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Overconfidence and Investment Decisions: A Descriptive Study of the Literature from a Behavioral Finance Perspective

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Abstract:

Investment has become a crucial part of modern economic life. Over time, there has been an increase in investment participation, along with several challenges related to investor behavior. This study aims to examine the impact of overconfidence on investment decision-making, analyzed using a descriptive qualitative research method through a literature review within a behavioral finance perspective. Overconfidence is a condition of excessive belief in one's abilities and knowledge, often causing investors to overlook actual risks and have unrealistic return expectations. This phenomenon can lead to mistakes in risk management and suboptimal investment decisions. The study finds that overconfidence is frequently experienced by Generation Z, who have quick and easy access to information and financial markets through digital platforms. The study concludes that overconfidence has a significant impact on investment decisions and may result in long-term losses. To mitigate the negative effects of overconfidence, investors are advised to be aware of their cognitive biases and adopt a data-driven approach in their decision-making.

Keywords: *Behavioral Finance, Overconfidence, Gen Z, Investment Decisions*

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1. Introduction

The capital market in Indonesia has experienced rapid growth over the past few decades, supported by economic stability and increased public awareness of the importance of investment. According to (Fridana & Asandimitra, 2020), investment is the sacrifice of current money to obtain greater returns in the future with a corresponding level of risk. They emphasize that investment involves risk analysis and expected returns. Since the establishment of the Indonesia Stock Exchange (IDX), more companies have conducted initial public offerings (IPOs), and there has been growing investor interest in trading stocks, bonds, and other derivative instruments. Technological developments, such as online trading platforms, have also facilitated public access to the capital market, expanding the investor base from individuals to institutions. In addition, government policies to attract foreign and domestic investors

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have further strengthened the infrastructure and regulation of Indonesia's capital market. According to KSEI (2018) data, investors in Indonesia are still dominated by the 21-30 age group, with a proportion of 39.72%. This age group largely consists of students, indicating that they already understand investment. In terms of gender, male investors still outnumber females, but this does not mean that women are not investing. The data shows significant growth in female investors by 956%, from 44,700 investors in December 2014 to 476,000 as of April 16, 2018.

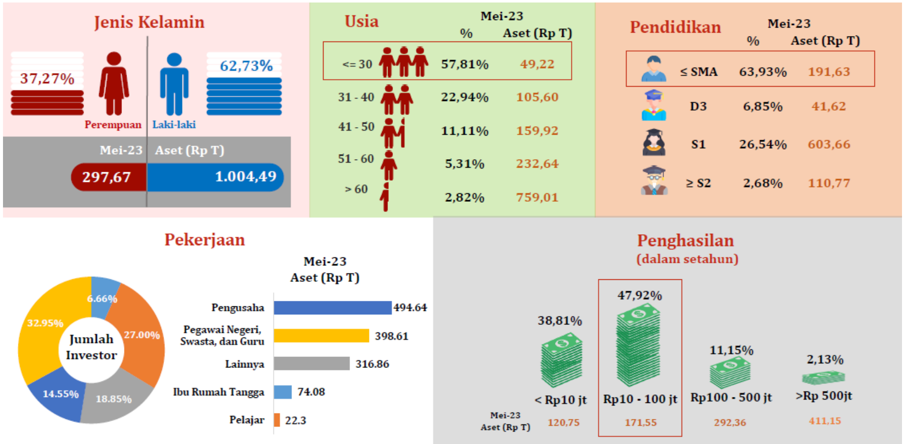

Figure.1 Number of Capital Market Investors mid-2023
(Source: Bareksa.com)

The investment phenomenon in Indonesia shows a significant shift, particularly with the increasing number of retail investors, especially from millennials and Generation Z. (Natasya et al., 2022) explain that awareness of the importance of financial management and long-term investment has been rising, spurred by advancements in digital technology and easy access to information through social media and online investment platforms. This trend is driven by various factors, including low savings interest rates and the push to seek alternative investments that offer higher returns. However, this phenomenon also comes with challenges, such as the potential for speculative behavior and a lack of understanding of risks, which demand broader financial education.

