

Overconfidence can influence investor behaviours in China

Guanhua(Edward) Gao

King's College London, iQ Shoreditch, 2 Silicon Way, London, N1 6AT, United Kingdom

Abstract. Overconfidence is a common psychological condition defined as the irrational belief that one's chances of success are higher than they really are. The damage that overconfidence can do in the world of finance is even more glaring. Small and medium-sized investors lack the information collection, professional skills, and trend-following behaviour of large shareholders, firm management, and institutional investors. In China, the stock market is dominated by small and retail investors. They lack information and often make a decision based on the limited knowledge and information that they have. Still, owing to hubris, many small and medium-sized investors falsely assume that making money is simple or that they can consistently outperform the market as a whole. Small and medium-sized investors frequently trade to provide liquidity to the market, but their overconfidence often leads them to set unrealistically high-profit targets, incorrectly attribute gains to their operating skills, and fail to adequately account for losses as a result of events outside their control. Transaction costs can eat into earnings. Overconfidence among investors has been shown to increase market risk and volatility.

Keywords: Overconfidence, behavioural finance, Chinese stock market.

1. Introduction

There have been many so-called financial anomalies that have arisen alongside the expansion of the

The financial market, notably the stock market, especially the formation and functioning of the stock market in developing transitional market countries. The Chinese stock market exhibits more pronounced and consequential financial abnormalities than the average immature developing capital market. Comparatively speaking, the stock markets of industrialized nations and regions place great value on the phenomena of booming and drooping and dramatic oscillations that are dangerously diverting from China's economic progress. To provide just one example, the price of shares with the same par value issued by the same Chinese business on the China A-share market is much higher than its price in Hong Kong, China's H-share market. The aforementioned financial abnormalities in China's stock market are clearly inexplicable by means of the conventional efficient market theory. China's stock market/financial oddities may be better understood using behavioural finance theory, which has emerged and developed over the last several decades. Investors' psychological preferences and trading habits will inevitably have an impact on the stock market price trend since the latter is the product of the actions of numerous traders. Therefore, we may investigate the aforementioned/abnormalities in China's stock market via the lens of investors' psychological preferences and behavioural finance theory. Overconfidence is a reasonably widespread and universal psychological preference among investors, and a significant body of psychological study literature demonstrates that individuals consistently exhibit the psychological propensity of overconfidence in economic life. This research, therefore, aims to explore the overconfidence bias and its impact on investors in China.

2. Research and analysis

2.1 Overconfidence of investors

Overconfidence bias is common in the world of investing, and it often causes novice investors to ignore evidence and the advice of professionals because they believe they know better. Consequently, individuals make poor investing decisions like trying to time the market or increasing their exposure to high-risk stocks. It's hardly shocking to learn that an overconfident investor's portfolio may

underperform. Furthermore, customers' overconfidence may cause them to overestimate their tolerance for risk, resulting in investing plans that aren't really aligned with their requirements. When the substantial transaction costs of buying and selling assets are factored in, the potential harm of overconfidence on customers' wallets and psyches becomes much more apparent.

One effect of heuristic simplification is self-deception, in which individuals falsely believe they are more competent than they really are [1]. Overconfident persons are described in the psychological and behavioural science literature as those who act as though they have more skill than they really possess [2]. Those investors are more likely to be overconfident if they believe their prior successes were the result of their competence and their failures were the result of poor luck. Overconfident investors aim to use their advantages to generate high profits. As a result, these optimistic investors make frequent trades while ignoring the potential dangers of such behaviour [3]. Trading frequency is sometimes used as a proxy for overconfidence when examining investor behaviour using stock brokerage data. These hypotheses are

backed up by the findings of Barber and Odean (2001), who conclude that individual investors in the United States engage in excessive trading, expose themselves to substantial risk, and make subpar ex-post investment judgments as the investment portfolio returns are inferior to a benchmark market-wide portfolio return [4]. Naturally, the frequency with which one trades is an unreliable indicator of overconfidence. High gains may be captured by frequent trading, which investors with better knowledge and trading abilities will do. As a result, both those with true high ability and those with a false belief in their own high ability will engage in excessive trading. Most people believe that the number of competent investors is far less than the number of arrogant ones. Therefore, it is often assumed that traders who frequently make trades are typically overconfident.

According to Yates et al., this Western way of thinking about things helps curb the propensity toward arrogance. Evidence from the field of psychology is few, but preliminary findings imply that Asian societies are more prone to overconfidence than Western ones. In the end, Weber and Hsee (2000) find that neither choice researchers nor cross-cultural psychologists have given much thought to the relationship between culture and decision-making [5]. Asians were shown to be more confident in their expertise than Americans were in similar research done in China and Taiwan [6]. The Chinese, the Japanese, and the Hong Kongers have been shown to be less risk averse and more overconfident than their Western counterparts in studies on risk perception [7].

