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Does Overconfidence Bias Exist in the Indian Stock Market? An Empirical Investigation[1]

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Abstract

The paper explores the existence of overconfidence bias in the Indian Stock Market. An empirical analysis is conducted in a VAR environment, following the methodology given by Statman et al. (2006). The study uses daily data for the period 1st January 2001 to 30th June 2020. The results show that the impact of past market return on current turnover in the market is significant. The study indicates that Indian investors are ill-informed about any market return movement and market turnover. This suggests that investors are overconfident in the Indian Stock Market. The market volatility used as the measure for market risk impacts market turnover significantly. The granger causality result shows that there is bi-directional causality between exchange rate and market return. The findings may help investors'/ researcher to formulate a new behavioural concept to reduce overconfidence bias, and hence reducing investors' losses in the stock market.

JEL Code : C32, D53, G40,G41,
Keywords : Overconfidence Bias; VAR Model; Stock Market; India

I. Introduction

THE INFLUENCE OF psychology on financial decision-making is not new to the area of research in economics. Keynes, along-with neo-classical economists, also wrote about the influence of psychology on economic decision making. However in 1990s, a renewed interest developed in study of behavioural economics in general and behavioural finance in particular. In study of behavioural finance, behavioural biases are the essence of the discipline. Presence of behavioural biases among the traders in stock market results in suboptimal decisions (Chordia, Roll and Subrahmanyam, 2002; Chen, 2012).

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It may be inferred from the study that Indian investors are perhaps not fully informed about the movement in return and volume. As a result, they might be making ill-informed investment decisions. The investors within the market are proven to be overconfident, as past market return affect the current turnover, indicating some degree of market inefficiency. Usually, the overconfident investors trade more aggressively in the market. Therefore, players in India's stock market may restrain themselves from overconfidence bias to avoid risk in the market. The regulatory authorities, like Securities Exchange Board of India (SEBI) may be guided to play role in educating investors to manage their decisions particularly during the crisis period and help investors avoiding potentially high risk in the stock market. However, the study can be extended with redefining overconfidence bias; using other control variables like interest rates, Gross Domestic Product (GDP), and Economic Policy Uncertainty Index (EPUI); and using high frequency data for further research.

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