Since their signals are more uninformative than hybrid traders, they need higher price threshold to enter in order to make their trades profitable.
3. Equilibrium with Communications

3.1 Model Setting

3.1.1 Information Group

Suppose some individual traders form a group with free entries and unique identities, where traders can exchange trading, fundamental, non-fundamental and other information with each other without any cost. And such a group is unknown to or ignored by other traders outside the group.

The number of informed, hybrid and momentum traders $S_I$, $S_H$ and $S_M$ in the group are $Q_I$, $Q_H$ and $Q_M$, where $Q_I \ll QQ_I$, $Q_H \ll QQ_H$ and $Q_M \ll QQ_M$.

3.1.2 Actions

The action space is two-dimensional, including trader $i$’s trades and posts. At period $s$, trader $i$’s action is denoted as $a_i^s = 2^2 = A = \{1, 0, 1\}$, where $1$, $0$, $1$ are defined as previous part, and $l$ means posting long positions, $s$ means posting short positions, and $n$ means not to post any position at all. Trader $i$’s strategy in periods $s = 0, 1$ can be denoted as $a^i = \{a_1^i, a_2^i\}$.

3.1.3 Reputation

Suppose each type of traders can only distinguish the traders who are the same skillful as them or less skillful than them.

3.2 Equilibrium

Proposition 1: With communications, informed traders $S_I$’s optimal strategy is

$$a^I(+) = \{a_0^I = 1, b_0^I = l; a_1^I = 1, b_1^I = n\};$$
$$a^I(=) = \{a_0^I = -1, b_0^I = s; a_1^I = -1, b_1^I = n\};$$
$$a^I(\{0\}, b_0^H = l, P_1 > v_0 - P_1^{**}) = \{a_0^I = 0, b_0^I = n; a_1^I = -1, b_1^I = s\};$$
$$a^I(\{0\}, P_1 < v_0 - P_1^{**}) = \{a_0^I = 0, b_0^I = n; a_1^I = 1, b_1^I = l\};$$
$$a^I(\{0\}, b_0^H = s, P_1 < v_0 + P_1^{**}) = \{a_0^I = 0, b_0^I = n; a_1^I = 1, b_1^I = l\};$$
$$a^I(\{0\}, P_1 > v_0 + P_1^{**}) = \{a_0^I = 0, b_0^I = n; a_1^I = -1, b_1^I = s\};$$

if $b_0^H = n$, inside informed traders trade as outside informed traders.

Proof: See Appendix B.
It is easy to show inside $S_I$ better off within this group. In the states $\omega^+/\omega^-$, inside $S_I$ benefits from posting thruthfully after building their positions because of the time discount factor. And in the state $\omega^0$, inferring from $S_H$’s posts, insider $S_I$ can exclude the noise in the price and make profits from trading against all momentum traders and outside hybrid traders.

Here, we need to notice the $\{0\}, P_1 < v_0 - P_1^{**}$ case, in which outside momentum traders will short so that inside informed traders will long to make profits no matter what inside hybrid traders post.

Similar analysis applies to the $\{0\}, P_1 > v_0 + P_1^{**}$ case.

**Proposition 2:** With communications, hybrid traders $S_H$’s optimal strategy is

- $a_H(\{+, 0\}, b_1^I = l) = \{a_0^H = 1, b_0^H = l; a_1^H = 1, b_1^H = n\}$;
- $a_H(\{+, 0\}, b_1^I = n, P_1 > v_0 - P_1^{**}) = \{a_0^H = 1, b_0^H = l; a_1^H = -1, b_1^H = s\}$;
- $a_H(\{+, 0\}, b_1^I = n, P_1 < v_0 - P_1^{**}) = \{a_0^H = 1, b_0^H = l; a_1^H = 0, b_1^H = s\}$;
- $a_H(\{-, 0\}, b_1^I = s) = \{a_0^H = -1, b_0^H = s; a_1^H = -1, b_1^H = n\}$;
- $a_H(\{-, 0\}, b_1^I = n, P_1 < v_0 + P_1^{**}) = \{a_0^H = -1, b_0^H = s; a_1^H = 1, b_1^H = l\}$;
- $a_H(\{-, 0\}, b_1^I = n, P_1 > v_0 + P_1^{**}) = \{a_0^H = -1, b_0^H = s; a_1^H = 0, b_1^H = l\}$;

if $b_0^H = n$, inside hybrid traders trade as outside hybrid traders.

Proof: See Appendix B.

Obviously, inside $S_H$ better off within the group. And after observing $S_I$’s posts at period 0, inside $S_H$ attain perfect information about the state. In the states $\omega^+$ and $\omega^-$, inside $S_H$ benefit from $S_I$’s informative posts and avoid being influenced by the noise in the price and exiting their position wrongly. And in the state $\omega^0$, inside $S_H$ make profits from trading against inside $S_M$ and all outside traders.

Here, we need to notice the $\{+, 0\}, b_1^I = n, P_1 < v_0 - P_1^{**}$ case, in which outside momentum traders will short so that inside hybrid traders will not try to short because the equilibrium value must be under $v_0$ and they post long because they still try to exit their long position with limit price $v_0$.

Similar analysis applies to the $\{-, 0\}, b_1^I = n, P_1 > v_0 + P_1^{**}$ case.

**Proposition 3:** With communications, momentum traders $S_M$ trade on both others’ posts and the price path.

- $a_M\left(b_1^M = l, P_1 > v_0 + P_1^{**}\right) = \{a_0^M = 0, b_0^M = n; a_1^M = 1, b_1^M = l\}$;
\[ a^M (b_1^M = s, P_1 < v_0 - P_{1^{**}}) = \{ a_0^M = 0, b_0^M = n; a_1^M = -1, b_1^M = s \}; \]
\[ a^M (b_1^M = n, P_1 > v_0 + P_{1^{**}}) = \{ a_0^M = 0, b_0^M = n; a_1^M = 1, b_1^M = l \}; \]
\[ a^M (b_1^M = n, P_1 < v_0 - P_{1^{**}}) = \{ a_0^M = 0, b_0^M = n; a_1^M = -1, b_1^M = s \}; \]

where \( P_{1^{**}} < P_{1^*} \).

\( S_M \) do not trade or post in other situations, \( \{ a_0^M = 0, b_0^M = n; a_1^M = 0, b_1^M = n \} \).

Proof: See Appendix B.

Here, we need \( Q_I \) small, compared with \( Q_H \), so that the difference in the number of posts in states \( \omega^- \) or \( \omega^+ \) or \( \omega^0 \) change momentum traders’ expectation little and thus do not change our equilibrium.

At period 1, \( S_M \) within the group face similar situations as outside \( S_H \): with \( l \) posts, \( S_M \) can exclude state \( \omega^- \); and with \( s \) posts, \( S_M \) can exclude state \( \omega^+ \). After excluding \( \omega^- \) or \( \omega^+ \), \( S_M \) also need the price path to make their trading decisions.

We can easily show that \( S_M \) better off within the group. In the states \( \omega^+ \) and \( \omega^- \), \( S_M \) benefit from informative posts. And \( S_M \)'s loss in the state \( \omega^0 \) is less than their benefits in the state \( \omega^+ \) and \( \omega^- \). In short, with more information, \( S_M \) cannot worse off.

The equilibrium can be shown in the following graphs. We describe how the price path forms in Figure 1 and then describe the price path and traders’ strategies in the equilibrium without Chatroom in Figure 2 and with Chatroom in Figure 3.

[Insert Figure 1 to 3 Here]

### 3.3 Empirical Implications

This part summarizes the observable implications in the equilibrium of the model. We have three hypothesis indicated from the equilibrium:

**Hypothesis 1.** Skills vs. Trading frequency: neither the most skillful nor the least skillful traders trade most frequently

Signals’ informativeness shows traders’ skill levels. Informed traders are the most skillful traders who get perfect information from their own analysis while momentum traders are the least skillful who cannot get any information from their own analysis.

