DOES OVERCONFIDENCE AFFECT ENTREPRENEURIAL INVESTMENT? (SUMMARY)

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SUMMARY

DOES OVERCONFIDENCE AFFECT ENTREPRENEURIAL INVESTMENT?

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Principal Topic

This paper investigates the affect of overconfidence on entrepreneurial investment. Overconfidence in this study describes a positive bias in self-perception, which can manifest in regard to an individual’s knowledge, accuracy of predictions, and personal abilities (Hayward, Shepherd and Griffin, 2006). Overconfidence has been shown in other management and finance domains to be associated with greater riskiness of product introductions (Simon and Houghton, 2003), greater persistence in developmental efforts of technologies (Lowe and Ziedonis, 2006), and greater cash-flow sensitivity of corporate investment (Malmendier and Tate, 2005). In this paper, we argue that overconfidence will influence the decision to begin operating the venture, the time and financial capital invested, the propensity to seek outside funding, and the riskiness of the investment.

Method

The Panel Study of Entrepreneurial Dynamics (PSED) was utilized to investigate overconfidence-entrepreneurial investment linkages. Overconfidence was measured from responses to questions grounded from psychology, which is advantageous because it avoids using proxies of overconfidence based on outsider perceptions, correlated financial choices, and demographic characteristics. Further, our tests controlled for many other economic factors associated with resource choices of individuals. Given nonrepetitive, ambiguous decision environments encourage overconfidence, the initial stage of venture creation provides a powerful setting to test for the affects of overconfidence.

Results and Implications

Consistent with our arguments, we found that overconfidence is positively related to the likelihood that a nascent entrepreneur will eventually begin operating his business, the amount of personal money she invests in the venture, and the riskiness of financial investments in the venture. Surprisingly, overconfidence increases the likelihood of being employed outside the venture and does not influence the decision to seek outside financing.

This study contributes to several areas of research. First, this study contributes to the literature of the affects of psychology on the economic choices of individuals. In this paper’s setting, the nexus between the beliefs of the individual and the resultant actions are strong given the founder’s influence on his and the venture’s behavior. Second, this study contributes to understanding what determines investment choice in entrepreneurial activity beyond simple economic predictions, such as liquidity constraints. By investigating several intended exposures, this study goes beyond merely examining start-up capital amounts invested, and considers a richer set of venturing investment choices.

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