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Professionals' endorsement of behavioral finance: Does it impact their perception of markets and themselves?

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ABSTRACT

This paper provides evidence on the hypothesis that many behavioral finance patterns are so deeply rooted in human behavior that they are difficult to overcome by learning. We test this on a target group which has undoubtedly very strong incentives to learn efficient behavior, i.e. fund managers. We split this group into endorsers and non-endorsers of behavioral finance. Endorsers do, indeed, view markets differently as they regard stronger influences from behavioral biases. However, when it comes to the perception of one's own behavior the endorsement of behavioral finance becomes almost meaningless, even though endorsers otherwise do adapt behavior towards their conviction.

1. Introduction

The history of many anomalies in financial markets has shown that they disappear over time (Fama, 1998). This has raised the suspicion that markets may need time to recognize such anomalies – which largely motivate behavioral finance – but that they react consequently afterwards. According to this view one may assess behavioral finance being largely concerned with transitory phenomena. Others argue that many behavioral finance patterns are so deeply rooted in human behavior that they are difficult to overcome by learning (Alpert and Raiffa, 1982; Fischhoff, 1982b; Tversky and Kahneman, 1982, and more recently Hirshleifer, 2001). Obviously, these two views make contrary predictions on the persistence of behavioral phenomena although both camps agree that in the long run fundamentals drive prices. If rational learning is dominant then one could expect that insights into behavioral finance impact one's own behavior. If, however, learning mechanisms are weak in this respect the insights into behavioral finance will have a minor impact on one's own behavior. We provide a test of these competing views and find evidence in support of the latter hypothesis put forward by psychologists working in behavioral decision-making and more recently by behavioral economists.[1]

Our research aims for extending literature in psychology which has clearly revealed the "bias blind spot" (Pronin et al., 2002), i.e. the belief that one's own judgments are less susceptible to biases than the judgments of others.[2] We extend this

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[1] Nowadays it is widely accepted that behavioral finance builds on two concepts, i.e. "investor psychology" and "limits to arbitrage" (see Shleifer and Summers, 1990; Barberis and Thaler, 2003).

[2] This asymmetry arises from the stance of "naive realism" as well as from different strategies people apply to detect bias in own judgments versus the judgments of others (Pronin et al., 2004; see also Ehrlinger et al., 2005). Recent research in this line includes adding individual's self-image to the utility function (Johansson-Stenman and Martinsson, 2006).

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research by addressing an important objection that economists might voice against evidence based on student surveys: The probability that behavioral biases hold depends on how strong incentives are to learn and thus to overcome entrenched behavior. One can easily imagine circumstances where people adhere to behavioral patterns as forecast by behavioral finance just because their welfare is not at stake. It seems therefore advisable for an empirical examination of the hypothesis put forward by psychologists and behavioral economists to choose a target group that has undoubtedly strong incentives to learn. We have thus targeted professional fund managers. Their investment performance is on the one hand negatively affected by behavioral biases (see e.g. Shefrin and Statman, 1985; Coval and Shumway, 2005; Biais and Weber, 2007) and on the other permanently monitored and linked to high performance-related bonuses. Among these fund managers we differentiate between "endorsers" of behavioral finance and others, who we call "non-endorsers".

Endorsers of behavioral finance are those fund managers who believe that the approach of behavioral finance truly reflects decision behavior in fund management (and who know the key messages of behavioral finance well). In contrast to them are non-endorsers, i.e. fund managers who are not that much convinced about the relevance of behavioral finance. We have surveyed more than 100 fund managers in Germany and classify them according to their self-assessment into these two groups. We then analyze whether fund managers' endorsement of behavioral finance, i.e. being an "endorser", impacts their perception of markets and themselves: do these groups respond in the same way to questionnaire items addressing, first, their perception of general fund managers' behavior and, second, their perception of their own behavior with respect to issues being raised by behavioral finance research?

We find a revealing split in responses: whereas endorsers recognize significantly stronger behavioral finance effects in other fund managers' behavior than non-endorsers, the perception of their own behavior is largely unaffected by their insights. When endorsers are asked about their own behavior with respect to items being linked to behavioral finance, such as hindsight bias or disposition effect, they answer as non-endorsers do. However, there is one exception to this pattern: endorsers show less miscalibration with respect to forecasting the interval of a stock index. As less miscalibration here also means more correct answers, this suggests that endorsers' conviction of behavioral finance may increase awareness for respective distortions and can improve decisions to some extent.

In a final exercise, we analyze whether endorsers' assessment of their own behavior may reflect the fact that behavioral finance does not influence their decisions in any respect. Therefore, we ask whether endorsers differ from non-endorsers regarding two further items of investment behavior, i.e. their preferred information sources and investment strategies. We find that both groups seem to differ clearly in their use of information sources although not to a statistically significant extent. The difference becomes significant, however, with respect to preferred investment strategies as endorsers rely more on momentum and contrarian strategies. We conclude that endorsers do not generally behave like non-endorsers, making the above found indifference between both groups with respect to their self-assessment more credible.

Thus, we come back to the hypothesis – proposed by psychologists and behavioral economists – that many behavioral patterns are difficult to overcome by learning. Our findings provide support for his view as insight into behavioral finance and thus into the behavior of others does not easily change one's own behavior. We regard it as an important and innovative aspect of our research that this result has been found among fund managers because this target group has strong incentives to improve behavior. In this respect we also find a partial justification for Fama's (1998) optimism into learning processes in that the endorsement of behavioral finance reduces miscalibration.

The remaining study is structured into four sections. Section 2 describes data of the questionnaire survey. The following sections present our analyses, starting with views on the market's behavior (Section 3), then views on one's own behavior (Section 4) and, finally, consequences on investment behavior (Section 5). Section 6 concludes.

2. Data

This study is based on a questionnaire survey that addressed all relevant fund management companies in Germany between 15 August 2002 and 12 December 2002 and yielded a useful and largely representative sample.

In total, out of the 59 relevant fund management companies 35 participated in the survey, with at least one appropriate questionnaire each. This resulted in a response rate of 59 percent concerning participated fund management companies.[3]

To ensure the reliability of responses many intensive interviews with fund managers were conducted in advance of the survey. These interviews served to formulate questions in an appropriate manner. Furthermore, in later stages the questionnaire was used in a pre-test with several fund managers as a final check of its acceptance and appropriateness. Feedback indicates that the response is useful for our research purpose.

The descriptive statistics in Table 1 provide a picture of personal characteristics of the respondents in this survey. Accordingly, the mean of responding fund managers shows an age of about 35 years, has professional experience of 10 years, is of male gender, earns a bonus payment of 25 percent, has a university degree, works rather in a non-governing position, practices active fund management and manages stocks rather than bonds. This data is consistent with the information from similar surveys in Germany such as Menkhoff (1998) or Arnswald (2001).

As basis for the formation of groups our questionnaire contains two useful statements on behavioral finance, i.e. endorsement and knowledge of behavioral finance. These statements are given in Table 2 as BF1 and BF2, both of which are assessed

[3] The structure of this response is largely similar to the industry's structure. Our sample is representative in this sense (see Appendix A).