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Are Biased Beliefs Fit to Survive?

An Experimental Test of the Market Selection Hypothesis *

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Abstract

We experimentally study the “market selection hypothesis,” the classical claim that competitive markets bankrupt traders with biased beliefs, allowing unbiased competitors to survive. Prior theoretical work suggests the hypothesis can fail if biased traders over-invest in the market relative to their less biased competitors. Subjects in our experiment divide wealth between consumption and a pair of securities whose values are linked to a difficult reasoning problem. While most subjects in our main treatment form severely biased beliefs and systematically over-consume, the minority who form unbiased beliefs consume at near-optimal levels – an association that strongly supports the market selection hypothesis.

Keywords: market selection hypothesis, survival of the fittest, efficient markets, Bayesian errors, Monty Hall problem, experimental economics

JEL codes: C9, D03 G1

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