

Why We Think We're Better Investors Than We Are

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From their earliest days, the loosely confederated research efforts that came to be known as behavioral economics spawned a large quantity of studies centered on securities investment. This was not because the field's pioneers were especially interested in stocks and bonds, nor was the early research commonly underwritten by financial services firms.

Rather, the hive of activity that evolved into its own field — behavioral finance — reflected that investment markets provide unusually robust data sets for analyzing “judgment under uncertainty” (the title of a seminal textbook co-edited by the winner of a Nobel in economic science, the behavioral economist Daniel Kahneman) and “decision under risk” (a phrase in the subtitle of his Nobel-winning “Prospect Theory”). Every day, global securities markets provide researchers with billions of data points for understanding how people make choices when resources are at stake and the outcome is unknown.

Which, if you think about it, is a fair description of most decisions. Indeed, the majority of cognitive biases and shortcuts that influence everyday judgment and choice have analogues in investment behavior. Consider the “sunk cost fallacy,” a primary reason an unhappy lawyer might struggle to leave the law and an unsuccessful investor might balk at selling money-losing shares.

Both people are highly likely to obsess over their sunk cost — law school tuition and time served for the lawyer, the original investment amount for the stock picker — in a nonconscious desire to justify their earlier decisions. Both are also very likely to fall prey to “loss aversion,” a key tenet of Prospect Theory, which tells us that humans typically respond to the loss of resources — be it time, effort, emotion, material goods or their proxy, i.e., money — more strongly than they react to a similar gain.

What differentiates the typical lawyer and average investor, however, is their justification for engaging in their activity. Lawyers are trained to do what they do, while the majority of investors are not. Ask a random player in a law firm's basketball league whether he or she could compete with LeBron James, and the most common response will be laughter. Yet many of those lawyers would willingly compete with the billionaire investor Warren E. Buffett.

Despite the spectacular growth of index funds — passive investment vehicles that track market averages and minimize transaction costs — millions of amateur investors continue to actively buy and sell securities regularly. This despite overwhelming evidence that even professional investors are no more likely to beat the market than monkeys throwing darts at securities listings.

Money managers, at least, are paid to make investment bets. But why do amateurs believe they can outperform the professionals — or even identify those pros who will outperform? (Performance of individual mutual funds cannot be predicted with any greater degree of accuracy than individual stocks or bonds.) Many biases and cognitive errors contribute to this costly behavior, but a few deserve mention.

Overconfidence

Consider this pair of challenges:

Give high and low estimates for the average weight of an empty Boeing 747, picking numbers far enough apart to be 90 percent certain that the true answer falls somewhere in between. Now, give high and low estimates for the diameter of the moon in miles. Again, choose numbers far enough apart to be 90 percent certain that the true answer falls somewhere in between.

Come up with a range for each so you could confidently bet \$9 against the prospect of winning \$1.

As it happens, an empty 747 weighs nearly 400,000 pounds, and the diameter of the moon is roughly 2,200 miles. But research involving these and similar problems suggests that these answers do not fall within your high and low estimates. That's because most people do not realize how little they know about the subjects or how difficult it is to bracket estimates as requested.

Instead, people come up with what they believe to be logical estimates of the plane's weight and moon's diameter, then they adjust from those figures to arrive at their brackets. But unless you work for Boeing or NASA, your initial estimates are probably going to be wildly off the mark, so the brackets should be wider they probably are — say, from one pound to one billion pounds for the plane's weight and from one mile to a billion miles for the lunar diameter. That most people do not default to such broad ranges reflects a trait that behavioral economists call overconfidence. This is not run-of-the-mill arrogance, but rather the tendency we all have to overrate our abilities, knowledge and skill, at whatever level we might place them.

Studies have revealed significant overconfidence in the judgments of scientists, lawyers, engineers, doctors and those in other professions. The University of Pennsylvania psychologists Philip Tetlock and Barbara Mellers collected more than 25,000 forecasts from people whose job it was to anticipate how the future would unfold. All demonstrated remarkable overconfidence. When they were 80 percent sure of their predictions, they were correct less than 60 percent of the time.

