



Financial forecasts during the crisis: Were experts more accurate than laypeople?

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ABSTRACT

The main goal of this paper was to examine the accuracy and confidence of financial forecasts during the 2009/2010 crisis. The study was carried out in February 2009 in Poland. The participants represented two groups: financial analysts and laypeople (people without knowledge or skills in finance). All participants were asked to forecast future stock market performance and foreign exchange rates. Additionally, they marked their confidence on a 100-point scale. The results showed that the forecasts significantly differed from the real values. In forecasting both the stock market and the currency exchange market, the prediction error significantly differed from zero. Even if the participants were optimistic in making the directional stock market forecasts, they were pessimistic when making point index predictions, which suggests a judgmental paradox. The experts were slightly better than the non-experts in predicting the stock market. However, their accuracy was generally not better in the exchange market forecasts. The next step of the analysis focused on the confidence factor. The results of this part of the research showed that the laypeople were less confident than the experts in all the judgments.

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1. Introduction

The financial crisis that struck the world markets in the first decade of this century is considered by many economists as the worst crisis since the Great Recession of the 1930s. It caused countless negative consequences for the global economic system, leaving its mark also on the psychology of financial markets, i.e. the way people make their financial judgments (Akerlof & Shiller, 2009). For example, analysts who compare economic and psychological features of the crisis argue that making predictions has become much more difficult (El-Erian, 2008; Gärling, Kirchler, Lewis, & van Raaij, 2010). Kotler and Caslione (2009) claim that in 'the new economic reality', regular economic cycles are absent, and upturns (booms) or downturns (recessions) are unpredictable.

Therefore the main goal of the research presented in this paper was to examine both the accuracy and the confidence of financial forecasts produced by experts (financial analysts) and laypeople during the recent crisis. The fact that the study was conducted at the peak of the depression (February 2009) makes it unique among previous studies on financial forecasts, because almost all of them were carried out at bull market. To my best knowledge, only one study tested directly how the stock market crash caused by the September 11 terrorist attacks influenced financial predictions (Glaser & Weber, 2005). This

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might mean that at least some psychological effects associated with the stock market judgments that were discovered in empirical studies are specific to propitious economic conditions. One of the examples can be the overconfidence fallacy considered as a universal feature of different financial judgments (see Shefrin, 2000; Wärneryd, 2001; Zaleskiewicz, 2006, for a review). If people are aware that market predictability is lowered by the crisis they should forecast the market with limited confidence. Moreover, laypeople who have limited knowledge about the causes and consequences of the market downturn (as compared to experts) should be aware they are particularly prone to making erroneous financial forecasts.

The study presented in this paper has not been a pioneer attempt to test the correctness of financial beliefs. Several authors examined the accuracy of both choices and predictions made by stock market experts. Ericsson, Andersson, and Cokley (2005), who reviewed a large body of research on financial expertise, conclude that some professionals are able to make superior portfolio choices by identifying undervalued stocks. Likewise, Sundali and Atkins (1994) reported that security market experts *did* outperform both market averages and randomly thrown darts. On the other hand, classic and more recent analyses reveal that mutual funds employing skilled investment managers (experts) generally underperform the market (Jensen, 1968; Malkiel, 2003).

Research on financial forecasting seems to be more consistent in revealing that financial analysts do not make more accurate probabilistic forecasts of stock prices than people without knowledge about stock market (Stael von Holstein, 1972; Tyszka & Zielonka, 2002; Yates, McDaniel, & Brown, 1991; Önkal & Muradoglu, 1994). In a relatively recent study, Törngren and Montgomery (2004) compared the accuracy of the stock performance predictions in two groups: financial professionals and laypeople. While the average accuracy in the group of students was 51%, the mean correctness in the group of professionals equaled 40%. In other words, experts scored worse than chance.

The empirical background outlined above indicates that the quality of stock market forecasts produced by experts is rather low, which seems to support the assumptions of the efficient markets theory (Fama, 1991). However, this does not necessarily mean that judgments in all areas of finance are incorrect. Önkal, Yates, Sigma-Mugan, and Öztin (2003) compared the accuracy of forecasting exchange rates between expert traders and sophisticated amateurs. They found that professional accuracy usually surpassed non-expert accuracy. This result implies that differences between financial experts and laypeople may depend on the subject matter to be predicted and that professional judgments may be more successful for some markets than for others.

Financial experts are not an exception in committing forecasting errors. Empirical findings in the field of the psychology of expertise suggest that professionals representing different disciplines rarely generate predictions whose quality exceeds the accuracy of judgments made by laypeople (Camerer & Johnson, 1991). A large body of research demonstrated a poor quality of expert judgments in such fields as: sport (Andersson, Edman, & Ekman, 2005; Andersson, Memmert, & Popowicz, 2009), macroeconomics (Mills & Pepper, 1999), business (Aukutsioneck & Belianin, 2001) or politics (Tetlock, 2006). Quoting the title of the paper by Camerer and Johnson (1991), one might ask: "How can experts know so much and predict so badly?" Two different approaches are offered as a solution of this paradox (Shanteau, 1992). The first of them, typical for the field of behavioral decision making (Kahneman, Slovic, & Tversky, 1982), assumes that experts commit the same cognitive errors as novices and this is why they do not produce better predictions. Examples of such errors are: anchoring (Tversky & Kahneman, 1974) and non-mean-reverting expectations (Kahneman & Tversky, 1972). The second approach proposes that the limited quality of expert judgments might be determined by specific task characteristics (Shanteau, 1992). Professionals representing certain disciplines act in a very dynamic environment, where stimuli involve human behavior, and conditions are highly changeable and barely predictable. This last point seems to be confirmed by results showing that experts who work in a more stable environment, e.g., weathermen (Murphy & Winkler, 1984), are able to make judgments of relatively high accuracy. According to Shanteau (1992), people professionally associated with the stock market, e.g., financial analysts, represent a poorly predictable area. If this is true, the quality of financial forecasts, especially at the economic crisis, should be low.

The analysis presented in this paper focuses not only on the accuracy of predictions but also on the confidence of these predictions. Previous research showed that experts from different fields tend to make their judgments with too much confidence (Ayton, 1992; Bolger & Wright, 1992). However, some experts were found to be well-calibrated, which means that in their case the correlation between confidence and accuracy was both positive and high (Keren, 1987; Murphy & Winkler, 1984). This suggests that committing the error of overconfidence might be typical only for certain areas of expertise and depend either on the features of the expert discipline (Allwood & Granhag, 1999) or on the characteristics of the task that must be solved (Gigerenzer, Hoffrage, & Kleinbölting, 1991; Klayman, Soll, González-Vallejo, & Barlas, 1999). Research on financial expertise (e.g., Tyszka & Zielonka, 2002; Törngren & Montgomery, 2004) shows that low quality of financial forecasting is typically accompanied by overconfidence that leads to excessive trading and lower earnings (Barber & Odean, 2000). However, as mentioned above, these studies were carried out at the growth market, which might have increased the participants' self-assurance. Consequently, one could assume that if both experts and laypeople participating in the present research were aware of the difficult economic conditions for making their predictions, they should not be too confident of their judgments.

2. The research problem and research questions

The research presented in this paper focused on two problems: the accuracy and the confidence of financial judgments, as well as the comparison between professionals and laypeople. The four main research questions tested in the empirical study

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