2.2 Overconfidence of investors in China due to cultural effects

Overconfidence may rely on numerous reasons including individual qualities. For example, Vissing-Jorgensen (2004) examines the investor optimism survey data produced by UBS and Gallup from 1998 to 2002 and shows that irrational behavior is weaker for more knowledgeable investors. The author utilizes wealth and investing experience as proxies for investor intelligence. Moreover, overconfidence may rely on cultural variations. Fan and Xiao (2005) and Statman (2010) illustrate that people in various civilizations and cultures may have distinct behavioral biases which may impact their financial choices. For example, individualism is a more visible feature in western nations, such as the USA and the UK, as collectivism is in eastern countries like China and India. Hofstede (2001) indicates that Chinese people are more collectivist compared to the USA, the UK and Western Europe [8]. Statman (2010) claim that people in collectivist cultures tend to be more risk tolerant, hence, one may anticipate collectivism to have an influence on overconfident conduct, as well [9]. Besides, the collectivistic aspect of Chinese society will let investigate how culture impacts overconfidence. A number of studies, including one by Fan and Xiao (2005), demonstrate that people from diverse cultural backgrounds are prone to different types of behavioral biases, which in turn might impact their choice of investment strategies [8]. According to Hofstede (2001), eastern countries like China shows that they are more collectivist than those in the United States, the United Kingdom, and Western Europe. Collectivist societies tend to have members who put more value on the collective than on themselves. People who are part of a community tend to relax and take greater chances as a result. When a person feels confident in the support of his or her group, he or she is more likely to act

confidently and accept risks than when acting alone. Hofstede's research may have been conducted many years ago, but since cultural norms change so slowly, the findings are still relevant today. Whether or not individualism or collectivism causes hubris, the literature is divided. In their analysis of trading volume, Chui et al. (2010) draw a connection between individualism and overconfidence, with the conclusion that people from less individualistic cultures behave less irrationally [10]. However, some research suggests that people from collectivist societies are more likely to be overconfident, take more risks, and engage in more trades than those from more individualistic societies. Overconfidence among Chinese investors is examined by Chen et al. (2007) using transaction data from a major Chinese brokerage business. Based on their research, the authors conclude that Chinese private investors engage in trading more often than their American counterparts [11]. The overconfidence of Asian and British pupils is measured by Aker and Duck (2008) using a stock market simulation and predicted test scores. Asian pupils are shown to have a higher rate of overconfidence than their British counterparts [12]. Chinese people are less risk-averse than Americans. Studies have shown that the Chinese tend to be more willing to take risks and/or to have an exaggerated sense of their own abilities. People living in collectivist cultures tend to be more likely to take risks and display a greater degree of overconfidence because they find safety in the company of others.

2.3 Overconfidence in Chinese retail investors

Many researchers have dedicated their time to learning about retail investors in an effort to better understand their trading habits, trading results, and contributions to information dissemination and price discovery in the financial markets. The Shanghai Stock Exchange reports that ordinary investors account for 85% of daily trading activity. Given the market's apparent tilt toward retail trading, individual investors may be considered the real stars. Chinese retail investors are in the tens of millions and make up the biggest segment of retail investors in the world's capital market. Results from these investigations, however, seem to be incongruous. For instance, over-confidence and over-trading are two examples of retail investors' behavioral biases that lead to poor investing decisions, as shown by Barber and Odean. Recent researches suggests that retail

investors are able to accurately predict future stock returns and trade accordingly, implying that retail investors may possess some insight into the behavior of stock prices. A new breed of retail investors, who take advantage of zero-commission trading platforms like Robinhood, has lately been the focus of attention. Robinhood investors have been shown to outperform the market, increase their need for liquidity, and increase their attention-induced trading [13]. Another research demonstrates that retail investor order flows are persistent [14]. Smaller retail investors' order flows exhibit momentum patterns on a daily time frame and have a high need for rapid liquidity. Smaller retail investors also exhibit strong irrational tendencies, such as overconfidence and a predilection for risky investments, and they are unable to accurately anticipate and digest earnings news. The biggest retail investors, on the other hand, show signs of contrarian trading; they go against the behavioral biases of other retail groups and are adept at anticipating and digesting earnings news. When it comes to explaining the predictive ability of order flow for future results, factors such as order persistence, daily movement trading, cognitive biases, and information disadvantages work against smaller individual investors, while factors such as contrarian trading, trading against behavioural factors, and information skills work in their favour.

