MISTAKE 1

Are You Overconfident of Your Skills?

People exaggerate their own skills. They are optimistic about their prospects and overconfident about their guesses, including which managers to pick.

—Richard Thaler

Jonathan Burton, in his book *Investment Titans*, invited his readers to ask themselves the following questions:

- Am I better than average in getting along with people?
- Am I a better-than-average driver?

Burton noted that if you are like the average person, you probably answered yes to both questions. In fact, studies typically find that about 90 percent of respondents answer positively to those types of questions. Obviously, 90 percent of the population cannot be better than average in getting along with others, and 90 percent of the population cannot be better-than-average drivers.

While, by definition, only half the people can be better than average at getting along with people, and only half the people can be better-than-average drivers, most people believe they are above average. Overconfidence in our abilities may in some ways be a healthy attribute. It makes us feel good about ourselves, creating a positive framework with which to get through life's experiences. Unfortunately, being overconfident of our investment skills can lead to investment mistakes.

The following illustrates this effect. A survey of investors about expectations of returns found they persistently forecasted that their portfolios would outperform the market.[1]

Forecasts of Market Returns versus Forecasts of Investor Returns

	MARKET	INVESTOR'S PORTFOLIO
June 1998	13.4%	15.2%
February 2000	15.2%	16.7%
September 2001	6.3%	7.9%

Another great example is a February 1998 survey by Montgomery Asset Management. It found that 74 percent of investors interviewed expected their funds to consistently outperform the market.[2] It is simply impossible for the average investor to beat the market since investors collectively are the market. The logic is inescapable: the average investor must, by definition, earn market rates of return, less the expenses of his or her efforts.

In a *New York Times* article, Professors Richard Thaler and Robert J. Shiller noted that individual investors and money managers persist in their belief that they are endowed with more and better information than others and that they can profit by picking stocks.[3] This insight helps explain why individual investors believe they can

- Pick stocks that will outperform the market
- Time the market so they're in when it is rising and out when it is falling
- Identify the few active managers who will beat their respective benchmarks

Even when individuals think that it is hard to beat the market, they are confident they themselves can be successful. Here is what the noted economist Peter Bernstein had to say: "Active management is extraordinarily difficult, because there are so many knowledgeable investors and information does move so fast. The market is hard to beat. There are a lot of smart people trying to do the same thing. Nobody's saying that it's easy. But possible? Yes."[4] That slim possibility keeps hope alive. Overconfidence leads investors to believe they will be one of the few who succeed.

Remember that to profit from the market's mistakes, either you must have information the market doesn't have (and remember, if it is inside information, you cannot legally trade on it), or you must interpret the information better than the collective wisdom of the market. Obviously, not everyone can be above average in doing so. And to beat the market, you must be well above average since you incur expenses in the effort.

Let's take a look at some further evidence on investor overconfidence. Brad Barber and Terrance Odean have done a series of studies on investor behavior and performance. The following is a list of their main findings:

- Individual investors underperform appropriate benchmarks.[5]
- Though the stock selections of women do not outperform those of men, women produce higher net returns due to lower turnover (lower trading costs). Also, married men outperform single men.[6] The obvious explanation is that single men do not have the benefit of the spouse's sage counsel to temper their overconfidence. It appears that a common characteristic of human behavior is that, on average, men have confidence in skills they don't have, while women simply know better.
- Individuals who traded the most (presumably due to misplaced confidence) produced the lowest net returns.[7]

Overconfidence causes investors to see other people's decisions as the result of mood, feelings, intuition, and emotion. Of course, they see their own decisions resulting from objective and rational thought. Overconfidence also causes investors to seek only evidence confirming their own views and ignore contradicting evidence. The late John Liscio, respected veteran bond reporter and founder of the Liscio Report, put it this way:

> *Forecasters, by definition, are biased and untrustworthy recorders of current economic events. In other words, they tend to uncover evidence that supports their forecasts, and they ignore or analytically dismiss anything that challenges it. And, even if the headline data appear to contradict their disclosure of the universe, they will undoubtedly uncover some statistic or extenuating circumstance that dovetails neatly with their worldview.*[8]

Examining the results of the Mensa (a high-IQ society) investment club provides an amusing bit of evidence on overconfidence. If any people deserve to be confident of their skills, it seems logical to believe that it should be the members of this group. Yet the June 2001 issue of *SmartMoney* reported that the Mensa investment club returned just 2.5 percent over the previous 15 years, underperforming the S&P 500 Index by almost 13 percent per year. Warren Smith, an investor for 35 years, reported that his original investment of $5,300 had turned into $9,300. A similar investment in the S&P 500 Index would have produced almost $300,000. One investor described his strategy as buy low, sell lower.[9] The Mensa members were overconfident that their superior intellectual skills could be translated into superior investment returns.

Wall Street Journal columnist Jonathan Clements made the following observation: “Beat the market? The idea is ludicrous. Very few investors manage to beat the market. But in an astonishing triumph of hope over experience, millions of investors keep trying.”[10] Overconfidence helps explain this triumph of hope over experience. Investors may even recognize the difficulty of the task, and yet they still believe they can succeed with a high degree of probability. As author and personal finance journalist James Smalhout put it, “Psychologists have long documented the tendency of Homo sapiens to overrate his own abilities and prospects for success. This is particularly true of the subspecies that invests in stocks and, accordingly, tends to overtrade.”[11]

Recognizing our limited ability to predict the future is an important ingredient of the winning investment strategy. Being aware of the tendency toward overconfidence, you can avoid the mistake of trying to outperform the market. Meir Statman, a finance professor at Santa Clara University, provided the following advice on how to avoid the mistake of overconfidence: “Start keeping a diary. Write down every time you are convinced the market is going to go up or down. After a few years, you will realize that your insights are worth nothing. Once you realize that, it becomes much easier to float on that ocean we call the market.”[12]