

Analysing how Overconfidence Biases Impact Portfolio Management and Risk Taking: A special reference to stock market investors in Lucknow City

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Abstract-This research examines the impact of overconfidence bias on investing decision-making processes and outcomes. Overconfidence, a cognitive bias in which people overestimate their knowledge, abilities, or chances of success, can have a significant impact on the performance of financial markets and individual investments. Through a comprehensive literature review and empirical analysis, this study investigates how overconfidence manifests in various areas of investment behavior, such as excessive trading, risk perception, and portfolio diversification. The study used a mixed-methods approach, integrating quantitative analysis of trade data from a sample of 500 retail investors over a three-year period with qualitative insights from semi-structured interviews with 50 professional fund managers. Results show that overconfident investors trade more frequently, have less diversified portfolios, and underestimate investment risks, all of which lead to less-than-optimal returns in comparison to their less confident peers. The study concludes by discussing the implications of these findings for legislators, financial advisors, and individual investors in order to offer strategies for mitigating the adverse effects of overconfidence bias in investment decision-making.

Keywords : Investment, Overconfidence, behavioural Bias

INTRODUCTION

Earning money and then making decisions of doing wise investments that give higher returns is a complicated task and is depend upon the behaviour of the investors. Investment decisions is a multi-step approach and investors have to analyse various steps before selecting a best investment alternative for doing investment.

This study assesses the presence and scope of behavioural biases more exactly. Behavioural biases are defined as a pattern of discrepancy in judgement that occurs sometimes lead to perceptual alteration, inaccurate judgement, illogical interpretation, or

what is largely called irrationality. Decision making is the mental or cognitive progression that results in the assortment of a course of action midst several alternative situations.

Investment decision making is a complex process that needs much more than money. Time, patience, and discipline are necessary for successful investing. Due to the fact that most investors do not act in accordance with the presumptions of conventional finance theory, the subject of behavioural finance has been expanding over the past 20 years. The rationality assumption has been superseded by behavioural finance, which draws on well-established studies of psychological characteristics.

Numerous academics have thoroughly investigated and documented how cognitive psychology directly informs the topic of modern behavioural finance. The study of cognition, or the mental processes that influence human behavior, is known as cognitive psychology.

The study of cognition, or the mental processes that influence human behavior, is known as cognitive psychology. When investing, people make mistakes because they are unable to solve the optimization issues that the fundamentals of traditional finance theory demand. As an alternative, they handle the stream of information by applying heuristics, biases, or rules of thumb. (Tversky, 1974) state that the investments have long-term financial and emotional repercussions, it is critical to comprehend the decision-making process.

When making financial decisions, investors display behavioural biases and employ a number of heuristics. (Riepe, 1998) introduced behavioural biases in three categories that includes.1) biases of judgement 2) errors of preference 3) biases associated with living with the consequences of decision. Overconfidence, optimism, hindsight, and

an overreaction to random events are examples of biases in judgment. The psychology of investors and the presence of biases in financial decision-making in the western setting have been the subject of several studies; however, relatively little research has been done to understand the psychology of Indian investors.

People have a propensity to overestimate their knowledge, accuracy, and prediction skills. Investors that are overconfident believe they are smarter and have reliable knowledge. Certainty overconfidence is the term used to describe when investors are overconfident in their choice. Prediction overconfidence is the term used to describe when investors give their investment predictions tight confidence intervals. Overconfidence in predictions and certainty can both result in poor investing decisions that hurt an investor's portfolio.

The aim of this study is to determine whether overconfidence bias exists among Lucknow investors. After a thorough literature analysis, the following overconfidence variables were found: self-attribution, optimism, the better-than-average effect, miscalibration, the illusion of control, trading frequency, and trading experience. A standardized questionnaire with a 5-point Likert scale was utilized to determine how these factors affected investors' decision-making.

LITERATURE REVIEW

The study of behavioural finance examines how a person's decision-making process might be influenced by behavioural factors. By administering a questionnaire and gathering empirical data regarding business students' subjective views of prejudice, the researchers were able to investigate the cognitive biases and heuristics that these students are susceptible to. (Thornton., 2008) describes behavioural bias in a broader term, the study states the irrationality in decision making or a replicable pattern in perceptual distortion, illogical interpretation and inaccurate judgement.

REVIEW OF OVERCONFIDENCE BIAS IN FINANCE

(W.F.M., 1985) said that "overconfidence is the key behavioural factor needed to understand the trading puzzle." The trade volume is another significant element that contributes to overconfidence. Overconfidence has been found by researchers to be

a significant factor in large trading volumes. (Terrance, 1999) claims that overconfident investors reduce their expected utility by trading more than reasonable investors. Therefore, increased overconfidence results in lower predicted utility and excessive trading. In addition to increasing trading activity, overconfidence makes investors overconfident in their beliefs.

Along with the functions that market anomalies and financial literacy play (Abideen, 2023) looks at how behavioural bias affect investors decision-making process while making investment in Pakistan equities market. Initially He collected empirical evidence showing the intimate connection between market anomalies and behavioural biases, as well as the degree to which these two elements impact investors' financial decisions. (Adil, 2022) examines how the relationship between investing decisions and behavioural biases is moderated by financial knowledge. The authors are interested in how investors' susceptibility to behavioural biases is affected by financial literacy and how this influences their investing choices.

