

The Presence of Investor Overconfidence in the South African Exchange Traded Fund Market

Authors : Damien Kunjal, Faezaz Peerbhai

Abstract : Despite the increasing popularity of exchange-traded funds (ETFs), ETF investment choices may not always be rational. Excess trading volume, misvaluations of securities, and excess return volatility present in financial markets can be attributed to the influence of the overconfidence bias. Whilst previous research has explored the overconfidence bias in stock markets; this study focuses on trading in ETF markets. Therefore, the objective of this study is to investigate the presence of investor overconfidence in the South African ETF market. Using vector autoregressive models, the lead-lag relationship between market turnover and the market return is examined for the market of South African ETFs tracking domestic benchmarks and for the market of South African ETFs tracking international benchmarks over the period November 2000 till August 2019. Consistent with the overconfidence hypothesis, a positive relationship between current market turnover and lagged market return is found for both markets, even after controlling for market volatility and cross-sectional dispersion. This relationship holds for both market and individual ETF turnover suggesting that investors are overconfident when trading in South African ETFs tracking domestic benchmarks and South African ETFs tracking international benchmarks since trading activity depends on past market returns. Additionally, using the global recession as a structural break, this study finds that investor overconfidence is more pronounced after the global recession suggesting that investors perceive ETFs as risk-reducing assets due to their diversification benefits. Overall, the results of this study indicate that the overconfidence bias has a significant influence on ETF investment choices, therefore, suggesting that the South African ETF market is inefficient since investors' decisions are based on their biases. As a result, the effect of investor overconfidence can account for the difference between the fair value of ETFs and its current market price. This finding has implications for policymakers whose responsibility is to promote the efficiency of the South African ETF market as well as ETF investors and traders who trade in the South African ETF market.

Keywords : exchange-traded fund, market return, market turnover, overconfidence, trading activity

Conference Title : ICBEF 2020 : International Conference on Business, Economics and Finance

Conference Location : Cape Town, South Africa

Conference Dates : April 16-17, 2020