Behavioural finance summative assignment

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We have all came across situations which we lean to becoming overconfident when answering arduous questions and unconfident when answering relatively easier ones. Overconfidence is one behaviour of mankind, and it is becoming increasingly difficult to ignore its importance on particular areas of work, as discovered by psychologists, ranging from engineers to surgeons. For the purpose of this paper, we are peculiarly interested in its impact on overtrading in financial markets, especially when investors and traders are overconfident in making judgements and decisions.

First things first, what are the key characteristics of an overconfident person? Overconfidence stems from the research findings of cognitive psychology, given the fact that it is hard to imagine how things will progress and people lacking the ability to foresee developments, they become excessively dependent on heuristics and tend to know they know better than they do. American psychologist Daniel Kahneman has more or less proven this level of self-confidence and optimism a cognitive bias when he finds out people, especially investors, are inclined to having poor estimates of probability events, with a trend of overestimating the possibility of occurrence of small probability events whilst underestimating those of high probability ones. This miscalibration suggests people are overestimating their abilities to complete particular tasks.

On the other hand, regarding as the confirmation bias, overconfident people are seemingly to overestimate prominent and compelling information when making decisions, especially those which are consistent with their existing beliefs. The nature of information affects behaviour; Evidence suggests people overreact to lively scenarios and information which supports certain ideas, whilst for opinions supported by strong or statistical probabilistic information, people usually underestimate it and react. Also, people's conservative nature has a learning towards gathering consensus information which supports their beliefs and ignore those that do not (Edwards et al., 1968). Even when contrary evidence exists, it's still very difficult to change their opinions. For these variety of reasons, overconfident people are very likely to underestimate risks.

Next, with an expectation of having a better probability of good things happening to themselves higher than that happening to the others (Cooper, Woo & Dunkelberg, 1988), this unrealistic illusion is presumably to make overconfidence people think that they have to ability to control over an outcome and outperform the market. In such way, they usually exaggerate the accuracy of their predictions, especially in situations when their predicted outcome occurs, they are biased to overestimate their roles. Daniel, Hirshleifer and Subrahmanyam (1998) had further looked into the matter, and they argued that winners love to attribute their successes to their personal abilities whilst failures to uncontrollable factors such as hard luck or accidents, and this self-attribution bias is likely to true reason of what really makes them overconfident.

As traders or investors, there are advantages of being overconfident. Through staying optimistic and having a sense of superiority, the group are working towards a direction of addressing problems more comprehensively and have a great chance of attaining goals or clientele tasks in a much smoother way. However, this characteristic can also certainly affect the financial markets as a whole.

One basic assumption of any economic model would presume every single individual in the market is rational. Under rational behaviour, people trade for various reasons such as the rebalancing of portfolios, tax-loss selling or liquidity needs etc. (Odean, 1999). Also, there are only very few on-going transactions in the financial markets as investors would be reluctant to buy the securities that another investor would throw with their risk-averse nature.

Yet, in reality, the modern environment is very complex and filled with countless uncertainties. While facing various sources of information, one's behaviour can easily deviate and behave irrationally. Overconfidence people do lie among this criterion and they are considered to be risk-neutral or even risk-loving. Behavioural Finance explains this particular overconfidence aspect of people are most found when they are making decisions, notably when the human brain has a maximum capacity to process information and people having emotions, irrational people would then start to act in an overconfident way. Overconfidence is likely to lead to disagreements among investors, and one major consequence is the occurrence of overtrading.

When investors are overconfident, the volume of transactions in the market will increase. Barber and Odean (2000) have looked into the relationship between high stock turnover and portfolio returns and first suggested that institutional investors and bankers should be able to outperform the market buy-and-hold strategies through their information sources. However, results from the study conducted using brokerage data have proven them wrong when it was found that there are no additional returns for extra efforts. In virtue of their nature, overconfident investors would frequently trade in financial markets, and even more often using the proceeds of their transactions or expected returns. Dow and Gorton (1997) discovered the fact that the daily volume of world foreign exchange is about one-fourth of the sum of global trade and annual investment flows. (Baike. baidu. com, 2018)

This irrational behaviour of having more trades would then equal to higher transaction costs and commission fees, and with the same amount invested, after liquidity demand, risk management and taxation effects had been factored in, it was found that the low turnover group had achieved a 18. 5% return on their investment while the high turnover group had only achieved a 11. 4% return, with the average annual gross returns of all groups was 18. 7%. (Barber and Odean, 2000) Eventually, trading more with poor stock selections would mean the investment income would be lower, expounding Shriller’s comments made in 1999 of trading is hazardous to your wealth.

Barber and Odean (2001) further did a research using a 6-year trading habit data between 1991 to 1997, based on the gender of investors. Men are assumed to be more confident in tasks which they perceive being masculine such as sports, leadership and getting along with others etc. Analysis was based on the annual trading volume as an indicator of overconfidence, and it was found that throughout the 38, 000 households investigated, the stock turnover rate was greatest among single men, followed by married men, married women and single women in that order, indicating male are overall more overconfident than female, as consistent findings have proven, which men have relatively high quantity of high risk stocks inside their under diversified portfolio combinations.

At the end of this research period sees the rise of switching from telephone trading to online trading, and this shift further increases men's overconfidence, based on the belief the Internet can provide vast amounts of current and past information and help improve their returns. Lacking the relevant training and experience, individual investors looked onto information from online analysts, news groups and chatrooms for expert trading tips. Dewally (2003) had analysed the recommendations posted on the message boards and found that those recommendations were overwhelmingly positive, based on a momentum basis. With being overconfident, investors purchased these stocks based on these tips. However, it was found that trading on the basis of these tips didn't product a significant return compared to the market and the conclusion was made of no information value from such recommendations; These do increase trading volumes but not returns. (Tumarkin and Whitelaw, 2001)

Not only did men trade more, but also failing at timing the market through buying and selling at the wrong time. A US research conducted in 1987 had also further implied that investors' annual investment transaction costs have accounted for 17. 8% of their annual earnings and based on these two assumptions, we can further confirm that overtrading would only mean further losses.

To sum up, the following conclusions can be drawn from the present study. Based on several findings, investors can be overconfident over their abilities to control, their knowledge as well as future prospects, and among those, it was found that men in particular, do stand out in the gender of being overconfident. People do have a limited capacity to process information and have different emotions, and overconfidence people are likely to act irrationally when faced with such kind of pressure and start to make arguments between investors, leading them to excess trading. However, past researches have come to a consensus of more trading doesn’t necessarily mean more profitable returns.

In fact, investors are more likely to have lower returns due to the transaction fees and commissions associated with trading as well as their poor stock selections. Because of these investors’ risk-loving nature, they tend to pick high risk stocks on online tips in the hope of better returns, but past history has proven this are likely to be impossible since their portfolios aren’t diversified enough and the risks that come along. To avoid overconfidence, investors should always bear in mind that no investment technique is perfect (Phung and Reiff, n. d.) and should find one which is suitable for his own needs, and in such way, this wouldn’t lead to excess trading and the disadvantages that come along.

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