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Trading Volume and Overconfidence with Differential Information, and Heterogeneous Investors

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Abstract: This paper adds to the overconfidence literature by specifically considering the differential nature of information and its use by different classes of investors. The literature suggests that overconfidence is a major determinant of stock trading volume. We postulate that private investors are more prone to overconfidence bias as compared to institutional investors. This implies that turnover in firms with low institutional ownership will be driven more by private information while turnover in firms with high institutional ownership will be driven more by public information. This is the essence of the two hypotheses we explore. We find strong evidence in support of the first proposition but only mixed evidence in support of the second proposition. However, the second proposition is found to be very significant in the most recent period if certain low value or low liquidity stocks are excluded from the data.

Keywords: Overconfidence; Behavioral finance; Over (under) reaction; Trading volume

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