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The Profitability of Day Traders

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Abstract

We used two distinct methodologies to examine the profitability of a sample of U.S. day traders. The results show that about twice as many day traders lose money as make money. Approximately 20 percent of sample day traders were more than marginally profitable. We found evidence that day-trader profitability is related to movements in the Nasdaq Composite Index.

A detailed study of the profitability of day traders is important for several reasons. First, day trading sparks widespread public interest because it is often perceived as an easy way to make money. Second, there are conflicting claims about day-trader profitability. Government agencies maintain that almost all day traders lose money, but the day-trading industry claims that 60 percent of day traders are profitable after an initial learning period. Neither side has sufficient evidence to support its claims.

We studied day-trading profitability by using data from February 1998 through October 1999 for seven branch offices of a national securities firm specializing in day trading. The original sample consisted of all orders sent by clients for each trading day. We extracted only the confirmed trades for analysis, and the final data set contained 324 individual day traders. We used two analytical techniques.

In the “trade-matching” methodology, we matched daily buy and sell trades (also buy and short-sell trades) by the number of shares of a given order number. In the “flat-stock” technique, we sorted data for a given trader by stock, then by date, and by time. A “trade” was defined any time the trader had a “flat” position (zero net position) in the stock. The premise behind both methodologies was that price times number of shares bought is a cash outflow and price times shares sold is a cash inflow.

We found that 116 traders (35.8 percent) had a net profit greater than zero after commissions and 208 traders (64.2 percent) had a net profit less than zero after commissions. Therefore, we found almost twice as many losing traders as winning traders in the data set. The most profitable trader made more than $197,000, and the least profitable trader lost more than $748,000. The average gross profit for all traders was more than $8,000, whereas the average net profit was about –$750. Thus, transaction costs apparently preclude earning an excess profit in most cases.

The results also showed that 35.8 percent of traders made a positive net profit, 19.4 percent made more than $5,000, and 14.2 percent made more than $10,000. These figures contrast with the 64.2 percent of traders who had negative net profits, the 25.0 percent who lost at least $5,000, and the 13.0 percent who lost more than $10,000. More than 35 percent of sample traders at least broke even, and about one out of five made more than $5,000. The implication is that, in spite of the fact that making a profit by day trading is indeed difficult, the odds against being profitable are not overwhelming.

Conventional Wall Street wisdom holds that day traders, in general, are profitable when the overall market is up (or, more specifically, when the Nasdaq Composite is up, because the vast majority of the trades in the study involve technology stocks) and lose money when the market (the Nasdaq) is down. To test this idea, we regressed overall trader profitability against movements in the Nasdaq Composite. We found, consistent with conventional wisdom, a significant positive relationship between movements in the Nasdaq and trader profitability.

The main results of this analysis can be summarized as follows:

- About twice as many day traders lose money as make money.
- About one trader in five is more than marginally profitable.
- Statistical evidence supports the notion that day-trader profitability is related to movements in the Nasdaq.

The fact that at least 64 percent of the day traders in this study lost money suggests that being a profitable day trader is more difficult than the industry maintains. The implication is that aspiring and novice day traders should give careful consideration to why they think they will be among the 20 percent of day traders who make at least $5,000 day trading. At a minimum, novice day traders should make sure they have enough initial capital to survive the three- to five-month learning period that the industry suggests is necessary to become successful.