In the equilibrium, \( S_H \) post much more frequently than \( S_I \) and \( S_M \). Thus, when observing the
data, we should see the U-shape relation between traders’ skills and their trading frequencies.

**Hypothesis 2. Skills vs. Following Behavior: The more skillful a trader is, the less frequently she follows others.**

We use a "following" trade to denote a trade which have a previous trade traded on the same direction and posted by another trader within 5 minutes. Based on this definition, in the equilibrium with communication, $S_I$ seldom follow while $S_M$ frequently follow others in stock picking. Thus, when observing the data, we should see that a trader’s skill is negatively related with her following frequency.

**Hypothesis 3. Who is Followed: The more skillful a trader is, the more frequently she is followed by others.**

We define the trade followed by a "following" trade as a "being followed" trade. In the equilibrium, $S_I$ are followed by $S_M$ with higher probability than $S_H$. Thus, when observing the data, we should see that a trader’s skill is positively related with the number of her "being followed" trades.

4. **Data and Empirical Tests**

4.1 **Data and Environment**

The second author collected the posts from the Active Trader Financial Chatroom at sporadic intervals over a four year period from 2000 to 2003. Our sample period is the most active trading month October 2000. The logs contain several interruptions when the chat client froze or when the author neglected to capture the feed. In October 2000, we have 14 trading days of information. Posts are time stamped to the minute. Trader identities are in <.>

4.1.1 **Posts**

The posts contain information about fundamental and technical analysis, trades, and some irrelevant information. Here is a sample chat log from 11:48 to 11:53 Eastern time on October 30, 2000.
CSCO chart support 37, can’t believe we will see that
CSCO wants low 40’s
CSCO selling 46
double_odds buys COVD 5 3/16
CSCO PE not looking that bad
sells CSCO
INTC going down with CSCO
CSCO 46
Matrix in CSCO
CSCO 800,000 shares traded last min
WallStArb buys CSCO 46 1/16
CSCO
adding csco
DMS buys ITRU on NEWS
double_odds sells INDG +1/2
added CSCO here
CSCO bounce
buys INTC
WallStArb places 46 1/8 stop on CSCO
Matrix sells some CSCO
Targetman Buys NAS-FUTURES @ 3102
Matrix buys YHOO 52
$35.70/share BOUT? at what PRM price?
Targetman Buys SP-FUTURES @ 1393.50
smart move Wally
naz looks overdone
bsvn stock upcross + spoos candle bottom
Targetman Buys CSCO @ 46 3/8
adds xxia 18 3/4

We summarize the type of posts, number of posters and frequency in Table 2.

[Insert Table 2 Here]

Although day traders trade mostly on technical analysis, those traders did post and use fundamental information in making trading decisions. They analyzed typical fundamental indicators, stock valuation, company financial status, CEO performances and product innovations. A typical fundamental post in the example log is “[11:50] <UofMichigan> CSCO PE not looking that bad,” which refers to the price earnings ratio.

Most posts about stock trading are non-fundamental posts, including technical analysis and price statements mentioning the new updates on the price path. A typical technical analysis is “[11:48] <UofMichigan> CSCO chart support 37” or "[11:53] <phishy> bsvn stock upcross + spoos candle bottom”\n; A typical statement about price direction is “[11:50] <aim> INTC going
down with CSCO”, which is simply repeating public information.

Traders also post their trades, which gives us the information about their real skills. A typical trade post is “[11:53] Targetman Buys CSCO @ 46 3/8”, in which the trader <Targetman> bought CSCO at the price he showed. We do not rely on the trader’s posted price and profit information, but instead verify this from transactions records.

There are posts irrelevant with stock trading, such as “[11:53] <scalper> smart move Wally” in the sample chat log. However, since there are chatroom administrators who keep the room focus on stock trading within trading hours, most totally irrelevant posts appear after trading hours.

4.1.2 Trades

We also summarize the trading activity for October 2000 in Table 2.

Traders use a wide variety of slang for their trades. We used various forms of the keywords, including their abbreviations and misspelled variants, to indicate buying activity: Accumulate; Add; Back; Buy; Cover; Enter; Get; Grab; In; Into; Load; Long; Nibble; Nip; Pick; Poke; Reload; Take; and Try. Keywords for selling were: Dump; Out; Scalp; Sell; Short; Stop; and Purge.

We cannot match open and closing trades for about 70% of the posts. We assume that all open positions whether long or short are closed at the end of the day. We do not consider after hours trades.

4.1.3 Profits

To compute dollar profit and losses for each trader, we make transaction cost assumptions for position size assumptions. For position size A, we assume a $20 commission. This is a $0.02 per share commission on the 1,000 share round trip. Numerous brokers offer commissions in this range. For position size B, we assume a $0.005 per share commission and a 50 basis point slippage. These reflect the lower commissions typically paid on larger lot sizes, and some market impact on the larger trades. We find that none of the position or transaction costs assumptions has a qualitative impact on our profit estimates.

We examine profits for all trades. The first profit measure is the aggregate difference between selling and buying prices so the reader can gauge the effect of the transactions costs. The second measure A uses the low cost estimate with flat commissions. The second measure B has higher transactions costs, but sometimes benefits from the larger lot sizes.

In our sample period, more than 50% of traders are profitable under A while 47.48% of the
traders are profitable under B. These are much higher ratios of profitable traders found in other studies of retail investors or day traders. This is why we feel comfortable regarding some semi-professional and professional traders as informed traders. The experts in our chat room are “Activetraders” for a good reason; trading, for them, is a profitable activity.

Our traders make money trading both long and short. When we break apart profits short versus long, we find that 74.7% of profits are made trading long and 25.3% short. Trades are equally likely to be profitable long versus short, 53.97% long compared to 56.07% short. The marginal profit per trade is substantially higher on the short side than the long, $210.84 per trade short versus $110.87 long in the pooled sample. Short traders are also more skillful overall. Over the four years, 51.55% of traders who never short are profitable under assumption A, compared with 62.21% for traders who trade both short and long.

For the remainder of this section, we will utilize the more conservative profit assumptions A.

4.2 Empirical Results

4.2.1 Hypothesis 1: Skills vs. Posting Behaviors

Our first test of the model is about posting frequency by trader \(j\) for the four types of posts: (1) fundamental posts, \(FP_j\); (2) non-fundamental posts, \(NFP_j\); (3) trade posts, \(TRP_j\); (4) irrelevant posts, \(IRR_j\). Trader \(j\)'s total posts are

\[
NP_j = FP_j + NFP_j + TRP_j + IRR_j. \tag{1}
\]

H1 tests the posting frequency of trades, \(TRP_j/NP_j\).

We calculate our standard skill measure, the profit per trade of trader \(j\)

\[
\pi_j = \frac{\sum_{t=1}^{T_{j,t}} \pi_{j,t}}{\sum_{t=1}^{T_{j,t}} T_{j,t}} \tag{2}
\]

And we separate all traders into two groups \(\pi_j^+\) and \(\pi_j^-\), where \(\pi_j^+\) refer to profits of traders with positive profits and \(\pi_j^-\) refer to profits of traders with negative profits, and then regress \(\pi_j^+\) and \(\pi_j^-\) respectively on the number of each type traders’ trading post,

\[
TRP_j = \alpha_{1A} + \beta_{1A} \pi_j^-; \quad \tag{3}
\]

and

\[
TRP_j = \alpha_{1B} + \beta_{1B} \pi_j^+; \quad \tag{4}
\]

We find statistically significant \(\beta_{1A} > 0\) and \(\beta_{1B} < 0\) in Table 3. \(\beta_{1A} > 0\) shows the middle
skill level traders post trades more frequently than the low skill level traders and \( \beta_{1B} < 0 \) shows they also post trades more frequently than the high skill level traders. Thus, the empirical results show the middle skill level traders post trades most often within the group.

