



Economica: How corporate overconfidence impacts important policies

By ET Bureau | 15 Nov, 2013, 12:00PM IST

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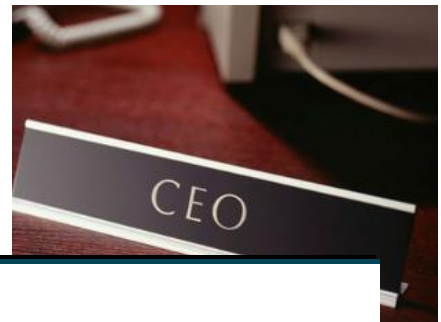
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Most of us know it is tough to forecast the stock market and would offer a wide range of possible outcomes if pressed for a prediction. Not true for Chief financial officers asked to explain move in company's stock price overconfident in their forecast correct.



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According to a new research study by [Itzhak Ben-David](#) of Ohio State University's [Fisher College of Business](#) and [John Graham](#) and [Campbell Harvey](#) of Duke University's [Fuqua School of Business](#), the range of outcomes that CFOs provide for oneyear stock market forecasts are unrealistically narrow. "These executives are too sure of their ability to predict the future. This overconfidence is linked to decision-making at their firms, so there is a real-world impact," says Ben-David.

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The study, published in the November issue of the Quarterly Journal of Economics, asked CFOs to predict a range of outcomes that would lead them to be 80% right. However, the ranges they gave were so narrow that they barely got 1 in 3 correct. "For example, they might say next year's return should fall in the range of -20 to +20%. If the market return is 10%, they are correct. But that is not what we found. They would give really tight ranges, like 11 to 18 percent. If the market return is 10%, they are wrong. This is a classic trait of severe overconfidence," said Harvey.

The magnitude of the miscalibration led the researchers to investigate whether this overconfidence impacted the way they ran their businesses. Graham said executives were also asked to predict the range of possible outcomes for their firm's own investment projects, "and again they proved to be extremely overconfident. It is well known that

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companies' investment outcomes are volatile but CFOs seem oblivious to this risk."

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