Accepted Manuscript

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PII: S0022-0531(18)30101-7
DOI: https://doi.org/10.1016/j.jet.2018.04.005
Reference: YJETH 4771

To appear in: *Journal of Economic Theory*

Received date: 16 February 2017
Revised date: 24 March 2018
Accepted date: 6 April 2018

Please cite this article in press as: Kendall, C., Oprea, R. Are biased beliefs fit to survive? An experimental test of the market selection hypothesis. *J. Econ. Theory* (2018), https://doi.org/10.1016/j.jet.2018.04.005

Are Biased Beliefs Fit to Survive? An Experimental Test of the Market Selection Hypothesis *

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April 12, 2018

Abstract

We experimentally study the "market selection hypothesis," the classical claim that competitive markets bankrupt traders with biased beliefs, allowing unbiased competitors to survive. Prior theoretical work suggests the hypothesis can fail if biased traders over-invest in the market relative to their less biased competitors. Subjects in our experiment divide wealth between consumption and a pair of securities whose values are linked to a difficult reasoning problem. While most subjects in our main treatment form severely biased beliefs and systematically over-consume, the minority who form unbiased beliefs consume at near-optimal levels – an association that strongly supports the market selection hypothesis.

Keywords: market selection hypothesis, survival of the fittest, efficient markets, Bayesian errors, Monty Hall problem, experimental economics

JEL codes: C9, D03 G1

*We would like to thank Marina Agranov, Elena Asparouhova, Pablo Beker, Peter Bossaerts, Cary Frydman, PJ Healy, John Matsusaka and Emanuel Vespa for valuable comments and discussions. We are also grateful to participants at the 2016 Bay Area Experimental Economics Workshop, the 2016 Economic Science Association North American Meetings, the Economic Science Institute Theory/Experiments Workshop at Chapman University, the Econometric Society Meetings in Montreal, the Society for the Advancement of Economic Theory, the Society for Experimental Finance 2016 Meetings and seminar audiences at the Claremont Graduate University, Georgia State University, ITAM, New York University, the Univeristy of Arizona, UC San Diego, University College London, the University of Pittsburgh, the University of Southern California and the University of Utah. We are, finally, grateful to the National Science Foundation under Grant SES-1357867 for supporting this research.

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