Generation Z has grown up in a digital era with quick access to information and technology, often displaying high confidence in various aspects, including investment. One factor influencing overconfidence among Gen Z is the ease of access to online investment platforms and social media, which provide instant information about investment opportunities. They tend to feel more informed and ready to take risks due to exposure to abundant content about investment success, which often obscures the actual risks involved. The phenomenon of self-attribution bias, where they attribute previous investment successes purely to their own abilities, also strengthens their excessive confidence.

However, this overconfidence can negatively impact investment decisions, as Gen Z often tends to overlook in-depth risk analysis and rush into transactions. The tendency to overtrade, where they frequently buy and sell assets without thorough calculations or with increased frequency, can eventually erode profits and even lead to losses (Barber & Odean, 2001). Their lack of experience in dealing with market volatility also makes Gen Z vulnerable to poor decision-making, especially when the market moves contrary to their expectations. Therefore, financial education and a deeper understanding of risk are crucial to reducing the impact of overconfidence in investing among this generation.

2. Methodology

This article employs a descriptive approach to provide a comprehensive overview of the topic being studied, based on the analysis of existing literature (Adlini et al., 2022). This research does not involve experiments or field data collection but relies on previous studies to identify trends, patterns, and key findings. The researchers conducted a selection and critical analysis of relevant literature to gain a comprehensive perspective, as well as to explore research gaps and opportunities for future studies. This methodology gathers information from reliable sources such as academic journals and previous research to understand the phenomenon of overconfidence in investment decisions from a behavioral finance perspective. The goal is to identify key findings, explore relevant theories, and uncover research gaps that could offer new contributions. This method provides a strong conceptual foundation for analyzing investor behavior related to overconfidence, supported by existing empirical evidence.

3. Empirical Findings/Result

Behavioral Finance

Behavioral finance is a branch of finance that studies how psychological and emotional factors influence individual financial decisions and the market (Senewe et al., 2018; L. T. Situngkir, 2023). Unlike traditional finance theory, which assumes that investors are always rational and make decisions based on perfect information, behavioral finance acknowledges that humans often act irrationally due to cognitive biases, emotions, and information limitations (Sabilla & Pertiwi, 2021). Some common biases studied in behavioral finance include overconfidence, herd behavior, and loss aversion, all of which can lead to deviations from the predictions of traditional financial models. According to (Ritter, 2003), the goal of behavioral finance is to understand how and why these errors occur, as well as their impact on markets and investment performance.

(Senewe et al., 2018) explain that behavioral finance is a field within finance that proposes psychology-based theories to explain stock market anomalies, such as sharp increases or decreases in stock prices. This field seeks to understand how psychological factors influence investor decisions, including the fear of losing money and the desire for greater profits. This research was conducted to test whether investors in the Indonesian capital market, particularly students as representatives of academia, always act rationally. The results show that students share similar experiences in facing the fear of not gaining profits and losing money when investing. Therefore, the Indonesia Stock Exchange (IDX) is expected to introduce more investment knowledge to students and the public to encourage them to become better investors (Fitria et al., 2022).

Overconfidence

Overconfidence in the context of investment decisions is the tendency of individuals to overestimate their ability to assess, predict, and make investment decisions (GERVAIS et al., 2011). Overconfident investors tend to have excessive confidence in their knowledge or skills in selecting assets, ignoring risks, and assuming that their decisions will always be profitable (L. T. Situngkir, 2023). This bias can lead to behaviors such as overtrading, where investors engage in transactions too frequently without considering proper risk analysis, or neglect portfolio diversification because they are overly confident in their choices. As a result, overconfidence often leads to poor investment performance and financial losses, as investors fail to anticipate unexpected market fluctuations or hidden risks. Overtrading is the act of executing too many transactions in a short period within financial markets, often without sufficient analysis. Investors involved in overtrading are usually driven by overconfidence or the need to react to every small market fluctuation, which can lead to high transaction costs and poor portfolio performance. Overtrading can also result in poor risk management, as investors tend to make transactions based on emotions or speculation rather than rational considerations.