4.2.2 Hypothesis 2: Skills vs. following behavior

We first test hypothesis H2a: The more skillful a trader is, the less likely she will follow others. We partition trade profits into following and non-following, \( \pi_j = \pi_j^{(f)} + \pi_j^{(nf)} \), using profits obtained while not following as a skill measure. We regress the following rate, \( F_j = \frac{TR_j^{(f)}}{TR_j^{(f)} + TR_j^{(nf)}} \), on profits per non-following trade \( \pi_j^{(f)} \) on

\[
F_j = \alpha_2 + \beta_2 \pi_j.
\]

We find that \( \beta_2 < 0 \), consistent with the hypothesis.

We next test hypothesis H2b: Do unskilled traders benefit more from following. We consider trades where an unskillful trader \( \pi_j < 0 \) follows a skillful trader, \( \pi_j > 0 \). We partition trade profits into following and non-following, \( \pi_j = \pi_j^{(f)} + \pi_j^{(nf)} \) and regress total profits on the difference,

\[
\pi_j^{(f)} - \pi_j^{(nf)} = \alpha_2 + \beta_2 \pi_j.
\]

We find that \( \beta_2 < 0 \).

\( \beta_2 < 0 \) and \( \beta_2 < 0 \) shows traders’ skills are negatively related with their following frequency and their profits from following.

4.2.3 Hypothesis 3: Who is followed

Hypothesis 3 asks whether skillful traders have more followers? Define trader \( j \)'s total trades and her trades followed by traders other than \( j \) as \( Tr_j \) and \( Tr_{-j}^{(f)} \), and define the being followed rate,

\[
F_{-j} = Tr_j / Tr_{-j}^{(f)}
\]

We then regress the skill level on the "being followed" rate,

\[
F_{-j} = \alpha_3 + \beta_3 \pi_j.
\]

and find that \( \beta_3 > 0 \), indicating strong support of the hypothesis.

\( \beta_3 > 0 \) shows traders’ skills are positively related with their being-followed rate.

5. Conclusions and Extensions

This paper studies individual day traders and their communications. An interaction game is built
up to explain individual traders’ strategic behaviors in an internet stock trading chat room. And we model how communications influence traders’ trading decisions and explain how the chat room is beneficial to all participants, even the most skillful traders. Informed traders benefit from trading against momentum traders. Hybrid traders benefit from both informed traders’ informative posts and trading against momentum traders. Momentum traders benefit from informative posts in the group.

We motivate three empirical results: (1). Neither the most informed nor the most uninformed traders communicates most often; (2). Both hybrid and momentum traders learn from public information about prices; and (3). They optimally follow informed traders. And we do find out that traders have some knowledge of who the skillful traders are and follow more often the most skillful traders, instead of the most active ones.

It is interesting to speculate whether Wall Street is just a large version of the chatroom. For example, large financial institutions are doing two things which skillful traders did in this chat room: (1). building positions before releasing information (see e.g. Mizrach (2005); and (2) taking advantage of reputation as was disclosed in Elliot Spitzer’s investigations in 2002.
References


Appendix A

Proof of Lemma

To simplify the problem, we assume $\lambda (QQ_I + QQ_H + QQ_M) < \hat{\nu}$, but releasing the assumptions does not change the conclusions.

For hybrid traders $S_H$:

$$\Pr[\omega^+ | \{+, 0\}] = \frac{\Pr[\{+, 0\} | \omega^+] \cdot \Pr[\omega^+]}{\Pr[\{+, 0\} | \omega^+] \cdot \Pr[\omega^+] + \Pr[\{+, 0\} | \omega^0] \cdot \Pr[\omega^0] + \Pr[\{+, 0\} | \omega^-] \cdot \Pr[\omega^-]} = 1 \cdot p = \frac{1 \cdot p + \frac{1}{2} \cdot (1 - 2p) + 0}{2p} = 1 - 2p,$$

and $\Pr[\omega^0 | \{+, 0\}] = 1 - 2p$, $\Pr[\omega^- | \{+, 0\}] = 0$.

\[
\Pr[\omega^+ | \{+, 0\}, P_1] = \frac{\Pr[P_1 | \{+, 0\}, \omega^+] \cdot \Pr[\omega^+ | \{+, 0\}]}{\Pr[P_1 | \{+, 0\}, \omega^+] \cdot \Pr[\omega^+ | \{+, 0\}] + \Pr[P_1 | \{+, 0\}, \omega^0] \cdot \Pr[\omega^0 | \{+, 0\}] + \Pr[P_1 | \{+, 0\}, \omega^-] \cdot \Pr[\omega^- | \{+, 0\}]} = \frac{\Pr[\omega^+ | \{+, 0\}]}{\Pr[P_1 | \{+, 0\}, \omega^+] \cdot 2p + \Pr[P_1 | \{+, 0\}, \omega^0] \cdot (1 - 2p)} = \frac{\phi \left( \frac{P_1 - v_0 - \lambda(QQ_I + QQ_H)}{\sigma_w} \right) \cdot 2p}{\phi \left( \frac{P_1 - v_0 - \lambda(QQ_I + QQ_H)}{\sigma_w} \right) \cdot 2p + \phi \left( \frac{P_1 - v_0 - \lambda QQ_H}{\sigma_w} \right) \cdot (1 - 2p)} \triangleq p^*
\]

To simplify the problem, we regard $v_0 = 0$, which does not influence our conclusions.

At period 0, $S_H$’s expected returns:

$$E[\pi_H (a_0^H = 0, a_1^H = 0) | \{+, 0\}] = 0$$

\[
E[\pi_H (a_0^H = 0, a_1^H = 1) | \{+, 0\}] = 2p \left\{ 0 + \beta \lambda \left( \frac{QQ_H}{2} \right) + \beta^2 [\hat{\nu} - \lambda (QQ_I + QQ_H)] \right\} + (1 - 2p) \left\{ 0 + \beta \lambda \left( \frac{QQ_H}{2} \right) + \beta^2 \cdot (-\lambda QQ_H) \right\} = \lambda \frac{QQ_H}{2} (\beta - 2\beta^2) + 2p \left\{ \beta^2 [\hat{\nu} - \lambda QQ_I] \right\}
\]
\[
E[\pi_H (a_0^H = 1, a_1^H = 0) | \{+, 0\}] \\
= 2p \left\{ \lambda \left( \frac{QQ_H}{2} + \frac{QQ_I}{2} \right) + \beta \lambda \left( -\frac{QQ_H}{2} \right) + \beta^2 \cdot 0 \right\} \\
+ (1 - 2p) \left\{ \lambda \left( \frac{QQ_H}{2} \right) + \beta \left( \frac{QQ_H}{QQ_I + QQ_H} \cdot \left( -\frac{QQ_H}{2} \right) \right) + \beta^2 \cdot \left( \frac{QQ_I}{QQ_I + QQ_H} \left( -\lambda QQ_H \right) \right) \right\} \\
= \frac{\lambda QQ_H}{2} \left( 1 - 2^\beta \frac{QQ_H}{QQ_I + QQ_H} - 2^\beta^2 \frac{QQ_I}{QQ_I + QQ_H} \right) + 2p \left\{ \lambda \frac{QQ_I}{2} - \lambda \frac{QQ_H}{2} \left( \frac{QQ_H}{QQ_I + QQ_H} \right) \left( 1 - 2^\beta \right) \right\} \\
\]

where \(a_0^H = 1, a_1^H = 1\) means hybrid traders send an order to buy at price not higher than \(2p\hat{v}\) at period 0 and hold the long position if the orders are executed; \(a_0^H = 1, a_1^H = 0\) means hybrid traders send an order to buy at price not higher than \(2p\hat{v}\) at period 0 and sell the long position at price not lower than 0 at period 1 if the orders are executed; \(a_0^H = 0, a_1^H = 1\) means hybrid traders hold position 0 at period 0 and send an order to buy at price not higher than \(p^*\hat{v}\) at period 1; \(a_0^H = 0, a_1^H = 0\) means hybrid traders do not buy or sell at all.

