OVERCONFIDENCE
A BEHAVIORAL RISK FOR BOTH FINANCIAL ADVISORS AND THEIR CLIENTS

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The increasing interest in decision making biases affecting the financial world can best be documented with this metric: A Google search of the phrase "Behavioral Finance" yields over 5 million hits. A cursory scan of a sample of those links highlights overconfidence as a significant bias affecting both investors and their advisors. Overconfidence can lead to poor portfolio performance.

Overconfidence Defined

Just as prices can inflate, so too can one's self-concept and sense of competence inflate. Overconfident individuals overestimate their own abilities and judgments, often believing they know more than others or perform certain tasks better than others. They don't recognize that there are things they do not know, and jobs they do not or cannot do well.

For example, seventy-three percent of U.S. drivers believe they are above average drivers (https://www.businessinsider.com/americans-are-overconfident-in-their-driving-skills-2018-1). Those drivers underestimate risk, a common characteristic of the overconfident. They believe they can drive while tired or intoxicated. They likely increase the incidence of accidents.

Surveys by Heck, Simons and Chabris (2018) concluded that sixty-five percent of Americans agreed with the statement "I am more intelligent than the average person." While possessing confidence in your intelligence can lead to increased self-efficacy and positive outcomes, individuals with excessive confidence in their intelligence likely take excessive risks, display arrogance, and make bad decisions. Also, when an overconfident person is found to be wrong, they subsequently lose more credibility than others; i.e., there is indeed a penalty for displaying inflated but unwarranted confidence.

The tendency to inflate one's abilities and judgment is not only well documented in the social sciences, it has even secured a label in popular culture: The Lake Wobegon Effect. Garrison Keillor's Lake Wobegon was a fictional mid-western town where "all the women are strong, all the men are good-looking, and all the children are above average." Lake Wobegon is indeed fictional, but believing and acting as if you were "strong, good-looking, and above average" has real life consequences, especially when making financial decisions.

The Overconfident Investor

Overconfident investors think they know how to pick stocks, when to buy and sell (the timing decision) and can predict the future returns of securities. As a result, they take excessive risks, over-trade, under-diversify, and inflate their past investing performance…. a "perfect storm" for poor portfolio performance.

For example, in a series of experiments, investors recalled their past performance as being better than it actually was. This tendency to have a positively biased memory likely contributes to overconfidence in investing ability (Walters and Fernbach (2021)).

Because of an inflated sense of their ability to pick stocks and/or time the market, overconfident investors tend to overtrade (Barber and Odean (2000)). They also sell their winners too soon and hold their losers too long. Moreover, the stocks they sell outperform the replacement stocks they buy, on average by 3.2% in the year following the transaction. Excessive trading creates unnecessary trading costs (commissions and/or the bid-ask spread). Barber and Odean found that the more investors trade, the lower their return; the most active traders underperform the market by 6.5%/year! Overconfident investors are also more likely to trade on margin and trade futures and options (Asaad (2020)). These activities increase their risk exposure and reduce potential returns.

Overconfident clients are less likely to listen to their financial advisor. Indeed, overconfident investors may pay for advice that they reject because of a belief in the value of their own “wisdom." The clients who fail to listen to their advisors have less diversified portfolios that underperform on a risk adjusted basis. Some advisors pander to their clients’ unsound beliefs. Hackethal et al (2018) liken this finding to doctors who prescribe antibiotics to patients that demand them, even in instances that antibiotics are inappropriate.

Lee and Hanna (2020) find that investors who are overconfident in terms of their financial knowledge are more likely to take early withdrawals from their retirement accounts. Such actions, of course, jeopardize future financial security.

The Overconfident Financial Advisor

Even though advisors might deny it, they too may reside in Lake Wobegon. Linnainmaa, Melzer and Previtero (2018) find that Canadian financial advisors invest in the same way as their clients. Overconfident advisors overtrade, chase returns, under diversify and invest in high-fee actively managed funds, just like overconfident investors. The result is that advisors’ net (risk adjusted) returns on their portfolios are -3%/year.

Van De Venter and Michayluk (2008) surveyed 340 Australian FP’s and found they displayed overconfidence in their ability to predict and forecast.

According to Montier (2006), 74% of professional investment fund managers believe they are above average at performing their jobs. Only 50% can truly be above average.

A survey by Schwab and Cerulli (2019) reported that 65% of financial advisors believe that their portfolio management skills will likely help their clients outperform the market.

Shared Traits of Overconfident Investors and Financial Advisors

The following list summarizes and synthesizes the research above. The overconfident client and the overconfident advisor tend to:

- jump on bandwagons and follow the herd.
- chase performance.
- often believe that a rising stock (or any asset) will continue to rise.

- over-trade.
- under-diversify.
- minimize or ignore risks.
- believe their past performance was better than it actually was.
- overestimate the predictability of the economy and financial markets.
- possess hindsight bias, which means they will often say "I always knew this would happen," when in fact they didn't. Relatedly, they will conveniently forget when their prior predictions were incorrect.
- believe they are more astute than their investing or advising peers.

<u>Managing Overconfidence</u>

The following recommendations speak directly to overconfident advisors, and indirectly to their clients.

- Know yourself. Increase self-awareness. You are not immune from overconfidence risk.
- Don't inflate your qualifications, skills, and abilities. Know what you cannot do and when appropriate, refer clients to others who have the necessary expertise.
- Don't misrepresent your past performance.
- Don't overstate what you are likely to achieve when you manage clients' money. Instead, work to exceed your clients' expectations; i.e., under-promise and over-deliver.
- Disclose the risks of every investment you make.
- Communicate to both understand and to be understood.
- Validate that your clients understand the potential risks of your advice.
- Think before you act. Delay a decision if emotionally distraught or physically stressed.
- Keep a diary/journal of what you think will happen in the future and compare your forecasts to what ultimately happens.
- Solicit other opinions. To temper overconfidence, immerse yourself in reading about and listening to competing opinions.
- Understand that luck and pure randomness, and not your abilities, often lead to outcomes. Remember, even a broken clock tells the correct time twice a day.
- Establish buy and sell rules in advance and stick to them.
- Many clients have excessive faith in their financial advisor's abilities. Be sure clients understand what you can and cannot do, and know that investing is inherently risky.
- Encourage your clients to talk about finances and investing with their spouses. Warmath, Piehlmaier and Robb (2019) find that when couples share investment decisions, overconfidence is reduced.
- Tactfully "nudge" your stubborn and resistant clients to invest intelligently when they appear to be heading down the wrong investing path.

- Educate yourself and your clients. Read about overconfidence. Read Part 3 of Kahneman (2011). Indeed, read all of Kahneman's book.
- Make investment decisions for the long run, and don't overtrade. Trade to rebalance a portfolio, not because you think you have identified a misvalued stock or believe it's the right time. Don't succumb to FOMO.

Conclusion

Lake Wobegon is a fantasy, as are omniscient financial advisors and investors who consistently time the market successfully and never lose on a trade. When both advisors and their clients reduce the risk of overconfidence, they will move from a fantasy world to the real world. That real world is one where goals and dreams can be reached, with wisdom, self-awareness, and self-control.

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