The dynamics of overconfidence: Evidence from stock market forecasters

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\textbf{Article info}

\textbf{Article history:}
Received 8 November 2007
Received in revised form 16 April 2010
Accepted 11 May 2010
Available online 26 May 2010

\textbf{JEL classification:}
D83
D84
G1

\textbf{Keywords:}
Overconfidence
Stock market
Behavioral finance
Learning
Panel data

\textbf{Abstract}

As a group, market forecasters are overconfident in the sense that they are miscalibrated. While overconfidence is persistent, respondents do exhibit some degree of rational learning in that they widen confidence intervals after failure as much as they narrow them after success. Market experience exacerbates overconfidence, primarily through knowledge deterioration.

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\textbf{1. Introduction}

There is abundant evidence that most people most of the time are overconfident in the sense that they overestimate the precision of their knowledge, a phenomenon known as miscalibration.\textsuperscript{2} In one variant of a calibration test, when individuals are asked to construct \(x\)% confidence intervals for currently (or soon to be) known magnitudes, such as the height of Mount Everest (or the level of the Dow in a month), usually markedly below \(x\)% of their intervals bracket is the true answer. Suboptimal financial decision-making, ranging from excessive trading (Barber and Odean, 2000; Deaves et al.,...
(2001), past successes exacerbate overconfidence, while past failures tend to be downplayed.7 The result is that those who have had the good fortune of being successful in their fields might for a time be more overconfident than new entrants. Eventually, however, experience should reveal to people their true knowledge level.

The purpose of this paper is to examine both the statics and dynamics of overconfidence of stock market forecasters. The survey instrument employed is the ZEW Finanzmarkttest which is a monthly survey of financial market practitioners in Germany. Respondents are asked for 90% confidence intervals for the level of the DAX 6 months ahead. While an analysis of forecasting accuracy is far from unusual, the purpose here is quite different. The availability of not just point estimates but also confidence intervals allows for a careful exploration of overconfidence in both its static and dynamic manifestations.6 Graham and Harvey (2003) make use of a somewhat similar dataset of CFO forecasts and confidence intervals for the U.S. stock market. Their focus is not on overconfidence, however, as they investigate what can be learned about ex ante equity premiums and the relationship between risk and return.

We begin by investigating whether, consistent with previous evidence, the respondent group as a whole is overconfident. Next we explore whether survey respondents adjust their confidence intervals in response to past successes and failures. The relationship between experience and miscalibration is then considered. To preview, market forecasters are overconfident. While overconfidence persists, some learning does seem to occur as confidence intervals widen with failure and narrow with success in equal measure. Greater market experience is associated with higher levels of overconfidence. Section 2 describes the ZEW Finanzmarkttest. The next section specifies the hypotheses to be tested. Section 4 details the key empirical findings, and the final section concludes.

2. The ZEW Finanzmarkttest survey

The ZEW Finanzmarkttest is a monthly survey of about 350 financial market practitioners in Germany. Most of these individuals work for a commercial bank, investment bank, insurance company or investment department of a large German company. Each month, beginning in 1991, participants have been asked to predict a series of key macroeconomic and financial market variables for the key industrialized economies as of 6 months in the future. For example, participants are asked to predict the inflation rate, long-term and short-term interest rates, economic activity, and stock market levels for these countries. Until recently, questions only asked for direction: that is, rise/fall/unchanged. This questionnaire forms the basis for the well-known ZEW Indicator of Economic Sentiment, an indicator which, together with the ifo Business Climate index, is one of the most important and most closely followed economic indicators in Germany.8

Of course in Germany one of the key magnitudes to forecast is the level of the DAX. This index is analogous to a German Dow. Specifically, the DAX is a value-weighted index composed of the 30 largest and most important German companies traded on the German Stock Exchange in Frankfurt.9 Starting in February 2003, ZEW survey respondents were asked to provide, in additional to a directional forecast, a quantitative one for the DAX. Specifically, point estimates for the DAX 6 months in

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3 Two examples are clinical psychologists (Oskamp, 1965) and engineers (Kidd, 1970).

4 Two examples of practitioners being overconfident are managers (Russo and Schoemaker, 1992) and investment bankers (Staël von Holstein, 1972).

5 A strict efficient markets view of the world would seem to argue that those fooling themselves in this way will be driven from the marketplace, but some have called this into question (Hirshleifer and Luo, 2001).

6 Related to this is cognitive dissonance, which sometimes induces us to forget what is unpleasant or did not go our way (Festinger and Carlsmith, 1959), and confirmation bias, the tendency to search out evidence consistent with one’s prior beliefs and to ignore conflicting data, may also contribute (Forsythe et al., 1992).


8 The ifo Business Climate index is based on a survey of about 7,000 companies in Germany on their business expectations. Every month the ifo Institute asks about 7,000 enterprises in manufacturing, construction, wholesaling and retailing to provide assessments of their current business situation and expectations for the next 6 months. These enterprises can characterize their situation as “good,” “satisfactory” or “poor,” and business expectations for the next 6 months as “more favorable,” “unchanged” or “more unfavorable.”

9 More specifically, the DAX is a net-dividend-reinvested index, which means it includes after-tax dividends which are reinvested in the index.
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