We assume \(\hat{v}\) large enough so that \(2p\hat{v} > \lambda (QQ_I + QQ_H)\).

Since \(\beta < 1\), we can easily attain that \(E[\pi_H (a_0^H = 1, a_1^H = 1) | \{+, 0\}] > E[\pi_H (a_0^H = 0, a_1^H = 1) | \{+, 0\}]\) always holds under any situation.

Suppose \(\hat{v}\) is large enough, i.e. \(\hat{v} > \frac{1}{2} (2 - \beta^2) \left( QQ_I + \frac{QQ_H}{2p} \right)\), we can also get
\[
E[\pi_H (a_0^H = 1, a_1^H = 1) | \{+, 0\}] > E[\pi_H (a_0^H = 0, a_1^H = 0) | \{+, 0\}] = 0
\]

Besides, it is easy to see that shorting at period 0 / \(a_0^H = -1\) yields negative expected returns when \(S_H\) receive positive signal \(\{+, 0\}\).

Therefore, at period 0, long \(a_0^H = 1\) is always the optimal choice for \(S_H\).

At period 1, \(S_H\)'s expected returns:
\[
E[\pi_H (a_0^H = 1, a_1^H = 0) | \{+, 0\}] = \]
\[
p^* \left\{ \lambda \left( \frac{QH}{2} + \frac{QI}{2} \right) + \beta \lambda \left( -\frac{QH}{2} \right) + \beta^2 \cdot 0 \right\}
\]
\[
+ (1 - p^*) \left\{ \lambda \left( \frac{QH}{2} \right) + \beta \left[ \frac{QI}{QI + QH} \cdot \left( -\frac{QH}{2} \right) \right] + \beta^2 \cdot \left[ \frac{QI}{QI + QH} \left( -\lambda QH \right) \right] \right\}
\]
\[
= \lambda \frac{QH}{2} \left( 1 - \beta \frac{QH}{QI + QH} - 2\beta^2 \frac{QI}{QI + QH} \right)
\]
\[
+ p^* \left\{ \lambda \frac{QH}{2} - \lambda \beta \cdot \frac{QI}{2} \left( \frac{QH}{QI + QH} \right) \right\}
\]
\[
E[\pi_H (a_0^H = 1, a_1^H = 1) | \{+, 0\}, P_1] - E[\pi_H (a_0^H = 1, a_1^H = 0) | \{+, 0\}, P_1] = \lambda \beta \frac{QH}{2} \frac{QH}{QI + QH} (1 - 2\beta) + p^* \left\{ \beta^2 \tilde{v} - \lambda \beta \frac{QI}{2} \left[ 2\beta + (2\beta - 1) \frac{QH}{QI + QH} \right] \right\}
\]
\[
E[\pi_H (a_0^H = 1, a_1^H = 1) | \{+, 0\}, P_1] > E[\pi_H (a_0^H = 1, a_1^H = 0) | \{+, 0\}, P_1]
\]
\[
\Rightarrow p^* > \frac{\lambda \frac{QH}{2} \frac{QH}{QI + QH} (2\beta - 1)}{\beta^2 \tilde{v} - \lambda \beta \frac{QI}{2} \left[ 2\beta + (2\beta - 1) \frac{QH}{QI + QH} \right]}
\]
\[
\Rightarrow \frac{\phi \left( \frac{P_1 - v_0 - \lambda (QI + QH)}{\sigma_e} \right) \cdot 2p}{\phi \left( \frac{P_1 - v_0 - \lambda (QI + QH)}{\sigma_e} \right) \cdot 2p + \phi \left( \frac{P_1 - v_0 - \lambda QH}{\sigma_e} \right) \cdot (1 - 2p)} > \frac{\lambda \frac{QH}{2} \frac{QH}{QI + QH} (2\beta - 1)}{\beta^2 \tilde{v} - \lambda \beta \frac{QI}{2} \left[ 2\beta + (2\beta - 1) \frac{QH}{QI + QH} \right]}
\]
\[
\Rightarrow P_1 > v_0 + P_1^*
\]

Therefore, hybrid trader’s optimal strategy is to buy the risky asset at the price not higher than \(2\tilde{v}\) at period 0, and then to hold the long position if price at period 1 passes the threshold \(P_1^*\); otherwise, exit the position at period 1.

We assume is \(\tilde{v}\) large enough so that \(p^*_{(v_0 + P_1^*)} \cdot \tilde{v} > \lambda (QI + QH)\).

Let’s consider momentum traders \(S_M\).
Since momentum traders do not receive any informative signal, i.e. \( \Pr[\omega^+ | \{+, 0, -\}] = p = \Pr[\omega^- | \{+, 0, -\}] \), obviously, the optimal choice for momentum traders at period 0 is to do nothing.

Then, at period 1,
\[
\Pr[\omega^+ | \{+, 0, -\}, P_1] = \frac{\Pr[P_1 | \{+, 0, -\}, \omega^+] \cdot \Pr[\omega^+ | \{+, 0, -\}] + \Pr[P_1 | \{+, 0, -\}, \omega^0] \cdot \Pr[\omega^0 | \{+, 0, -\}] + \Pr[P_1 | \{+, 0, -\}, \omega^-] \cdot \Pr[\omega^- | \{+, 0, -\}]}{\Pr[P_1 | \{+, 0, -\}, \omega^+] \cdot p + \Pr[P_1 | \{+, 0, -\}, \omega^0] \cdot (1 - 2p) + \Pr[P_1 | \{+, 0, -\}, \omega^-] \cdot p} \]
\[
\triangleq p^+
\]

Similarly,
\[
\Pr[\omega^0 | \{+, 0, -\}, P_1] = \frac{\phi \left( \frac{P_1 - v_0}{\sigma_e} \right) \cdot (1 - 2p)}{\phi \left( \frac{P_1 - v_0 - \lambda(QQ_i + QQ_H)}{\sigma_e} \right) \cdot p + \phi \left( \frac{P_1 - v_0}{\sigma_e} \right) \cdot (1 - 2p) + \phi \left( \frac{P_1 - v_0 + \lambda(QQ_i + QQ_H)}{\sigma_e} \right) \cdot p} \]
\[
\triangleq p^0
\]
\[
\Pr[\omega^- | \{+, 0, -\}, P_1] = \frac{\phi \left( \frac{P_1 - v_0 + \lambda(QQ_i + QQ_H)}{\sigma_e} \right) \cdot p}{\phi \left( \frac{P_1 - v_0 - \lambda(QQ_i + QQ_H)}{\sigma_e} \right) \cdot p + \phi \left( \frac{P_1 - v_0}{\sigma_e} \right) \cdot (1 - 2p) + \phi \left( \frac{P_1 - v_0 + \lambda(QQ_i + QQ_H)}{\sigma_e} \right) \cdot p} \]
\[
\triangleq p^-
\]

