Buying high in the stock market caused by overconfidence

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The golden rule for investing has always been "buy low, sell high." Past research has shown that many people make the common investing mistake of selling stocks at a low price after the stock market has experienced a decline. However, little is known about what causes people to make mistakes on the other end of the spectrum: buying stocks at a high price.

Now, Rui Yao, an associate professor of personal financial planning at MU, has found that overconfidence in the stock market can lead to buying high. She says investors who experienced prior investment gains are twice as likely to invest in the stock market at high prices than investors who experienced prior losses in the market.

"Overconfidence appears to be a major issue when it comes to making investment mistakes," Yao said. "If inexperienced investors experience gains in the stock market initially, they may irrationally believe the stock market will keep improving and thus decide to allocate more defined contribution plan assets to stocks even when prices are very high. This can be damaging because the market will always correct, which in cases like this would mean a decline. Anyone who made the mistake of allocating a higher percentage of wealth in stocks at the high mark would experience losses—in some cases, large losses."

For her study, Yao examined data from the Survey of Consumer Finances from 2001-2013. The survey is conducted every three years and supported by the Federal Reserve and U.S. Department of the

Treasury. By analyzing data from nearly 4,800 American households, Yao found that people with higher incomes and lower net worth tended to commit this investment mistake.

Also, those with a high risk tolerances and long financial horizons, or many years until they need to reach their financial goals, such as retirement, were more likely to buy high as well. Yao says that investors advised by financial planners were less likely to buy high in the stock market.

"This study showed that some people tend to overshoot their risk tolerance, or their willingness to take financial risks, when they are confident in their own investing abilities or the stock market outlook," Yao said. "Working with a financial planner is a good way to avoid those problems, since the study revealed that people were less likely to experience this type of overconfidence, or at least were more likely to take advice from a financial expert. This shows the importance of receiving objective financial advice, or at least being aware of an individual's risk tolerance and investment goals and making wise decisions that align with those factors."

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