
RESEARCH ELSEWHERE

Robert A. Olsen

Financial Analyst Characteristics and Herding Behavior in Forecasting

By Michael B. Clement and Senyo Y. Tse

The Journal of Finance, Vol. 60, No.1, 2005, pp. 307–341.

Previous research has demonstrated that investors respond to revisions in analyst's earnings forecasts. More specifically, investors respond with the most vigor to large or "bold" forecast revisions. This empirical paper uses market data to identify analyst characteristics that are associated with bold forecast revisions. It also investigates the relative accuracy of "bold" forecasts.

The authors classify forecasts as "bold" if they are above (or below) both the analyst's own prior forecast and the consensus forecast. Lesser revisions are classified as "herding forecasts". Using forecasts of annual earnings from 1989 to 1998 (57,596 observations) the authors report the following results.

1. Bold forecast revisions vary directly with prior analyst accuracy, brokerage firm size, forecast frequency, general analyst experience and forecast horizon. Also, the prevalence of bold forecasts declines with the number of industries followed by the analyst.
2. Bold forecasts tend to be more accurate than herding forecasts.
3. Bold forecasts reflect the analysts' private information more than do herding forecasts.

Robert A. Olsen is Professor Emeritus from California State University, Chico and a Research Fellow with Decision Research in Eugene, Oregon. He holds graduate degrees in Finance from the University of Oregon and the University of Massachusetts. Professor Olsen has business experience as a Financial Analyst and consulting experience with small business start-ups. Professor Olsen's research interests are focused on Risk Perception and Behavioral Finance.

Requests for reprints should be sent to: Robert A. Olsen, Decision Research, 1201 Oak Street, Eugene, OR 97401. Email: olsenbfin@msn.com

As would be expected, analysts with lesser professional experience and in more vulnerable personal work situations tend to herd to a greater extent and avoid making bold forecasts.

On the Psychology of "if only": Regret and the Comparison Between Factual and Counterfactual Outcomes

By Eric van Dijk and Marceel Zeelenberg

Organizational Behavior and Human Decision Processes, Vol. 97, 2005, pp. 152–160.

This laboratory study is unique in that it investigates the influence of "comparability" in triggering the "feeling of regret". Regret is a negative emotion that is experienced when the decision maker realizes or imagines that he/she would have been better off if only they had made an alternative choice. The authors hypothesize that regret requires the running of a mental simulation that pits what has happened against what might have happened. Thus the strength of regret should be a positive function of the comparability of the factual and counterfactual outcomes. They also suggest that people differ in their need to compare their personal situation with that of others. Thus they also hypothesize that decision makers with a lower felt need to engage in social comparison would tend to feel less regret, all else equal.

In a series of experiments the authors find that regret is reduced when:

1. What might have happened is less certain. In particular, increased inability to arrive at reasonable probability estimates reduces regret.
2. When the factual outcome and the counterfactual alternative are not easily compared. Concrete examples of this would include a comparison of outcomes that may be

measurable in different dimensions, such as dollars versus hours of free time, or comfort

3. Individuals with a lesser felt need to engage in social comparisons have less regret.

Neuroeconomic Foundations of Trust and Social Preference: Initial Evidence

By Ernst Fehr, Urs Fischbacher and Michael Kosfeld

Working Paper, Institute for Empirical Research in Economics, Zurich, 2005.

Some Economists are willing to tolerate a model of decision making that incorporates the possibility of individual cooperation only if it contains the implicit assumption of reciprocity. This review article suggests that such an assumption is unnecessary.

This paper summarizes recent neuroeconomic evidence relating to “other-regarding” behavior. The principal conclusions reached are that:

1. People derive nonpecuniary utility from mutual cooperation.
2. People derive nonpecuniary utility from punishing unfair behavior.

Thus the mutual cooperation that takes place despite strong free riding incentives may be the result of evolutionary influences that gave adaptive advantage and need not be viewed as a cognitive strategy. The authors also discuss the role of the neuropeptide oxytocin as an influence on the decision to trust. In particular, they note that higher levels of oxytocin are associated with greater feelings and willingness to trust. Thus individuals decisions to accept personal risk should not be modeled as a purely cognitive strategic activity.

Consumer Choices Under Small Probabilities: Overweighting or Underweighting?

By Rong Chen and Jianmin Jia

Marketing Letters, Vol. 16, 2005, pp. 5–18.

Empirical evidence suggests that decision makers tend to overweight the chance of low probability events. In fact a formal weighting function of this type has been incorporated into Prospect Theory. In this laboratory study, the authors suggest that this behavior is an artifact of the way in which previous studies have been conducted. More specifically, they

demonstrate that the weighting pattern appears to be a “framing issue” related to the contrast between the values associated with the various possible outcomes. They present evidence consistent with the following hypotheses.

1. When the contrast between outcome values is reduced, risky options with small probabilities are less likely to be over weighted.
2. As the associated outcome payoffs increase, over weighting of small probabilities diminishes.
3. Over weighting tends to be directly related to the decision makers wealth level.

In general the authors suggest that the over weighting phenomena is context dependent and that the results are easily explained by the differential attention given to different payoff magnitudes. Large relative payoffs encourage more attention and small relative payoffs less attention. Also, individuals experience difficulty in interpreting small probabilities in a way that further magnifies the over weighting phenomena.

