FTG Summer School on Frictions in Firms and Markets
Behavioral Issues – Overconfidence

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Description

In the last two decades, economics and finance have witnessed a shift from the rational paradigm towards one that incorporates the possibility that the actions of economic actors are influenced by various behavioral biases documented in psychology. In particular, studies of the calibration of subjective probabilities find that individuals are overconfident: they tend to overestimate the precision of their knowledge and information, and their ability to improve outcomes. The goal of this session is to provide you with a theoretical framework to model overconfidence and to study its impact on financial markets and firms. The session will start with a brief introduction to models of financial markets, and will successively look at the following topics.

- Overconfidence in financial markets.
- The emergence of overconfidence.
- Overconfidence in firms.
- Overconfidence and contracting.

Readings

Here is a list of readings for each of the session's topics (the paper titles embed links to the papers). We will focus on the papers marked with ($\star$).

Models of Financial Markets

($\star$) Grossman, Sanford J., and Joseph E. Stiglitz, 1980, "On the Impossibility of Informationally Efficient Markets," *American Economic Review*, 70(3), 393–408.

- Kyle, Albert S., 1985, "Continuous Auctions and Insider Trading," *Econometrica*, 53(6), 1315–1335.

Overconfidence in Financial Markets

(⋆) Odean, Terrance, 1998, "Volume, Volatility, Price, and Profit When All Traders Are Above Average," *Journal of Finance*, 53(6), 1887–1934.

- Daniel, Kent D., David Hirshleifer, and Avanidhar Subrahmanyam, 2001, "Overconfidence, Arbitrage, and Equilibrium Asset Pricing," *Journal of Finance*, 56(3), 921–965.
- Scheinkman, José A., and Wei Xiong, 2003, "Overconfidence and Speculative Bubbles," *Journal of Political Economy*, 111(6), 1183–1220.

The Emergence of Overconfidence

(⋆) Gervais, Simon, and Terrance Odean, 2001, "Learning to Be Overconfident," *Review of Financial Studies*, 14(1), 1–27.

- Daniel, Kent D., David Hirshleifer, and Avanidhar Subrahmanyam, 1998, "Investor Psychology and Security Market Under- and Overreactions," *Journal of Finance*, 53(6), 1839–1885.
- Bernardo, Antonio E., and Ivo Welch, 2001, "On the Evolution of Overconfidence and Entrepreneurs," *Journal of Economics and Management Strategy*, 10(3), 301–330.

Overconfidence in Firms

(⋆) Goel, Anand M., and Anjan V. Thakor, 2008, "Overconfidence, CEO Selection, and Corporate Governance," *Journal of Finance*, 63(6), 2737–2784.

- Stein, Jeremy C., 1996, "Rational Capital Budgeting in an Irrational World," *Journal of Business*, 69(4), 429–455.
- Gervais, Simon, and Itay Goldstein, 2007, "The Positive Effects of Biased Self-Perceptions in Firms," *Review of Finance*, 11(3), 453–496.

Overconfidence and Contracting

(⋆) Gervais, Simon, J. B. Heaton, and Terrance Odean, 2011, "Overconfidence, Compensation Contracts, and Capital Budgeting," *Journal of Finance*, 66(5), 1735–1777.

- De la Rosa, Leonidas E., 2011, "Overconfidence and Moral Hazard," *Games and Economic Behavior*, 73(2), 429–451.
- Palomino, Frédéric, and Abdolkarim Sadrieh, 2011, "Overconfidence and Delegated Portfolio Management," *Journal of Financial Intermediation*, 20(2), 159–177.