Overconfidence in Investment Decision Making

In understanding studies on overconfidence in investment decision-making, several researchers have conducted various case studies. Research by (Barber & Odean, 2001; Situngkir et al., 2024) examines how overconfidence affects individual investment decisions, focusing on the differences between men and women. The results show that men tend to be more overconfident than women, leading to overtrading and a decline in portfolio performance. This study suggests that overconfidence is a key factor causing men to invest more aggressively and less cautiously. Meanwhile, research conducted by (GERVAIS et al., 2011) explores overconfidence as a factor influencing corporate investment decisions in the context of capital budgeting. The authors found that overconfident managers tend to be overly optimistic in estimating the investment projects they propose, leading to excessive and sometimes inefficient investment decisions. This study also highlights how performance-based compensation can exacerbate overconfident behavior (Taufiq et al., 2023).

In their research, (GERVAIS et al., 2011) outline several factors that contribute to overconfidence in investment decision-making. First, limited experience can lead investors who have been successful in a few investment decisions to become overly confident in their abilities. Early success often makes them believe they possess the necessary skills to consistently generate profits, even though this success may have been due to luck or favorable market conditions. Second, self-attribution bias occurs when investors attribute their investment successes to personal expertise while blaming external factors when they experience losses. This strengthens their excessive confidence, as they fail to objectively assess the causes of their gains or losses. Third, the illusion of control plays a role, where investors often believe they have more control over investment outcomes than they do. They think their decisions can influence market movements, even though many external factors contribute to asset price changes. Lastly, excessive optimism can lead investors to underestimate risks and overestimate investment outcomes. This optimism can cause them to invest without conducting thorough risk analysis or assuming that they are capable of handling potential losses.

4. Discussion

One case study that illustrates overconfidence among Gen Z is the phenomenon of stock market and cryptocurrency investments during the early stages of the COVID-19 pandemic. This is emphasized in a study by Juwita et al., (2022), which states that when the stock market experienced a sharp decline in 2020, many Gen Z investors saw an opportunity to enter, hoping to profit from a quick recovery. This phenomenon was further exacerbated by the FOMO effect, or 'fear of missing out,' which prompted many individuals to invest without considering the psychological impact of potential losses (Gupta & Shrivastava, 2022). Armed with information from social media, investment forums, and commission-free trading apps like Robinhood, many felt confident they could make substantial profits in a short period. The initial success experienced by some investors during the market recovery reinforced their confidence, leading them to engage in more transactions without conducting thorough analysis or seriously considering the associated risks.

Drawing from reviews and previous research on behavioral finance, overconfidence plays a significant role in risk management during investing. Overconfident investors often underestimate or overlook the risks associated with their investment decisions, believing that their skills and knowledge are sufficient to navigate market fluctuations. This overconfidence results in less caution when identifying potential losses (Natasya et al., 2022). Such investors perceive risks as lower than they are, which increases their likelihood of investing in high-risk assets or relying excessively on limited diversification. This situation worsens when the market does not perform as expected, as overconfident investors are often ill-prepared for adverse outcomes. As a result, they may experience heightened anxiety, leading to impulsive and irrational decision-making (Rahman & Gan, 2020). Over time, poor risk management can lead to significant losses and ultimately diminish overall portfolio performance.

In the realm of behavioral finance, the overconfidence displayed by Gen Z in managing investment risks has significant implications for current investment trends. Growing up with rapid access to information through technology and online investment platforms, Gen Z tends to feel more knowledgeable and confident in making investment choices (Natasya et al., 2022). This often leads to overconfident behavior, where they underestimate risks or fail to conduct thorough analysis of the assets they select. For instance, Gen Z individuals who have recently experienced success in stock or cryptocurrency investments may believe they possess exceptional skills, even though such outcomes might be due to market trends or mere luck. This is known as the illusion of control, where individuals feel they have greater influence over investment outcomes than they do (Pradikasari & Isbanah, 2018). This overconfidence results in poor risk management, as they neglect portfolio diversification or fail to account for potential market volatility. When the market faces downturns or uncertainty, overconfident Gen Z investors can suffer substantial losses due to inadequate risk mitigation strategies. This case highlights the importance of financial education and a deeper understanding of risk for this generation to avoid the detrimental effects of overconfidence on their investment decisions (Aristi et al., 2023).

