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Believing in yourself can backfire when investing in equity crowdfunded ventures

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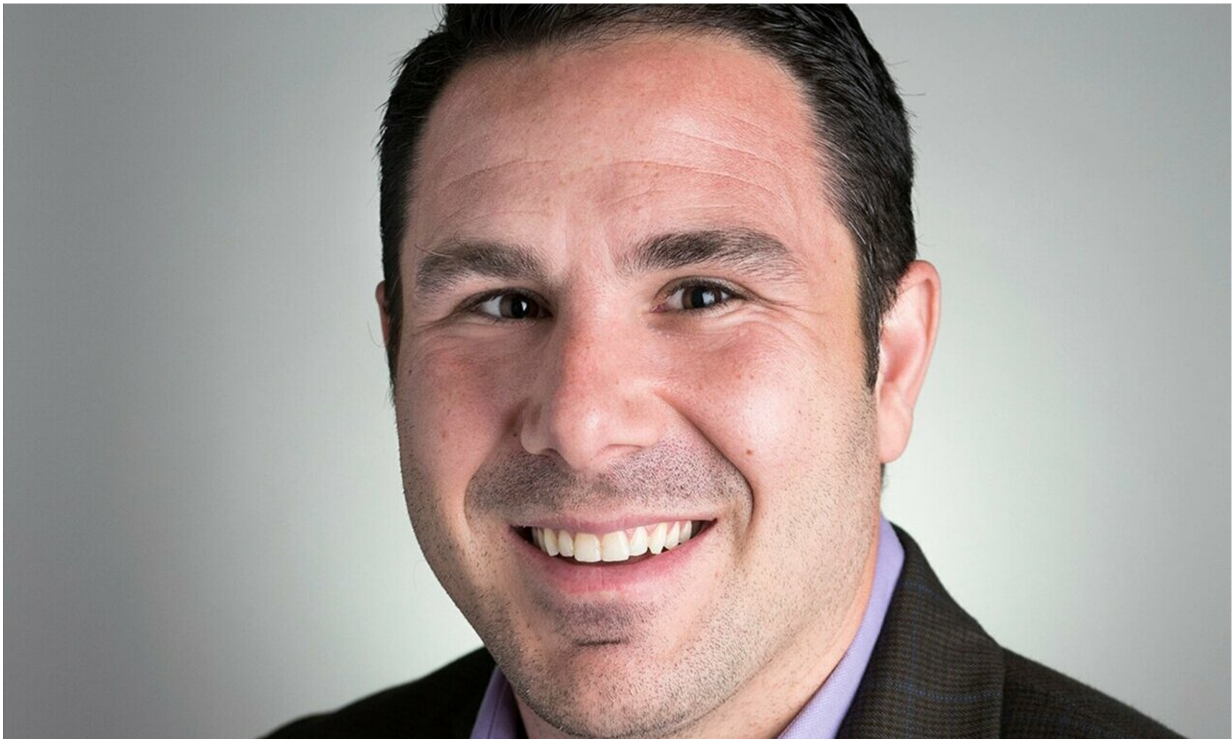

Regan Stevenson. Credit: Indiana University

Normally, it's good to believe in yourself. But research from Indiana University's Kelley School of Business indicates that it can be bad advice for amateurs investing online in unregulated, sometimes risky, equity crowdfunded ventures.

In a new paper, researchers reveal that amateur investors with an inflated view of their investing acumen are three times more likely to make poor decisions when investing in equity crowdfunded opportunities.

"Our research shows that crowdfunders with inflated self-belief quickly stop processing information properly, put in less decision-making effort, erroneously follow the crowd and make hasty investment decisions in poor-quality investment opportunities," said Regan Stevenson, assistant professor of management and entrepreneurship at Kelley.

Investing in equities has always been challenging, particularly for amateurs. But a 2016 federal law—passed with bipartisan support—enables startup companies to offer people a piece of the business through online crowdfunding, without the regulatory protections that have existed since 1933.

To date, many crowdfunders have suffered significant financial losses from poor investments in equity crowdfunded ventures. Data from one of the leading equity crowdfunding portals shows that one in five such deals returns nothing to investors.

Stevenson and his co-authors—Michael Ciuchta of the University of Massachusetts, Chaim Letwin and Jenni Dinger of the Suffolk University and Jeffrey Vancouver of Ohio University—suspected that some form of self-efficacy would lead certain types of people into following the crowd toward bad investments.

"Our results contribute to the developing understanding of the impact of informational cues in new venture funding decisions," Stevenson said. "Specifically, we show that amateurs with inflated levels of self-efficacy are highly susceptible to crowd bias and herding behaviors.

"These funders invested nearly three times as much in a poor-quality

venture when compared with a control group. Practically speaking, our results raise some concern for amateur funders with high self-efficacy engaged in risky equity crowdfunding decisions," he added.

Stevenson said he is encouraged by the creation of ratings companies, similar to those that exist for traditional securities, that could provide additional information about startups to investors.

"Training could solve a lot of these problems; even modest online training courses could help," he said. "I am a huge proponent of equity crowdfunding. These new rules can greatly benefit entrepreneurs and people in the community who want to invest in startups they love. It's just that it's being rolled out with limited oversight, and, not surprising, amateurs are going to make bad decisions.

"Given that the market for equity crowdfunding is growing rapidly—and may someday soon disrupt traditional private equity models—it is imperative that educators, regulators and legislators think about ways to ameliorate the potential risks for amateur crowdfunders engaged in the high-risk world of startup investing."

Stevenson and his colleagues conducted three studies—two controlled lab experiments and a field study—involving more than 500 people. In the initial study, they randomly separated participants into two groups who viewed equity crowdfunding pitches. Afterward, people made a series of investment decisions. Investors identified as having a higher belief in themselves were less likely to identify and invest in high-quality venture opportunities, compared to the control group.

In the second study, participants were given crowd cues—comments from others that ventures were good or bad investments—that didn't match the quality of the investment. The researchers observed that "when funder self-efficacy was inflated, they were much more likely to

blindly follow the crowd into a bad investment opportunity." A third quasi-experimental field study had results similar to the lab experiments.

More information: Regan M. Stevenson et al, Out of control or right on the money? Funder self-efficacy and crowd bias in equity crowdfunding, *Journal of Business Venturing* (2018). DOI: 10.1016/j.jbusvent.2018.05.006

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