Financial Literacy and Investor Trading Behavior: The Impact of Overconfidence, Warning Signals and Financial Attention

There is a link between investors' financial literacy and their trading behavior. Investors who overestimate their own financial literacy are considered overconfident, and this overconfidence affects their trading decisions. Overconfidence influence investor demand, performance, and broker profits, underscoring the need for stronger regulations to mitigate the potential adverse effects of this behavioral bias on financial markets. Both theoretical and empirical findings reveal that overconfident investors tend to trade excessively, exceeding the activity of rational investors, incur higher transaction costs, and often ignore signals indicating their low financial literacy. These investors also achieve poorer performance as their financial attention increases.

Overconfidence, Financial Literacy and Excessive Trading

The link between the investors trading behavior and their level of financial literacy is investigated, specifically analyzing how investors trade when they are overconfident about their financial literacy and tend to overestimate it. Overconfidence is measured by the MiFID test scores. The MiFID is the Markets in Financial Instruments Directive (Directive 2004/39/EC), which came into force in Europe in 2007.

The results suggest that overconfident investors exhibit a higher demand for risky assets and face higher transaction costs, thereby benefiting brokers. Additionally, it is shown that the stress resulting from a mismatch between MiFID test scores and the subjective financial literacy mitigates the impact of overconfidence.

Effectiveness of Warning Signal and Overconfident Investors

The impact of the MiFID-mandated warning signal on curbing excessive trading behavior among financially illiterate investors is explored. According to MiFID regulations, financial intermediaries warn investors when a financial product is deemed inappropriate according to their level of financial literacy. Investors fill in an appropriateness questionnaire, and if they do not succeed it, they receive a warning signal. The warning is issued in a standardized way. The results prove that an effective warning signal can reduce investors demand for risky assets, thereby lowering transaction costs and, to some extent, improving investor performance. However, the study also demonstrates that overconfidence in financial literacy can undermine the effectiveness of the signal.

When it Pays to Pay Attention?

The influence of investors' financial attention, alongside varying levels of financial literacy, on their performance is analyzed. Financial attention is defined as an input into decision-making process for trading, and implies monitoring the own stocks portfolio and gathering financial information.

The results indicate that when financial attention is combined with high financial literacy, it enhances investors performance. In contrast, financial attention combined with low financial literacy has a negative impact. Illiterate investors are not able to correctly interpret financial information or properly monitor their portfolio. These effects are even more pronounced for investors who are overconfident in their financial literacy and overestimate it.

Policy Implications

As a general conclusion, it can be inferred that investors' overconfidence, especially if combined with low financial literacy, can have a negative impact on investors' trading behavior and may become an element of risk that can lead to financial losses. From this point arises the need for stricter rules in designing the MiFID questionnaire, in order to make it a more trustworthy tool to grade investors' financial literacy, and in designing the warning signal, in order to make it more effective in limiting excessive trading from illiterate investors. On the other hand, when investors exhibit high levels of financial literacy, overconfidence seems to be favorable for them, because they benefit from the first-mover advantage or from trading in riskier assets.

Contact: Mariachiara.tedde@ugent.be