Executive Summary

There exist popular beliefs about certain simple trading strategies rumored to attain desirable outcomes. The common feature of these strategies is their liability to simplicity so any investor can apply them without any sophisticated calculation needed. In this study, two particular trading strategies are aimed to be analyzed regarding their utility to the investor. These are either to sell bad performing stocks early and to let the well performing ones run or to realize gains as soon as a stock hits the profit zone while letting losses run. What I intend to do is to test whether such a trading, based on a simple heuristic, can provide a superior outcome from an economic point of view.

Simple heuristics is a term originating from Gerd Gigerenzer's studies about bounded rationality and heuristics in decision making questioning convenient statistical principles like the conjunction rule or Bayes' rule to define normativity, i.e., sound reasoning. Gigerenzer's critiques are very conceptual based and argue against the suitability of the so called judgmental heuristics we know from Tversky and Kahneman. Hence, Section 2 is dedicated to give the reader a comprehensive overview of Gigerenzer's theories and how they are incorporated into scientific context. I provide a sketch of Gigerenzer's findings about fast and frugal heuristics and how he relates them to previous decision theories. I pay special attentions to his stock market example and provide a little summary on the evolution of economic theory since the late 1940s. At the end of the section I try explain how my trading strategy can be seen as a kind, or at least as a derivative of Gigerenzer's fast and frugal approach.

In Section 3 I show how I created the simulation model and how I incorporated the two trading strategies into it. Data generation, variable calibration or the underlying Markov process, as crucial factors of the model, are described with reasonable accuracy to let the reader understand how the model works.

Section 4 deals with the economic evaluation of the trading strategies considered. Based on mean-variance, prospect theory, and Value at Risk models measures of success are derived to figure out whether or not a simple trading strategy can attain superior results. As a kind of reference I introduce a buy and hold strategy and a strategy characterized by predefined best barriers so I can compare my initial two strategies to them. I tested every strategy under the condition of the economic states (upswing, downturn, and neutral) and of the investment horizon.

The results of my tests all point into the same direction; towards a simple buy and hold strategy to be the superior alternative. In any case the simple trading strategies perform worst. To predefine best barriers up front according to the economic state prevailing brings an improvement compared to the two initial strategies, occasionally even outperforming a buy and hold strategy, but it suffers from the curse of not knowing how long a certain economic state (expansion or downturn) will last ex-ante. The best barrier approach only sometimes has a superior outcome during economic contraction. This is due to the fact that we then are advised to sell our stocks very early and, hence, put all our money in a bank account. In a nutshell, to have no strategy is the best strategy.