Overconfidence in investing often results in unrealistic expectations about the returns or profits to be achieved. Investors who are overconfident tend to overestimate their ability to predict market trends, choose the right assets, and manage risks effectively. They frequently believe they can outperform the market or secure higher-than-average returns without fully considering the associated risks (Juwita et al., 2022). While overconfidence may lead to short-term gains if the market performs as anticipated, these results are often due to luck or favorable market conditions rather than skill. Unfortunately, many investors incorrectly attribute this success to their own abilities rather than external factors. Over the long term, overconfidence typically has a detrimental effect on investment returns. Overconfident investors are more prone to overtrading, making excessive transactions without proper analysis, which results in increased transaction costs and reduced profits. Additionally, they often neglect proper portfolio diversification, leaving them vulnerable to significant market volatility. When the market shifts or fails to meet their expectations, these investors are usually unprepared for losses due to a lack of effective risk management strategies (T. L. Situngkir & Nugraha, 2021) As a result, their returns are often considerably lower compared to more cautious and rational investors. Therefore, before making investment decisions, it is crucial for investors to assess their level of confidence and recognize potential cognitive biases that may cloud their judgment (Shantha, 2019).

The literature review reveals a clear link between overconfidence and behavioral finance in Gen Z, as reflected in their investment behaviors, which are often shaped by excessive confidence in their financial decision-making skills. Having grown up in the digital age with instant access to information and technology, Gen Z tends to feel more knowledgeable and confident in investing, even though they may lack the experience or deep understanding of market risks (TEKMAPRO et al., 2023). In behavioral finance, overconfidence is a cognitive bias that leads Gen Z investors to overestimate their abilities, often resulting in a disregard for diversification and an increase in overtrading. Their tendency to follow trends and imitate the investment behaviors of their peers further reinforces their belief that their decisions are sound (Theressa & Armansyah, 2022). This behavior suggests that while Gen Z is highly active in capital markets, without proper risk management, overconfidence can negatively impact their long-term investment performance.

To manage overconfidence in investing, a strategy that combines self-awareness, discipline, and a data-driven approach is essential. Investors should first increase their awareness of cognitive biases by regularly assessing their investment decisions and distinguishing between luck and skill. Implementing a fact-based, data-driven approach, such as conducting thorough fundamental and technical analysis before making decisions, can help curb the tendency toward excessive confidence (Alsabban & Alarfaj, 2020). Furthermore, portfolio diversification is critical for mitigating unexpected risks, and limiting the frequency of trades helps prevent overtrading, which often stems from overconfidence. Additionally, seeking advice from third parties, such as financial advisors or mentors, offers an objective perspective, aiding investors in making more balanced and rational decisions. Ultimately, effective risk management is the cornerstone of successful investing, and by managing their confidence, investors can make more informed decisions and protect their portfolios from unnecessary losses (Sabilla & Pertiwi, 2021; T. L. Situngkir et al., 2022)

5. Conclusions

Overall, overconfidence has a significant impact on investment decision-making, often resulting in poor risk management and unrealistic return expectations. Gen Z, exposed to rapid information and easy access to financial markets, is particularly vulnerable to overconfident behavior, which can lead to substantial long-term losses. To mitigate these risks, investors should be mindful of their cognitive biases, adopt a data-driven approach, and implement sound risk management strategies, including portfolio diversification and seeking advice from experts. By understanding and addressing overconfidence, investors can make more rational decisions and optimize their potential returns while properly accounting for associated risks.

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