At period 1, momentum traders’ expected returns:
\[
E[\pi_M (a_0^M = 0, a_1^M = 0) | \{+, 0, -\}, P_1] = 0
\]
\[
E[\pi_M (a_0^M = 0, a_1^M = 1) | \{+ , 0, -\} , P_1] \\
= p^+ \left\{ 0 + \beta \lambda \left( \frac{QQ_M}{2} \right) + \beta^2 \left[ \tilde{\nu} - \lambda (QQ_I + QQ_H + QQ_M) \right] \right\} \\
+ p^0 \left\{ 0 + \beta \lambda \left( \frac{QQ_M}{2} \right) + \beta^2 \left[ -\lambda QQ_M \right] \right\} \\
+ p^- \left\{ 0 + \beta \lambda \left( \frac{QQ_M}{2} \right) + \beta^2 \left[ \tilde{\nu} + \lambda (QQ_I + QQ_H - QQ_M) \right] \right\} \\
= \lambda \beta \frac{QQ_M}{2} (1 - 2\beta) + (p^+ - p^-) \beta^2 \{ \tilde{\nu} - \lambda \beta (QQ_I + QQ_H) \}
\]

\[
E[\pi_M (a_0^M = 0, a_1^M = -1) | \{+ , 0, -\} , P_1] \\
= p^+ \left\{ 0 + \beta \lambda \left( \frac{QQ_M}{2} \right) + \beta^2 \left[ -\tilde{\nu} + \lambda (QQ_I + QQ_H - QQ_M) \right] \right\} \\
+ p^0 \left\{ 0 + \beta \lambda \left( \frac{QQ_M}{2} \right) + \beta^2 \left[ -\lambda QQ_M \right] \right\} \\
+ p^- \left\{ 0 + \beta \lambda \left( \frac{QQ_M}{2} \right) + \beta^2 \left[ \tilde{\nu} - \lambda (QQ_I + QQ_H + QQ_M) \right] \right\} \\
= \lambda \beta \frac{QQ_M}{2} (1 - 2\beta) + (p^+ - p^-) \beta^2 \{ \tilde{\nu} - \lambda \beta (QQ_I + QQ_H) \}
\]

Similarly,

\[
E[\pi_M (a_0^M = 0, a_1^M = 1) | \{+ , 0, -\} , P_1] \\
> E[\pi_M (a_0^M = 0, a_1^M = 0) | \{+ , 0, -\} , P_1] = 0 \\
\implies (p^+ - p^-) \beta^2 \{ \tilde{\nu} - \lambda \beta (QQ_I + QQ_H) \} > \lambda \beta \frac{QQ_M}{2} (2\beta - 1) \\
\implies P_1 > v_0 + P_1^{**}
\]

where \( a_0^M = 0, a_1^M = 1 \) means momentum traders hold position 0 at period 0 and send an order to buy at price not higher than \( p^+ \tilde{\nu} \) at period 1; \( a_0^M = 0, a_1^M = 0 \) means momentum traders do not
buy or sell at all. We assume is large enough so that \( p_\alpha > \lambda (QQ_I + QQ_H + QQ_M) \).

It is easy to mathematically prove \( P_1^* > P_1^* \). And the reason is that momentum traders’ signal is less informative than hybrid traders’ and thus, they need the price path walk further to confirm the trend.

For informed traders \( S_I \):

Obviously, \( S_I \)'s optimal strategy is \( \{a_0^I = 1, a_1^I = 1\} \) if receiving \{+\} and \( \{a_0^I = -1, a_1^I = -1\} \) if receiving \{-\}.

\[
E[\pi_I (a_0^I = 1, a_1^I = 1) | \{+\}] = E[\pi_I (a_0^I = -1, a_1^I = -1) | \{-\}]
\]

\[
= \lambda \left( \frac{QQ_I}{2} + \frac{QQ_H}{2} \right) + \beta \cdot Pr [\varepsilon > P_1^* - \lambda (QQ_I + QQ_H)] \cdot (\lambda QQ_M)
\]

\[+ \beta^2 (\varepsilon - \lambda (QQ_I + QQ_H + Pr [\varepsilon > P_1^* - \lambda (QQ_I + QQ_H)]) QQ_M)]
\]

\[
= \beta^2 (\varepsilon - \lambda (QQ_I + QQ_H)) (1 - 2\beta^2) + \lambda \beta QQ_M (1 - \beta) [1 - \Phi (P_1^* - \lambda (QQ_I + QQ_H))]
\]

When receiving a signal \( \{0\} \):

\[
Pr \{S_H = \{+, 0\} | P_1, \omega^0 \} = \phi \left( \frac{P_1 - v_0 - \lambda QQ_M}{\sigma} \right) \cdot \frac{1}{2} \cdot (1 - 2p)
\]

\[
= \frac{\phi \left( \frac{P_1 - v_0 - \lambda QQ_M}{\sigma} \right) \cdot \frac{1}{2} \cdot (1 - 2p) + \phi \left( \frac{P_1 - v_0 + \lambda QQ_M}{\sigma} \right) \cdot \frac{1}{2} \cdot (1 - 2p)}{1 - p^*}
\]

\[\triangleq p^* \]

and

\[
Pr \{S_H = \{-, 0\} | P_1, \omega^0 \} = 1 - p^*
\]

When \( P_1 > v_0 \), we have \( p^* > \frac{1}{2} > 1 - p^* \); and when \( P_1 < v_0 \), we have \( p^* < \frac{1}{2} < 1 - p^* \).

Thus, when \( v_0 < P_1 < v_0 + P_1^* \)

\[
E[\pi_I (a_0^I = 0, a_1^I = -1) | \{0\}, v_0 < P_1 < v_0 + P_1^*]
\]

\[= p^* \left\{ \lambda \beta \left( \frac{QQ_H}{2} + \frac{QQ_I}{QQ_I + QQ_H} \right) \right\}
\]

and
\[
E[\pi_I (a_0^I = 0, a_1^I = 1) | \{0\}, v_0 < P_1 < v_0 + P_1^*]
= (1 - p^{**}) \left\{ \lambda \beta \left( \frac{QH}{2}, \frac{QI}{QH + QQ} \right) \right\}
\]

where \(a_0^I = 0, a_1^I = 1\) means informed traders hold position 0 at period 0 and send an order to buy at price not higher than \(v_0\) at period 1; \(a_0^I = 0, a_1^I = -1\) means informed traders hold position 0 at period 0 and send an order to sell at price not lower than \(v_0\) at period 1.

Since \(P_1 < v_0 + P_1^* \implies p^{**} > \frac{1}{2} > 1 - p^{**},\)

\[
E[\pi_I (a_0^I = 0, a_1^I = -1) | \{0\}, v_0 < P_1 < v_0 + P_1^*]
> E[\pi_I (a_0^I = 0, a_1^I = 1) | \{0\}, v_0 < P_1 < v_0 + P_1^*]
\]

when \(P_1 > v_0 + P_1^*,\)

\[
E[\pi_I (a_0^I = 0, a_1^I = -1) | \{0\}, P_1 > v_0 + P_1^*]
= p^{**} \left\{ \lambda \beta \left( QH - \frac{QI}{2} \right) \right\}
\]

and

\[
E[\pi_I (a_0^I = 0, a_1^I = 1) | \{0\}, P_1 > v_0 + P_1^*]
= (1 - p^{**}) \left\{ \lambda \beta \left( QH - \frac{QI}{2} \right) \right\}
\]

Since \(P_1 > v_0 + P_1^* \implies p^{**} > \frac{1}{2} > 1 - p^{**} \implies p^{**} > \frac{1}{2},\)

\(E[\pi_I (a_0^I = 0, a_1^I = -1) | \{0\}, P_1 > v_0 + P_1^*] > E[\pi_I (a_0^I = 0, a_1^I = 1) | \{0\}, P_1 > v_0 + P_1^*]\) for sure.

when \(P_1 < v_0,\)

\[
E[\pi_I (a_0^I = 0, a_1^I = -1) | \{0\}, v_0 < P_1 < v_0 + P_1^*]
= p^{**} \left\{ \lambda \beta \left( \frac{QH}{2}, \frac{QI}{QH + QQ} \right) \right\}
\]

and
\[ E[\pi_I (a_0^I = 0, a_1^I = 1) \mid \{0\}, v_0 < P_1 < v_0 + P^*_1] = (1 - p^{**}) \left\{ \lambda \beta \left( \frac{QQ_H}{2}, \frac{QQ_I}{QQ_I + QQ_H} \right) \right\} \]