Another example is shown in a 2012 study from the State Street Center for Applied Research, in which investors were asked about their financial acumen.

“Nearly two-thirds rated their financial sophistication as advanced,” said Mirtha Kastrapeli, a senior research analyst at State Street. “This seemed a little optimistic, so in our 2014 study, *The Folklore of Finance*, we ran a financial literacy exam. The average score was just 61 percent, barely a passing grade. This disconnect between actual and perceived financial sophistication, she explains, is evidence of how widespread the overconfidence bias is.”

Optimism Bias

Overconfidence is hard-wired into our brains because it is useful. Many of our mental biases evolved because they make us cautious or they otherwise protect us from harm, but overconfidence is part of a suite of cognitive traits that serve to propel us forward. Just as no one would think to write a children’s book about a train engine that repeats, “I think I can’t,” few explorers would venture into the wild — and few entrepreneurs would start new businesses — unless they believed that they would succeed in the face of long odds.

A bias toward optimism helps to explain why many, if not most, smokers are confident that they will not develop cancer; why many drivers are certain that their texting will not lead to an accident; and why many investors believe they can outperform the market. “We are evolutionarily programmed to believe that things will work out,” said David Hirshleifer, a finance professor at the University of California, Irvine.

Hindsight Bias

More confounding than the existence of investor overconfidence is its persistence: As markets teach us costly lessons, we should grow humble. But the fact that many do not reflects what Professor Hirshleifer describes as self-enhancing psychological processes. One of the biggest esteem builders is hindsight bias, or the tendency to rewrite our own history to make ourselves look good. In landmark experiments by the psychologist Baruch Fischhoff, then at Hebrew University, study participants were directed to make predictions about real-life events, then were asked periodically to recall the events and their predictions after the fact. His findings? Participants consistently misremembered their forecasts, in ways that made them look smarter. Too often we look back not in anger but in awe, at least of our own capacities.

Attribution Bias

Of course, many people easily recall failures, which suggests that hindsight bias is not all that powerful. But even when our failures remain vivid memories, we remember them in a way that neutralizes their ability to inhibit our present-day decisions. When events unfold that confirm our thoughts or deeds, we attribute that happy outcome to our skills, knowledge or intuition. But when life proves our actions or beliefs to have been wrong, we blame outside causes over which we had no control — and thus maintain our faith in ourselves. The Harvard psychologist Ellen Langer describes the phenomenon as, “Heads I win, tails it’s chance.”

Confirmation Bias

Finally, even if investors are not rewriting history or blaming outside forces, they are still highly likely to miss signs of their own incompetence. The culprit is confirmation bias, which leads us to give too much weight to information that supports existing beliefs and discount that which does not. And those existing beliefs need not be long held, explains Thomas Gilovich, a Cornell University psychology professor. “Once one entertains the idea that ‘this seems like a good investment,’ the processing of relevant information narrows considerably — and in a direction that leads to overconfidence.”

Professor Gilovich, an author of “The Wisest One in the Room: How You Can Benefit from Social Psychology’s Most Powerful Insights,” warns that overcoming overconfidence is difficult. Common prescriptions include a meaningful period of diligently logging one’s investment ideas, to keep track of hits and misses. Note the emphasis on ideas and not just actions. More often than not, the aforementioned biases lead us to recall investments that soared that we thought to make but did not — and to forget those that plummeted.

Professor Hirshleifer advises a strategy of self-distancing, or considering the opposite side of any transaction before making it.

Such a strategy was also recommended by Professor Gilovich, with a caveat. “Something more specific and guided is likely to be more effective, like conducting a ‘pre-mortem,’ ” he said. “The idea is to suppose that your idea bombed. What would you be saying to yourself right now about how or why you should have foreseen it?”

Gary Belsky is an author of “Why Smart People Make Big Money Mistakes and How to Correct Them: Lessons From the Life-Changing Science of Behavioral Economics.”