Chapter 47

Fund Manager Overconfidence and Investment Narratives

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ABSTRACT

This chapter proposes a novel approach to measuring fund manager overconfidence and its impact on investment performance. Among numerous behavioural biases identified in financial agents, overconfidence is perhaps most widely studied. Abundant research suggests that overconfidence can have a significant value-diminishing impact on financial decisions taken by small investors, but very few studies have sought to measure the overconfidence of professional investors. This study investigates more than 4600 US equity mutual funds and demonstrates why the proxies commonly used to measure investor overconfidence cannot be readily applied to fund managers, hence the usefulness of the content analysis approach as an alternative. A number of potential proxies for overconfidence including overoptimism, excessive certainty, and excessive self-reference are measured across fund manager reports. The findings suggest that superior past performance boosts overconfidence, which is, in turn, associated with diminished future investment returns. In addition, word frequency analysis is conducted to shed light on the genre and tone fund managers employ in their investment narratives and how this interplays with their demonstrated level of overconfidence.

1. INTRODUCTION

Traditional finance often uses theoretical models predominantly assuming that economic agents are rational, i.e., efficient and unbiased information processors who constantly seek to maximise their utility. It is now widely agreed that these appealingly simple assumptions are quite inaccurate (Barberis & Thaler, 2003). Behavioural finance, on the other hand, assumes that investors are often subject to behavioural biases that can negatively affect their financial decisions. These biases and heuristics, which are typically grounded in the cognitive psychology literature, are being increasingly applied in financial contexts. Indeed, studies in behavioural finance often lead to conclusions that significantly resonate with what professionals in the finance industry experience and “know” at a deeper and perhaps unconscious level (Taffler & Tuckett, 2010).
In this context, studying investor psychology is of paramount importance. Hirschleifer (2001), among others, provides a detailed survey of studies linking investor psychology to asset pricing and argues that this issue lies at “the heart of the grand debate in finance spanning the last two decades.” While a complete understanding of investor psychology requires familiarity with a wide range of individual and group behaviours, a few psychological traits are often recognized as highly influential in shaping investors decisions. The overconfidence effect clearly belongs to this list.

The overconfidence effect, due to its broadness and importance, has been widely influential outside the field of psychology (Daniel, Hirshleifer & Subrahmanyam, 1998; Statman, Thorley & Vorkink, 2006; Garcia, Sangiorgi & Urošević, 2007). The role of overconfidence in influencing the behaviour of economic agents and, by extension, the functioning of financial markets, is an emerging, increasingly important and widely researched topic. In fact, it has been suggested that in the field of judgment and decision-making, no problem is “more prevalent and more potentially catastrophic than overconfidence” (Plous, 1993).

To properly understand overconfidence, it is appropriate to start from the closely related concept of “optimism.” Optimism seems to be an integral part of the human psyche. From the perspective of evolutionary processes, it is proposed that optimism must have brought the early humans important benefits, and therefore, in the course of thousands of years of evolution, it has become part of the genetic hardwiring of the human brain. Apart from this evolutionary perspective, it is now widely known that humans constantly learn about themselves and their abilities by observing the consequences of their actions. In doing so, most people overestimate the degree to which they play a role in their own successes. This tendency is often amplified by an illusion of control, i.e. by thinking that one can control or influence an outcome. The overconfidence resulting from this mechanism can have several negative consequences for decision-making, as I will discuss in detail in the literature review. In fact, many researchers cite overconfidence as an explanation for wars, strikes, litigations, entrepreneurial failures and, not surprisingly, stock market bubbles (Glaser, Noth & Weber, 2007; Moore & Healy, 2008).

A large body of literature has more recently focused on the overconfidence of corporate managers, and its impact on corporate investment decisions in areas such as capital structure and M&A activity (see Malmendier & Tate, 2005; Malmendier & Tate, 2008; Malmendier, Tate & Yan, 2011; Gervais, Heaton & Odean, 2011). The questions asked in this chapter, however, concern the impact of overconfidence on professional investors, which is a far less studied topic. The underlying research questions are motivated by three large areas of literature, i.e. studies of mutual fund performance and persistence, studies of financial accounting narratives and business communication, and studies of professional investor psychology. In particular, the following research questions are asked in this chapter:

1. Can fund manager overconfidence be robustly measured through content analysis of investment narratives?
2. How does a fund manager’s prior investment performance affect his or her overconfidence?
3. Do fund managers strategically change the tone of their investment narratives to justify their prior investment outcomes and express views on future investment outcomes?

As financial agents, professional investors often operate in an environment that is significantly different from the assumptions of conventional models. Conventional finance views financial agents in terms of “rational” actors in the marketplace who use formal methods of asset valuation in an attempt to identify those stocks or other assets which may be mispriced; even though, on the other hand, markets are viewed traditionally