Since \( p^{**} > \frac{1}{2} > 1 - p^{**} \),

\[ E[\pi_I (a_0^I = 0, a_1^I = -1) \mid \{0\}, v_0 < P_1 < v_0 + P^*_1] < E[\pi_I (a_0^I = 0, a_1^I = 1) \mid \{0\}, v_0 < P_1 < v_0 + P^*_1] \]

So, if receiving signal \( \{0\} \), informed traders long at price not higher than \( v_0 \) at period 1 if \( P_1 \) is lower than \( v_0 \) and short at price not lower than \( v_0 \) at period 1 if \( P_1 \) is higher than \( v_0 \). Please note that informed traders send limit order with limit price \( v_0 \) because they have perfect information about stock value. Therefore, the probability that informed traders can executive their orders is \( \frac{QQ_I}{QQ_I + QQ_H} \) if they send their orders together with hybrid traders.
Appendix B

Proof of Proposition

Within this group, we suppose every trader can only recognize another trader's type is higher or lower than hers. And we also assume the number of informed traders $Q_I$ is small enough that momentum traders' inference from number of posts cannot change their expectation about the states and thus do not change our equilibrium.

It is easy to show informed traders better off by posting truthfully in state $\omega^-$ and $\omega^+$:

$$E[\pi_I (a_0^I = 1, b_0^I = n, a_1^I = 1, b_1^I = n) | \{+\}]$$

$$= E[\pi_I (a_0^I = -1, b_0^I = n, a_1^I = -1, b_1^I = n) | \{-\}]$$

$$= \lambda \left( \frac{QQ_I}{2} + \frac{QQ_H}{2} \right) + \beta \cdot \Pr[\varepsilon > P_{1}^{++} - \lambda (QQ_I + QQ_H)] \cdot (\lambda QQ_M)$$

$$+ \beta^2 \left[ \tilde{\nu} - \lambda (QQ_I + QQ_H + \Pr[\varepsilon > P_{1}^{++} - \lambda (QQ_I + QQ_H)] QQ_M) \right]$$

$$= \beta^2 \tilde{\nu} + \lambda \left( \frac{QQ_I}{2} + \frac{QQ_H}{2} \right) (1 - 2\beta^2) + \lambda \beta QQ_M (1 - \beta) \left[ 1 - \Phi \left( \frac{P_{1}^{++} - \lambda (QQ_I + QQ_H)}{\sigma_{\varepsilon}} \right) \right]$$

Since $\beta < 1$,

$$E[\pi_I (a_0^I = 1, b_0^I = l, a_1^I = 1, b_1^I = n) | \{+\}] = E[\pi_I (a_0^I = -1, b_0^I = s, a_1^I = -1, b_1^I = n) | \{+\}] | \{-\}]$$

$$> E[\pi_I (a_0^I = 1, b_0^I = n, a_1^I = 1, b_1^I = n) | \{+\}] = E[\pi_I (a_0^I = -1, b_0^I = n, a_1^I = -1, b_1^I = n)$$

Thus, we can conclude informed traders $S_I$ always post truthfully in state $\omega^-$ and $\omega^+$ after building their positions because of the time discount factor.

And informed traders also better off in state $\omega^0$.

$$E[\pi_I (a_0^I = 0, b_0^I = n; a_1^I = -1) | \{0\} , b_0^H = l, P_1 > v_0 - P_{1}^{**}]$$

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\[ E[\pi_I(a_0^I = 0, b_0^I = n; a_1^I = 1) | \{0\}, b_0^H = s, P_1 < v_0 + P_1^{**}] \]

\[ = \Pr[P_1 > v_0 + P_1^*] \cdot \left\{ \lambda \beta \left( \frac{QQ_H - Q_H + Q_M - \frac{QQ_I + Q_H}{2}}{2} \right) \right\} \]

\[ + \Pr[v_0 < P_1 < v_0 + P_1^*] \cdot \left\{ \lambda \beta \left( \frac{QQ_H + Q_M}{2} \cdot \frac{QQ_I}{QQ_I + Q_H} \right) \right\} \]

\[ + \Pr[v_0 - P_1^{**} < P_1 < v_0] \cdot \left\{ \lambda \beta \left( \frac{QQ_H + Q_M}{2} \cdot \frac{Q_I}{Q_I + Q_H} \right) \right\} \]

\[ = \Phi \left( \frac{P_1^* - \lambda QQ_H}{\sigma_\varepsilon} \right) \cdot \left\{ \lambda \beta \left( \frac{QQ_H - Q_H + Q_M - \frac{QQ_I + Q_H}{2}}{2} \right) \right\} \]

\[ + \left[ \Phi \left( \frac{-\lambda QQ_H}{\sigma_\varepsilon} \right) - \Phi \left( \frac{P_1^* - \lambda QQ_H}{\sigma_\varepsilon} \right) \right] \cdot \left\{ \lambda \beta \left( \frac{QQ_H + Q_M}{2} \cdot \frac{QQ_I}{QQ_I + Q_H} \right) \right\} \]

\[ + \left[ \Phi \left( \frac{-P_1^{**} - \lambda QQ_H}{\sigma_\varepsilon} \right) - \Phi \left( \frac{-\lambda QQ_H}{\sigma_\varepsilon} \right) \right] \cdot \left\{ \lambda \beta \left( \frac{QQ_H + Q_M}{2} \cdot \frac{Q_I}{Q_I + Q_H} \right) \right\} \]

Without the communication group,

\[ \Pr \{ S_H = \{+0\} | P_1, \omega^0 \} \]

\[ = \phi \left( \frac{P_1 - v_0 - \lambda QQ_H}{\sigma_\varepsilon} \right) \cdot \frac{1}{2} \cdot (1 - 2p) + \phi \left( \frac{P_1 - v_0 + \lambda QQ_H}{\sigma_\varepsilon} \right) \cdot \frac{1}{2} \cdot (1 - 2p) \]

\[ \triangleq p^{**} \]

\[ E[\pi_I(a_0^I = 0, a_1^I = -1) | \{0\}, P_1 > v_0] \]

\[ = E[\pi_I(a_0^I = 0, a_1^I = 1) | \{0\}, P_1 < v_0] \]

\[ = p^{**} \left\{ \Pr[v_0 < P_1 < v_0 + P_1^*] \cdot \lambda \beta \left( \frac{QQ_H}{2} \cdot \frac{QQ_I}{QQ_I + Q_H} \right) \right\} \]

\[ + \Pr[P_1 > v_0 + P_1^*] \cdot \lambda \beta \left( \frac{QQ_H - \frac{QQ_I}{2}}{2} \right) \right\} \]

\[ = p^{**} \left\{ \left[ \Phi \left( \frac{P_1^* - \lambda QQ_H}{\sigma_\varepsilon} \right) - \Phi \left( \frac{-\lambda QQ_H}{\sigma_\varepsilon} \right) \right] \cdot \lambda \beta \left( \frac{QQ_H}{2} \cdot \frac{QQ_I}{QQ_I + Q_H} \right) \right\} \]

\[ + \Phi \left( \frac{P_1^* - \lambda QQ_H}{\sigma_\varepsilon} \right) \cdot \lambda \beta \left( \frac{QQ_H - \frac{QQ_I}{2}}{2} \right) \right\} \]

Obviously,

\[ E[\pi_I(a_0^I = 0, b_0^I = n; a_1^I = -1) | \{0\}, b_0^H = l, P_1 > v_0 - P_1^{**}] \]
\[ E[\pi_I (a_0^T = 0, b_0^H = n; a_1^T = 1) | \{0\}, \pi^H_0 = s, P_1 < v_0 + P^*] \]
\[ > E[\pi_I (a_0^T = 0, a_1^T = -1) | \{0\}, P_1 > v_0] \]
\[ = E[\pi_I (a_0^T = 0, a_1^T = 1) | \{0\}, P_1 < v_0] \]

In the cases \( \{0\}, P_1 < v_0 - P^* \) and \( \{0\}, P_1 > v_0 + P^* \), inside informed traders take the same action and make the same profits as outside informed traders.