The Eco-Efficiency Premium Puzzle

By Jeroen Derwall, Nadja Guenster, Rob Bauer and Kees Koedijk

Financial Analysts Journal, Vol. 61, No. 2, 2005, pp. 51–63

This market data based study is interesting for the questions it raises rather than the answers it provides. In particular it suggests that over the period 1995–2003 a portfolio of ecologically “good firms” offered about 6% more risk adjusted return per year than a portfolio of ecologically “bad firms”, ceteris paribus. This return differential is much larger than other researchers have found and it is especially intriguing since the authors went to considerable effort to control for other factors that might have been responsible for the performance difference.

Portfolios of good and bad firms were constructed and compared on the basis of their eco-efficiency. Eco efficiency was defined as the ratio of the value a company adds, to the value of the ecological burden that it produces. The company ratio data were obtained from Innovest and are based on the weighting of 60 different value/cost dimensions. All companies were U.S. firms and the good and bad portfolios consisted of the top 30% and bottom 30% of the Innovest ranked firms. The multifactor model controlled for seven widely acknowledged market and industry factors as well as market tilt. After ruling out return differentials due to

risk, the authors suggest that the performance difference appears to be caused by an inability of investors to appropriately measure and price the benefits and costs of eco-efficiency.

The Recalcitrance of Overconfidence and its Contribution to Decision Aid Neglect

By Winston R. Sieck and Hal R. Arkes

Journal of Behavioral Decision Making, Vol. 18, 2005, pp. 29–53.

This study tested the hypothesis that greater overconfidence in the efficacy of one's intuitive judgment leads to a greater reluctance to use decision aids, even when the aids are known to be beneficial. Utilizing a series of laboratory experiments, the authors found that even though observed judgmental accuracy was greater when subjects were allowed to use a statistical forecasting equation, subjects still preferred to excessively rely on their own intuitive judgment. Three alternative feedback methods were used to reduce decision maker overconfidence and to give subjects a more accurate view of their intuitive ability. Reducing overconfidence via calibration feedback did result in somewhat greater use of the forecasting equation. However, the overall conclusion was that poor judgment, due to overconfidence, is not easily eliminated. While subjects readily acknowledged overconfidence in the aggregate, it was hard to get them to acknowledge its presence when making individual forecasts. The authors suggest that rather than trying to reduce overconfidence in intuitive abilities, it may be more efficacious to increase subject's confidence in the value of statistical models.

Money as Tool, Money as Drug: The Biological Psychology of a Strong Incentive

By Stephen E. G. Lea and Paul Webley

Behavioral and Brain Sciences, Vol. 28, No. 2, 2005, pp. 1–32.

While this literature review does not deal explicitly with investment decisions, it has potential implications for certain types of investment activity such as day trading, tape reading, etc. In particular, the article implies that activities of this type may be encouraged by an addictive process, wherein the activity stimulates brain areas associated with immediate reward.

The paper begins with the examination of two theories explaining the desire for money. The first theory is

the “tool use theory”. This is the standard theory of economic analysis. It assumes that money is instrumental and is valued and desired only for the benefits that it can provide to its possessor. The second theory is the “drug theory”. According to this theory, money like drugs, may intrude upon the normal functioning of the nervous system. More specifically, the authors suggest that money might be seen as perceptual drug, somewhat like visual pornography, that can act as a natural motivator even though it does not produce any evolutionarily adaptive benefit. Although the response to money may be a cognitively mediated response, the authors suggest that it is still strongly affective. In essence the “tool use theory” deals with situations where money has a real underlying function while the “drug theory” deals with desire situations of functionless money motivation.

The authors conclude that money may act like a drug by “hijacking” the evolved brain systems that are related to the desire to engage in trade and the desire to engage in play activities. They argue that both the motivation to trade with others and to learn, through object play, would have been naturally adaptive and beneficial.

Loss Aversion Without the Endowment Effect and Other Explanations for the WTA-WTP Disparity

By Thomas C. Brown

Journal of Economic Behavior and Organization, Vol. 57, 2005, pp. 367–379.

This set of laboratory studies, utilizing a unique experimental design, was designed to further investigate the role of loss aversion in situations where the willingness to accept compensation (WTA) is greater than the willingness to pay compensation (WTP). Many studies have documented a tendency for the sellers of a good to ask a higher selling price than they would be willing to pay to acquire the identical good. The usual explanation for this “Endowment Effect” is loss aversion. That is, a good becomes more valuable once acquired and owners are therefore averse to experiencing the discomfort realized by selling it at a price below this new higher personal value.

The results of this research suggests that loss aversion is related to the WTA-WTP discrepancy but that it is not because a good becomes more valuable once it is possessed. Instead, sellers and buyers are simply averse to incurring a loss from either selling the good too cheaply or buying it at too high a price. In other words, both buyers and sellers are motivated only by the desire to “get a good deal”. This further confirms

the conclusions of other researchers who suggest that the WTA-WTP discrepancy has more to do with the differing perspectives of buyers and sellers than it does with the sudden appearance of a new higher “possession value”. This study also suggests that af-

fect may play a role in the WTA-WTP discrepancy in that individuals stressed the need to “feel” that they are getting a “good deal” when undertaking a transaction.

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