Behavioural biases are irrational beliefs or behaviours that affect investment decisions. These biases may lead to less-than-ideal financial choices and even significant losses. Understanding financial concepts and being able to apply this knowledge to make informed financial decisions are both components of financial literacy. High financial knowledge is thought to counteract behavioural biases. Choosing where to invest is the process of making an investment. Among the many factors affecting this process are behavioural biases and financial literacy (Barber, 2001). The theoretical foundations of overconfidence bias can be found in Kahneman and Tversky's (1979) prospect theory, which challenged accepted notions of rational economic decision-making. Adding to this, De Bondt and Thaler (1985) were among the first to apply the concept of overconfidence to financial markets, suggesting that some market anomalies may be explained by investor reaction to new information. (Grinblatt, 2009) Odean (1998) demonstrated how overconfident traders may lead to higher trading volume, greater volatility, and lower expected value by creating a formal model of overconfidence in financial markets. This seminal work served as the basis for other empirical studies investigating the effects of overconfidence on various aspects of investment behavior.

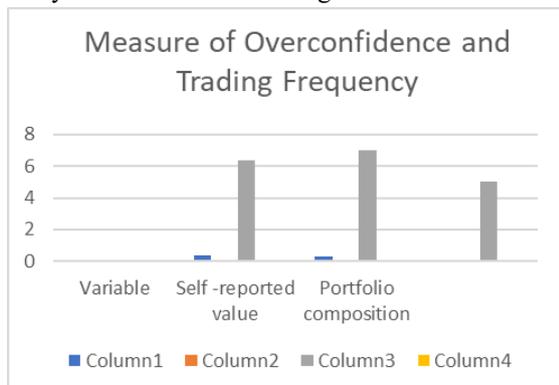
The impact of overconfidence bias on trading frequency is among the most thoroughly researched consequences. Overconfidence investors conducted a groundbreaking study using account data from a large discount brokerage and found that men, who were perceived as being more overconfident, traded more frequently than their less confident peers (Hilary). This excessive trading led to lower profitability due to growing transaction expenses. These findings have been confirmed by further research on different markets and investment categories. For example, (Kaustia, 2012) examined the trading habits of Finnish investors and verified the connection between excessively aggressive trading and overconfidence. They also found that this effect was more pronounced among younger, wealthier, and more experienced investors.

RESEARCH METHODOLOGY

Data Analysis

Variable	Coefficient	Standard error	t-statistic	p-value
Self-reported value	0.34	0.053	6.4	<0.001
Portfolio composition	0.28	0.041	7.0	<0.001
Risk Taking	0.19	0.038	5.13	<0.001
Age	-0.018	0.004	-4.50	<0.001
Investment experience	-0.025	0.007	-3.57	<0.001
R-squared	0.312			
N	500			

Measures of overconfidence and trading frequency show a notable positive correlation according to our study of retail investor trading data



Interpretation: The regression results in Table 1 show that increased trading frequency is associated with higher levels of self-reported confidence, portfolio concentration, and risk-taking behavior. Interestingly, trading frequency has a negative

correlation with age and financial experience, suggesting that overconfidence may diminish with expertise. These numerical findings are corroborated by our conversations with seasoned fund managers. Many respondents acknowledged that overconfidence may lead to excessively aggressive trading, particularly among novice investors or during periods of market mania. "It's a common pitfall, especially for newer managers," stated one of the fund managers. They believe that by continuously shifting their positions, they may outwit the market, but in most cases, this only results in lower returns and increased transaction costs.

FINDINGS OF THE STUDY

1. Overconfidence could be lessened by encouraging self-reflection, diversification, and long-term investment method advantages emphasis.
2. Financial advisers should be taught to spot overconfidence in their clients and to have tools to deal with it. This might involve routinely talking about the psychological features of investing with clients and including behavioural exams into the client onboarding process.
3. Asset management companies and brokerage firms should give institutional protections against overconfidence some thought, including those advised by the professional fund managers in our research.
4. Financial authorities should think about including knowledge of overconfidence bias into programs for financial literacy and investor protection policies. This could call for requiring brokers to present instructional materials on behavioural biases or mandating disclosures regarding the possible effects of overconfidence on investing results.
5. Our results draw attention to several areas for future study, including the development of more strong measures of overconfidence in investment environments, exploration of effective debiasing techniques, and study of the long-term effects of overconfidence on wealth accumulation and financial well-being.
6. Trading frequency is positively correlated with overconfidence, thereby possibly resulting in lower returns and higher transaction costs.
7. Overconfident investors often undervalue the risks connected to their portfolios, which can lead to unanticipated losses in declining markets

CONCLUSION

This study highlights the significant impact of overconfidence bias on investment decision-making, particularly among retail investors. The findings confirm that higher trading frequency is strongly correlated with self-reported confidence, portfolio concentration, and risk-taking behavior, while experience and age appear to moderate these tendencies.

Given the risks associated with overconfidence, several strategies can help mitigate its effects. Encouraging self-reflection, portfolio diversification, and long-term investment strategies may help investors make more rational decisions. Financial advisors play a crucial role in recognizing and addressing overconfidence in their clients, using behavioural assessments and regular discussions on psychological biases. Additionally, brokerage firms and asset management companies should implement institutional safeguards to protect investors from the pitfalls of excessive confidence-driven trading.

Financial regulators should consider incorporating awareness of overconfidence bias into investor education programs and protection policies. Mandating disclosures about behavioural biases and their potential impact on investment outcomes could help investors make more informed choices.

Finally, this study opens avenues for further research into stronger measures of overconfidence in financial decision-making, effective debiasing strategies, and the long-term effects of overconfidence on financial well-being. Addressing these issues can contribute to a more stable and rational investment landscape, reducing unnecessary risks and improving overall market efficiency.

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