Therefore, informed traders always better off within the group.

For momentum traders \( S_M \),

\[
Pr[\omega^+|b_0^M = l, P_1] = \frac{Pr[P_1|\omega^+] \cdot Pr[\omega^+|l]}{Pr[P_1|\omega^+] \cdot Pr[\omega^+|l] + Pr[P_1|\omega^0] \cdot Pr[\omega^0|l] + Pr[P_1|\omega^-] \cdot Pr[\omega^-|l]} 
\]
\[
= \frac{1 \cdot p + \frac{1}{2} \cdot (1 - 2p) + 0}{2p} 
\]

\[
Pr[\omega^+|b_0^M = l, P_1] = 1 - p^* \text{, } Pr[\omega^-|b_0^M = l, P_1] = 0. 
\]

Thus, the posts in the group help momentum traders exclude one state. With others’ posts, momentum traders attain the same informative signal as outside hybrid traders.
\[ E[\pi_M (a_0^M = 0, a_1^M = 1) | b_1^{-M} = l, P_1] \]
\[ = p^* 0 + \beta \lambda \left( \frac{Q_M}{2} + \Pr [P_1 > v_0 + P_1^{**}] \cdot \frac{QQ_M - Q_M}{2} \right) \]
\[ + \beta^2 \left[ \tilde{v} - \lambda (QQ_I + QQ_H + Q_M + \Pr [P_1 > v_0 + P_1^{**}] \cdot (QQ_M - Q_M)) \right] \]
\[ + (1 - p^*) \left\{ 0 + \beta \lambda \left( \frac{Q_M}{2} + \Pr [P_1 > v_0 + P_1^{**}] \cdot \frac{QQ_M - Q_M}{2} \right) \right\} \]
\[ + \beta^2 \lambda - Q_M - \Pr [P_1 > v_0 + P_1^{**}] \cdot (QQ_M - Q_M) \]
\[ = \lambda \beta \frac{QQ_M}{2} (1 - 2 \beta) + \beta \lambda \frac{QQ_M - Q_M}{2} (1 - 2 \beta) \left[ 1 - \Phi \left( \frac{P_1^{**} - \lambda QQ_H}{\sigma_\varepsilon} \right) \right] \]
\[ + p^* \left\{ \beta^2 [\tilde{v} - \lambda (QQ_I + QQ_H)] \right\} \]
\[ + \beta \lambda \frac{QQ_M - Q_M}{2} (1 - 2 \beta) \left[ \Phi \left( \frac{P_1^{**} - \lambda QQ_H}{\sigma_\varepsilon} \right) - \Phi \left( \frac{P_1^{**} - \lambda (QQ_I + QQ_H)}{\sigma_\varepsilon} \right) \right] \]
\[ E[\pi_M (a_0^M = 0; a_1^M = 1) | b_1^{-M} = l, P_1] > E[\pi_M (a_0^M = 0; a_1^M = 0) | l, P_1] = 0 \]
\[ \implies p^* > \frac{\lambda \beta \frac{QQ_M}{2} (1 - 2 \beta) + \beta \lambda \frac{QQ_M - Q_M}{2} (1 - 2 \beta) \left[ 1 - \Phi \left( \frac{P_1^{**} - \lambda QQ_H}{\sigma_\varepsilon} \right) \right]}{\beta^2 [\tilde{v} - \lambda (QQ_I + QQ_H)] + \beta \lambda \frac{QQ_M - Q_M}{2} (1 - 2 \beta) \left[ \Phi \left( \frac{P_1^{**} - \lambda QQ_H}{\sigma_\varepsilon} \right) - \Phi \left( \frac{P_1^{**} - \lambda (QQ_I + QQ_H)}{\sigma_\varepsilon} \right) \right]} \]
\[ \implies P_1 > v_0 + P_1^{**} \]
where \( P_1^* < P_1^{***} < P_1^{**} \).

Inside momentum traders are better off within the group because of more information.

For hybrid traders,

\[ E \left[ \pi_H (a_0^H = 1, b_0^H = l; a_1^H = 1) | \{+, 0\} \cdot b_1^H = l \right] \]
\[ = E \left[ \pi_H (a_0^H = -1, b_0^H = s; a_1^H = -1) | \{-, 0\}, b_0^H = s \right] \]
\[ = \lambda \frac{QQ_I + QQ_H}{2} + \beta \lambda QQ_M + \beta \lambda \cdot (QQ_M - Q_M) \cdot \Pr [\varepsilon > P_1^{**} - \lambda (QQ_I + QQ_H)] \]
\[ + \beta^2 \left[ \tilde{v} - \lambda (QQ_I + QQ_H + Q_M + \Pr [\varepsilon > P_1^{**} - \lambda (QQ_I + QQ_H)] (QQ_M - Q_M)) \right] \]
\[ = \beta^2 \tilde{v} + \lambda \left( \frac{QQ_I}{2} + \frac{QQ_H}{2} \right) (1 - 2 \beta^2) + \lambda \beta QQ_M (1 - \beta) \left[ 1 - \Phi \left( \frac{P_1^{**} - \lambda (QQ_I + QQ_H)}{\sigma_\varepsilon} \right) \right] \]
In the two cases \( \{+, 0\}, b_1' = n, P_1 > v_0 - P_1^{**}\) and \( \{-, 0\}, b_1' = n, P_1 > v_0 + P_1^{**}\), insider hybrid traders attain the same payoffs as outside hybrid traders.

Obviously, in all the three states, inside hybrid traders are better off within the group.
## Table 1

### Signals and States

<table>
<thead>
<tr>
<th>Trader $i$</th>
<th>Signal $\theta_i$ at $t = 0$</th>
<th>state $\omega^+$ $F = \theta_i + \bar{v}$</th>
<th>state $\omega^-$ $F = \theta_i - \bar{v}$</th>
<th>state $\omega^0$ $F = \theta_i$</th>
</tr>
</thead>
<tbody>
<tr>
<td>$S_I$</td>
<td></td>
<td>${+}$</td>
<td>${-}$</td>
<td>${0}$</td>
</tr>
<tr>
<td>$S_H$</td>
<td>${0,+}$</td>
<td>${0,-}$</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$S_M$</td>
<td>${+,0,-}$</td>
<td>${+,0,-}$</td>
<td>${+,0,-}$</td>
<td></td>
</tr>
</tbody>
</table>
Table 2
Summary of Posts and Trades

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Year:</strong></td>
<td>2000</td>
</tr>
<tr>
<td><strong>Number of posts</strong></td>
<td>77,712</td>
</tr>
<tr>
<td><strong>Trades</strong></td>
<td>3,658</td>
</tr>
<tr>
<td><strong>Number of Posters</strong></td>
<td>2,184</td>
</tr>
<tr>
<td><strong>Overall Profits</strong></td>
<td>$349,578.10</td>
</tr>
<tr>
<td><strong>Profit Per Trade</strong></td>
<td>$135.06</td>
</tr>
<tr>
<td><strong>% Profitable</strong></td>
<td>52.82%</td>
</tr>
</tbody>
</table>
Table 3
Empirical Tests