Individual investors in the Chinese stock market, like most individuals, unavoidably have a psychological preference for overconfidence. However, they may have an even larger psychological preference for overconfidence than the typical person. There are a large number of retail investors active in China's stock exchange. In making stock investing choices, many retail investors depend on gut instincts instead of hard data because they lack the resources to do so. Trading stocks in the face of market chatter, and subsequently displaying a propensity for overconfidence and noise trading. The book returns of equities owned by individual investors would naturally grow while the Chinese stock market is in a rising stage. Now that their investment returns have gone up, they may pat

themselves on the back for a job well done. Causes a marked inclination toward optimism or pessimism based on expectations: when the stock market is in a downturn, individual investors may seem excessively gloomy because of the decline in book income; when the market recovers, many of these same individuals may sell their holdings. When the market inevitably promotes the stock market to return to a condition of decline, it confirms the soundness of the trading choices of those investors who cut the meat out of the market and makes them aware of the degree and grasp of their stock investing skills. When unfavorable information turns out to be true, it tends to foster an attitude of overconfidence. It is clear that individual investors in the Chinese stock market, whether in a bull or a bear market, tend to be overconfident in their ability to correctly assess market conditions and anticipate the direction of stock prices. The previous study shows that Stock market price volatility rises as investors get more self-assured; the anticipated price rises as investors become more risk-averse and as the average supply of stocks rises. Stock market quality will deteriorate as the number of individual investors rises, and the range of the price of stocks volatility will widen relative to the actual range of fluctuations in the value at the end of the period; however, individual investors' model's overall investment returns will rise in proportion to the rise in the number of individual investors [15]. It falls as investors become more certain of their abilities, rises as they become warier of taking risks, and falls again as the average number of stocks on the market rises. All of the aforementioned findings about China's stock market's soaring and plunging, its high premium compared to markets in developed nations and regions, its high volatility that significantly departs from the fundamentals of China's economic progress, and its investment potential make sense. The return on investment is poor across the board.

3. Possible consequence of overconfidence of investors in China

3.1 trading volumes

Confident investors place a disproportionate amount of trust in their own knowledge and abilities, while ignoring key pieces of public data. Intuitive overconfidence may boost transaction volume by using non- public knowledge. Benos (1998) argues that risk-averse traders tend to be more self-confident as a result of their access to proprietary information [16]. Increased trading activity is caused by overconfident traders who are unable to compete with more knowledgeable and sensible market participants. On the contrary, Zhou and Chen (2018) discover that overconfident investor arbitrage dampens price informativeness and trade volume due to the investors' secret knowledge [17]. Not only do Chinese stock market investors tend to be overconfident, but so do stock analysts (He and Ma, 2019). Trading activity might rise if merchants are overconfident in their abilities (Moore and Healy, 2008). Some also argue that investors trade more often when they make a lot of money because they become overconfident in their abilities [18]. Using a large sample of US stocks, Some scholars establish a positive correlation between market turnover and historical profits, providing empirical support for the theory that more trading volume is correlated with more optimism in the market [9]. As a result of significant profits, investors risk more and lessen their portfolio diversity. Quite the opposite, studies show that via public ignorance of essential facts, overconfidence may enhance trade volume [9]. When specific pieces of information are acquired, investors should halt trading [19]. On the other hand, investors who are too sure of themselves can ignore this data and engage in additional trading anyhow.

Confidence in one's own abilities, based on secret data, may lead to more frequent trading. Overconfident investors make more frequent trades due to relying too much on non-public information [19].

Overconfidence might lead to more frequent trades since traders have faith in their own abilities. Despite reviewing data from a brokerage business, they found that, after experiencing significant gains in the past, individual investors favored online trading over telephone contact. Therefore, they now trade more often, but at a lower rate of return. Successful investors increase their trading frequency [20]. Investors who are bolstered by their success in the past are more likely to take risks

by trading more often in more volatile stocks. Intense competition for earnings may lead to overconfidence, which in turn can boost trading volume. Theoretically, as shown by Michailova and Schmidt (2016), very overconfident markets generate larger market bubbles than less overconfident markets, leading to more trading volume and thus, higher mispricing [21]. when the market is mispriced, investors would trade more actively in an attempt to benefit from the discrepancy and bring the market back into equilibrium.

Overconfident traders, according to Benos (1998), may end up ahead of the game financially. Overconfident merchants tend to have greater wealth than their less confident counterparts, according to research by Gervais and Odean (2001) [18]. Successful traders, on the other hand, may see their predicted returns fall below those of less successful traders. Most successful traders are competent, but often overestimate their own abilities. But there's also research that shows how overconfident investors might harm their returns by trading too often. According to research by Barber and Odean (2002), when traders are exposed to a new trading strategy, they end up making fewer trades and less money overall [4]. This conclusion is backed up by a recent research conducted in South Africa [22]. Similar to what was shown by Barber and Odean (2000), there is a negative correlation between the number of times an investor trades and their return on investment. You may find similar evidence [23]. Even in a hypothetical Chinese stock market, Zhang et al. (2014) demonstrate an inverse correlation between gains and trading volume.

4. Conclusion

Based on these findings, it can be seen that overconfidence exists among Chinese investors. further promote the development of financial derivatives, boost information transparency, decrease the cost of acquiring information, and strengthen risk education for retail investors. It is of importance to enhance the long-term health of China's stock market and mitigate the destructive influence of investors' inherent bias toward optimism and overconfidence, which can lead to excessive trading volume and frequency and can harm portfolio performance.

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