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Overconfidence and delegated portfolio management [☆]

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ABSTRACT

We study the impact of overconfidence on investment decisions by financial institutions. These institutions are characterized by the delegation of investment decisions to portfolio managers and the design of contracts that aim at aligning managers' incentives with those of the institution. We show that when rational and overconfident agents acquire information of the same precision, overconfident agents trade *lower* quantities than rational agents. However, overconfidence also generates incentives to overinvest in information acquisition. In such cases, overconfident agents trade larger quantities and take more risk than rational agents. The direct consequence of these results is that, as far as delegated portfolio management is concerned, overconfidence generates high trading volumes only through over-acquisition of information. Based on psychological evidence that overconfidence is generated by a self-attribution bias, our results are consistent with recent empirical evidence about mutual fund managers' portfolio-rebalancing patterns and changes in mutual funds' advisory contracts.

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1. Introduction

It is widely acknowledged that some financial investment decisions are difficult to reconcile with fully rational behavior. Accordingly, the analysis of financial markets in the presence of irrational agents has received increasing attention over the last fifteen years. One form of irrational behavior studied extensively is overconfidence (see Kyle and Wang, 1997; Benos, 1998; Odean, 1998; Wang, 1998, 2001; Daniel et al., 1998, 2001; Caballé and Sákovics, 2003). A common feature of these models

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is that market participants are individual investors maximizing their expected utility of wealth given their beliefs. Furthermore, the common result is that overconfident investors hold riskier position/trade larger quantities than rational investors.

However, a large fraction of company stocks are held by financial institutions. As highlighted by Lewellen (2008), institutions held 68% of the US equity market at the end of 2007. Furthermore, (i) their investment strategies differ from those of individual investors (see Cohen, 1999; Grinblatt and Keloharju, 2000; Cohen et al., 2002; Ekholm and Pasternack, 2008); and (ii) recent empirical and experimental studies provide evidence of overconfidence on the side of professional investors (see, for example, Gort, 2007; Pütz and Ruenzi, 2008; Choi and Lou, 2008).¹ As a consequence, in order to analyze the impact of overconfidence on financial asset prices, one needs first to study how overconfidence influences the investment strategies of institutional investors.

A fundamental characteristic of financial institutions is the delegation of investment decisions to professional money managers. As a consequence of this delegation, agency conflicts may arise. Therefore, the institution will design a compensation contract aimed at mitigating conflicts of interest.

Faced with overconfident managers, the institution must also deal with the biases overconfidence may generate.² Hence, the institution will design a compensation contract that deals with both agency problems and biases associated with overconfidence.

In the end, the investment strategy of the manager will depend on his compensation contract. Therefore, in order to analyze how overconfidence influences institutional investments, one must endogenize compensation contracts and study investment strategies resulting from these endogenous contracts.

To address this issue, we analyze a delegated portfolio management problem in which a risk-averse financial institution (the principal) hires a risk-averse money manager (the agent) who may be of two types: rational or overconfident. By exerting effort, the agent acquires private information about the value of a risky asset. If the agent is rational, he updates his beliefs in a Bayesian fashion. However, if overconfident, the agent over-estimates the precision of his private signal. Based on his updated beliefs, the agent then makes an investment decision.

In this situation, the moral hazard problem faced by the principal has two aspects, overconfidence having an impact on each of them. First, the principal must provide the agent with incentives to exert effort and acquire information. Second, if the principal and the agent have different levels of risk aversion (as we will assume), the principal must calibrate the risk-taking incentives the contract provides to the agent.

In order to disentangle the impact of overconfidence on each aspect of the agency problems, we consider two different cases regarding the acquisition of information. First, we assume that effort is a binary choice. It implies that if rational and overconfident agents acquire information, it is of the same precision. As a consequence, the effect of overconfidence on the acquisition of information is neutralized, and only the effect of overconfidence on the portfolio allocation is at work. In this environment, we show that overconfident agents trade *lower* quantities than rational agents do. A direct implication of this result is that those obtained in the case of private investors (i.e., excessive trading) may not extend to the case of delegated portfolio management. When considering institutional investment, overconfidence may not generate excessive return volatility if the appropriate compensation contract is used.

The second case we consider is such that effort is a continuous variable. We show that overconfident agents acquire more precise information and trade larger quantities than rational agents do. The riskiness of investment strategies is then influenced in two ways. First, it is decreased through a lower risk level per unit of investment, and second it is increased through larger risky-asset holdings. We

¹ Though this paper concentrates on the miscalibration of private information, empirical studies suggest that overconfidence can take several forms, including thinking of being better than others and a self-attribution, this latter bias leading to miscalibration of private information.

² Barber and Odean (2002) provide a review of psychological literature on overconfidence. As they explain, "overconfidence is greatest for difficult tasks, for forecasts with low predictability. . . Selecting common stocks that will outperform the market is a difficult task. Predictability is low; feedback is noisy. Thus stock selection is the type of tasks for which people are most overconfident."

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