High finance, high anxiety

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Credit: George Hodan/public domain

Studying events like the 2008 financial crisis in hindsight leads many to ask, "How could they have gotten it so wrong?"

New research by University of Michigan professor Martin Schmalz finds that overconfidence—underestimating risks—can be a rational response to fear, or "anxiety," but the balance between the two can fluctuate over time.

"So many CFOs were overconfident before the financial crisis and underestimated risk. That's quite puzzing" said Schmalz, assistant professor of finance at U-M's Ross School of Business. "Given they are the experts, why were they still so bad at it?"

His study, "Anxiety, Overconfidence, and Excessive Risk Taking," with Thomas Eisenbach of the Federal Reserve Bank of New York, indicates that there's a balance between overconfidence and fear that can get out of whack during times of robust profits or market crashes.

Given the human tendency to be overly afraid of near-term risks, overconfidence is necessary for profits and innovation, Schmalz said. If nobody took chances, few things of value would be created.

People know they will be nervous before making a risky move, he said. So they signal the move to others, which helps prevent them from backtracking or "chickening out." They also tend to ignore negative opinions or facts about what they're about to do.

This variation in confidence levels over time can explain why otherwise rational people missed risk that in hindsight looks obvious and amplifies bubbles, and why everyone acts timid after a market crash when the risks are lower, he said.

"A moderate amount of overconfidence is just at the sweet spot counteracting our irrational fears," Schmalz said. "That's something that can help economists understand the role human nature plays in the market."

Provided by University of Michigan

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