<table>
<thead>
<tr>
<th>Hypothesis</th>
<th>Dep. Var.</th>
<th>$\pi_j$</th>
<th>$\pi^-_j$</th>
<th>$\pi^+_j$</th>
<th>$R^2$</th>
</tr>
</thead>
<tbody>
<tr>
<td>H1 A</td>
<td>$TRP_j$</td>
<td>11.624</td>
<td></td>
<td></td>
<td>6.2%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(2.61)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>H1 B</td>
<td>$TRP_j$</td>
<td></td>
<td>$-15.371$</td>
<td></td>
<td>3.1%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(-2.02)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>H2a</td>
<td>$F_j$</td>
<td>$-0.974$</td>
<td></td>
<td></td>
<td>9.2%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(-2.27)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>H2b</td>
<td>$\pi_j^{(f)} - \pi_j^{(nf)}$</td>
<td>$-2.152$</td>
<td></td>
<td></td>
<td>38.1%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(-5.60)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>H3</td>
<td>$F_{-j}$</td>
<td>0.062</td>
<td></td>
<td></td>
<td>17.9%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(2.73)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

In H1, we limit the sample to traders with more than 1 trade and more than 10 posts and exclude 6 traders on the tails of profit/trade, including high&mid skill level traders whose profits are between -4 and 0.1 in H1A and low&mid skill level traders whose profits between -0.1 and 4 in H1B. In H2, we include only those who follow more than 1 time. In H3, we limit the sample to traders who are followed by others more than once but not always been followed.
Figure 1
Price Path

State \( \omega \): Price Path

<table>
<thead>
<tr>
<th>Time</th>
<th>s=0</th>
<th>s=1</th>
<th>s=2</th>
<th>s=3</th>
</tr>
</thead>
<tbody>
<tr>
<td>V 1</td>
<td>( + )</td>
<td>( \epsilon )</td>
<td>( + )</td>
<td>( \epsilon )</td>
</tr>
<tr>
<td>V 2</td>
<td>( \epsilon )</td>
<td>( + )</td>
<td>( \epsilon )</td>
<td>( + )</td>
</tr>
</tbody>
</table>

Signal

\( V_1 \) depends on orders at period \( s=0 \)
\( V_2 \) depends on orders at period \( s=1 \)

Information release
Figure 2(a)
Price Path Without the Chatroom

State $\omega^+ : S_I : \{+\}; S_H : \{+, 0\}; S_M : \{+, 0, -\}$;

Case I:

Time

Information release

Case II:

Time

Information release

Case III:

Time

Information release

Case IV:

Time

Information release

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Figure 2(b)
Price Path Without the Chatroom
State $\omega^0: S_I: \{0\}; S_H: \{+, 0\}; S_M: \{+, 0, -\};$

Case I:

<table>
<thead>
<tr>
<th>s=0</th>
<th>s=1</th>
<th>s=2</th>
<th>s=3</th>
</tr>
</thead>
<tbody>
<tr>
<td>$\uparrow$</td>
<td>$\uparrow$</td>
<td>$\uparrow$</td>
<td>$\uparrow$</td>
</tr>
<tr>
<td>Information release</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Case II:

<table>
<thead>
<tr>
<th>s=0</th>
<th>s=1</th>
<th>s=2</th>
<th>s=3</th>
</tr>
</thead>
<tbody>
<tr>
<td>$\uparrow$</td>
<td>$\uparrow$</td>
<td>$\uparrow$</td>
<td>$\uparrow$</td>
</tr>
<tr>
<td>Information release</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Case III:

<table>
<thead>
<tr>
<th>s=0</th>
<th>s=1</th>
<th>s=2</th>
<th>s=3</th>
</tr>
</thead>
<tbody>
<tr>
<td>$\uparrow$</td>
<td>$\uparrow$</td>
<td>$\uparrow$</td>
<td>$\uparrow$</td>
</tr>
<tr>
<td>Information release</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Figure 2(c)
Price Path Without the Chatroom
State $\omega^0 : S_I : \{0\} ; S_H : \{+, 0\} ; S_M : \{+, 0, -\}$;

Case IV:

Case V:
Figure 3(a)
Price Path With the Chatroom

State $\omega^+: S_I: \{+\}; S_H: \{+, 0\}; S_M: \{+, 0, -\};$

Case I:

Case II:

Case III:
Figure 3(b)
Price Path With the Chatroom

State $\omega^+ : S_I : \{+\}; S_H : \{+ , 0\}; S_M : \{+ , 0 , -\}$;

Case IV:

```
   Time

<table>
<thead>
<tr>
<th>s</th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
</tr>
</thead>
<tbody>
<tr>
<td>U</td>
<td>n</td>
<td>1</td>
<td>s</td>
<td></td>
</tr>
<tr>
<td>I</td>
<td>n</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>U</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
```

Information release

```
   Time

<table>
<thead>
<tr>
<th>s</th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
</tr>
</thead>
<tbody>
<tr>
<td>U</td>
<td>n</td>
<td>1</td>
<td>s</td>
<td></td>
</tr>
<tr>
<td>I</td>
<td>n</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>U</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
```

Information release

Case V:

```
   Time

<table>
<thead>
<tr>
<th>s</th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
</tr>
</thead>
<tbody>
<tr>
<td>U</td>
<td>n</td>
<td>1</td>
<td>s</td>
<td></td>
</tr>
<tr>
<td>I</td>
<td>n</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>U</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
```

Information release

```
   Time

<table>
<thead>
<tr>
<th>s</th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
</tr>
</thead>
<tbody>
<tr>
<td>U</td>
<td>n</td>
<td>1</td>
<td>s</td>
<td></td>
</tr>
<tr>
<td>I</td>
<td>n</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>U</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
```

Information release

Case VI:

```
   Time

<table>
<thead>
<tr>
<th>s</th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
</tr>
</thead>
<tbody>
<tr>
<td>U</td>
<td>n</td>
<td>1</td>
<td>s</td>
<td></td>
</tr>
<tr>
<td>I</td>
<td>n</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>U</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
```

Information release

```
   Time

<table>
<thead>
<tr>
<th>s</th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
</tr>
</thead>
<tbody>
<tr>
<td>U</td>
<td>n</td>
<td>1</td>
<td>s</td>
<td></td>
</tr>
<tr>
<td>I</td>
<td>n</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>U</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
```

Information release

36
Figure 3(c)
Price Path With the Chatroom
State $\omega^0 : S_I : \{0\}; S_H : \{+, 0\}; S_M : \{+, 0, -\};$

Case I:

<table>
<thead>
<tr>
<th>State</th>
<th>Time</th>
</tr>
</thead>
<tbody>
<tr>
<td>$S$</td>
<td>$n$</td>
</tr>
<tr>
<td>$I$</td>
<td>$i$</td>
</tr>
<tr>
<td>$U$</td>
<td>$n$</td>
</tr>
</tbody>
</table>

Information release

Case II:

<table>
<thead>
<tr>
<th>State</th>
<th>Time</th>
</tr>
</thead>
<tbody>
<tr>
<td>$S$</td>
<td>$n$</td>
</tr>
<tr>
<td>$I$</td>
<td>$i$</td>
</tr>
<tr>
<td>$U$</td>
<td>$n$</td>
</tr>
</tbody>
</table>

Information release

Case III:

<table>
<thead>
<tr>
<th>State</th>
<th>Time</th>
</tr>
</thead>
<tbody>
<tr>
<td>$S$</td>
<td>$n$</td>
</tr>
<tr>
<td>$I$</td>
<td>$i$</td>
</tr>
<tr>
<td>$U$</td>
<td>$n$</td>
</tr>
</tbody>
</table>

Information release
Figure 3(d)
Price Path With the Chatroom
State $\omega^0: S_I: \{0\}; S_H: \{+, 0\}; S_M: \{+, 0, -\};$

Case IV:

Case V:

Case VI: