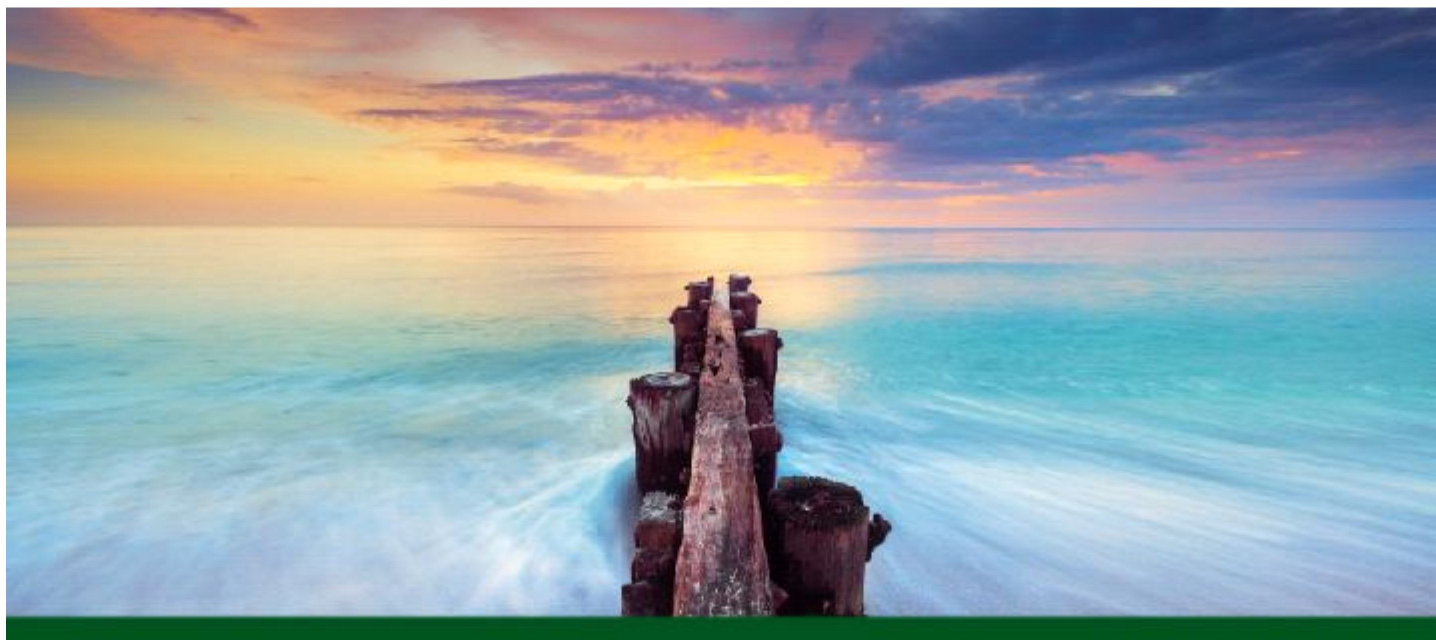

Investing with Overconfidence

"How fortune brings to earth the oversure!"
– Petrarch

In our most recent article we introduced you to the field of behavioral finance. Behavioral finance uses psychology to describe the financial decisions that individuals make and to explain why these decisions are often irrational. In the next few articles, we will address some of the main concepts in behavioral finance in order to make you more aware of the financially dangerous psychological biases that all humans have. In this article, we begin by addressing one of the most common psychological biases: overconfidence.

Humans have a natural tendency to be overconfident. We tend to overestimate our knowledge of a particular subject, overestimate our skills, overestimate our ability to control outcomes and underestimate the risks involved in uncertain situations. In one classic study (Svenson, 1981), a group of American drivers was asked to rate their own driving skills as being either better or worse than the average person. If the study participants were accurately describing their own driving skills, we would expect that approximately 50 percent of the respondents would claim to have better than average skills and 50 percent would claim to be worse than average. However, *an astonishing 93 percent* of the participants claimed to be better than average drivers, which demonstrates a significant tendency towards overconfidence. Similar results have been found when asking people to rate their own intelligence, popularity, or the time that it takes them to use an ATM.

The human tendency to be confident is beneficial in many areas, including athletics, business and science. Mankind needs to have its dreamers; without them our rate of progress would be far less rapid and our outlook on life would be more pessimistic. However, overconfidence is not a beneficial trait in the world of investing. It can lead us to falsely believe that we can predict the future movements of individual stocks or the market as a whole, that we can control the return on these investments, or that our activities involve little or no risk.

Overconfident Amateurs

Many amateur investors engage in overconfident behavior without even realizing it. For example, whenever you buy the stock of any individual company, you are suggesting that your knowledge of the company's prospects is superior to the overall knowledge of the market as a whole. Your

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implicit claim is that you have an ability to predict the future movement of the price of that particular stock and that the stock will outperform other stocks of comparable risk. But how can you justify such a claim? Do you know more about the company than dozens of Wall Street analysts whose job it is to assess the company's future prospects? Can you predict how the irrational sentiments and behavioral biases of other investors will impact the future price of the stock? The truth is that stock picking is a speculative enterprise, and any individual who claims to be able to accurately predict future price movements is simply exhibiting the very natural human tendency to be overconfident in his own abilities.

Overconfident Professionals

Not only do we exhibit overconfidence in our own abilities, we also tend to be overconfident in the abilities of certain "experts," including economists and financial strategists. While it is obvious that most amateur stock pickers are likely to underperform, many people still maintain a belief that the professionals have an edge and that their predictive ability holds the key to investment success.

Unfortunately, the results for the pros are no better. It is an established fact that, on average, professional investors who attempt to pick stocks or time the market tend to underperform. Their overconfidence leads them to a false belief about their skills, which in turn leads to over-trading and high expenses. Yet, despite the dismal performance of professional stock pickers, individual investors continue to solicit their services. The public's overconfidence in the abilities of these professional managers reinforces the overconfidence of the managers themselves, and the vicious circle of overconfidence is perpetuated.

Overconfident Advice

As we learn about psychological biases such as overconfidence, we must keep in mind that these biases are an integral part of human nature and they cannot be removed from our psyche. The best we can hope to do is to increase our awareness of the presence of these biases so we can account for them when making financial decisions.

When working with a financial advisor, you should make sure that the advisor recognizes that overconfidence is present in all of us, that the future is not predictable, that we have limited control over market outcomes and that hidden risks are everywhere. An advisor who is aware of these biases can implement a disciplined investment strategy for you, but a lack of such awareness can be very hazardous to your financial health. As noted economist Ken French has said, "Overconfidence is almost certainly the most important bias in behavioral finance. But most people still think I'm not talking about them."

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The original version of this article was written by Heritage for the May 2013 edition of The Light, a local magazine serving Broward County, Florida.

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