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BEHAVIOURAL FINANCE

DANGERS OF OVERCONFIDENCE

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IN his 1965 University of Chicago PhD dissertation, Eugene Fama spoke about the efficient market — a theory on the behaviour of the stock market.

The economist's message was simple and clear.

Predictions about future stock prices are pointless because the market is too efficient. This is because in an efficient market, as information becomes available, intelligent players assimilate that information in a way that causes prices to adjust instantaneously.

To summarise, at any given point, prices reflect all available information. Therefore, the market is efficient. The market is a thermostat that adapts itself to changing information. But this is theory.

In practice, markets are not efficient. This is in line with the thinking of fundamental investors like Warren Buffett.

Fama is a theorist who wrote from his academic ivory tower.

Buffett is a practitioner who invested from the trenches.

Fundamental investors believe that there are pockets of inefficiency that allow shareholders to make profits. And one of the greatest contributors to these pockets of inefficiency is our behaviour.

Hence, the birth of a new branch of scientific study known as behavioural finance.

Behavioural finance is an investigative study that uses psychological theories to explain market inefficiencies. The theories are premised on the fact that we make foolish mistakes based on illogical assumptions when investing. There are many psychological concepts to explain the irrationalities in our thinking when investing.

Overconfidence

Many behavioural traits contribute to market inefficiencies, and one is overconfidence. There is a distinction between confidence and overconfidence. The former is not necessarily a bad thing and can be counted as a boon, but the latter can be damaging when we are dealing with investing. Overconfidence is a trait that can cause us to lose money.

When we are overconfident, we tend to make errors in judgment. We tend to think that we are above average — when often we are not. The self-realisation that we are not often above average arises from humility and is a great starting point for successful investing.

"One of the hardest things to imagine is that you are not smarter than average," said Daniel Kahneman, professor of psychology and public affairs at Princeton University's Woodrow Wilson School of Public and International Affairs and winner of the Nobel Prize in economics.

Accepting the sobering deflating reality that not all of us are above average is a good start to successful investing.

Robert J. Shiller, an economics professor at Yale University, once said that people do not learn to correct most of their tendencies to overconfidence is apparently just one of the limitations of the human mind.

And overconfident investors, apart from contributing to their ruin, contribute to the market inefficiencies that allow others to profit at their expense. Overconfident investors have a powerful effect on the market.

A hand-on-heart self-analysis will make us realise that as investors, we are often highly confident that we are smarter than everyone else.

Hindsight will however consistently show us that we tend to overestimate our skills and knowledge.

This overconfidence stems from a bias towards the information that is readily available. We read and we are convinced. We hear and we are convinced. We are convinced that we have better information and that we can outsmart others. We do not seek out unknown information. We do not seek news that may prove us wrong.

Instead, we search and savour news that affirms our beliefs — the affirmation bias (another bias in the realms of behavioural finance).

And that is why so many research analysts make the wrong calls. While we have awards for the analysts who make the best calls, it would be interesting to find out how many research analysts made the wrong calls. And the main reason for the wrong calls would be overconfidence.

They take too much confidence from the information that they have.

In the end, it comes to the sufficiency of information. There will be a point when we must pull the trigger and make the investment decision. And there will never be a time when complete information will be available.

At best, the time to invest will be the time when we, with all humility and acknowledgement, realise that there is much that is unknown, and that based on what is known, the odds appear in favour of a successful investment decision, and that we are probably not above average and that there is a possibility that the market will outsmart us.

Overconfidence can result in recklessness, while under-confidence can be debilitating. We should all strive for confidence — right smack between the two extremes.

We should nurture confidence against a backdrop of profound humility that there is much that is unknown, for indeed, there is much that is unknown.

The writer is chief executive officer of Minority Shareholders Watch Group