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TRANSITIONS
Wealth Management, LLC

How overconfidence hurts investors

In his book "Investment Titans," Jonathan Burton invited readers to ask themselves the following questions: Am I better than average in getting along with people, and 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. The logical conclusion we can draw is that a high percentage of those self-described "above average" individuals are in fact below average in those areas. And they are blissfully unaware of their incompetence.

Just because you believe it doesn't mean it's true.

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.

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. Among those mistakes are:

1. Concentrating assets and failing to diversify because diversification is only for those who cannot foresee the future
2. Buying risky investments because they believe they aren't really risky
3. Trading too much because they believe they can successfully time the market
4. Using active fund managers because they believe they can identify the few future outperformers

QUOTABLE

"It's that time of year again. Crisp fall air, football, jumping in piles of leaves, pumpkin pie and government shutdowns." Burt White, Chief Investment Officer at LPL Financial

"The market is saying it doesn't like Summers, Syria, Tapering" - the market is a nuthouse full of deranged robots and QE addicts." Josh Brown, Author - The Reformed Broker

"There's a lot of amazement that the market has done so well. But in some ways, we used to call a slow growth and low inflation environment Goldilocks." Liz Ann Sonders, Chief Investment Strategist at Charles Schwab

"Should you find yourself in a chronically leaking boat, energy devoted to changing vessels is likely to be more productive than energy devoted to patching leaks." Warren Buffett

"So who still believes markets don't work? Apparently it is only the North Koreans, the Cubans and the active managers." Rex Sinquefeld, Dimensional Funds

The great irony is that the more incompetent the investor, the less qualified he is to assess anyone's skill in that space, including his own. Exacerbating the problem is that the incompetent often don't even know they are doing poorly because they often don't know their returns, let alone measure them against appropriate risk-adjusted benchmarks. Consider the evidence from two studies.

The authors of a study called "Positive Illusions and Forecasting Errors in Mutual Fund Investment Decisions" found that most participants had consistently overestimated both the future performance and past performance of their investments. In fact, more than a third who believed that they had beaten the market had actually underperformed by at least 5 percent, and at least a fourth lagged by at least 15 percent.

Additionally, the authors of the study "Why Inexperienced Investors Do Not Learn: They Don't Know Their Past Portfolio Performance" found that:

1 Investors are unable to give a correct estimate of their own past portfolio performance. The correlation coefficient between return estimates and realized returns was not distinguishable from zero.

2 People overrate themselves. Only 30 percent considered themselves to be average. Investors overestimated their own performance by an astounding 11.5 percent a year. And portfolio performance was negatively related with the absolute difference between return estimates and realized returns -- the lower the returns, the worse investors were when judging their realized returns. It seems likely that investors are unable to admit how badly they have done. While just 5 percent believed they had experienced negative returns, the reality was that 25 percent did so.

3 On average, investors underperformed relevant benchmarks. For example, while the arithmetic average monthly return of the benchmark was 2 percent, the mean gross monthly return of investors was just 0.5 percent. And over 75 percent of investors underperformed.

The bottom line is that investors who don't know they perform poorly end up believing that they are doing well -- the incompetent are unaware. The study "Unskilled and Unaware of It: How Difficulties in Recognizing One's Own Incompetence Lead to Inflated Self Assessments," further proves that point. In short, it explains that the incompetent overestimate their own abilities and are less able to recognize actual competence in others.

Be a competent investor

One of our favorite sayings is that it isn't what a man doesn't know that tends to get him in trouble, but what he knows for sure that isn't true. British philosopher Bertrand Russell put it this way: "The trouble with the world is that the stupid are cocksure." (He added that "the intelligent are full of doubt.") And Charles Darwin believed that "ignorance more frequently begets confidence than does knowledge."

The unfortunate truth is that incompetence robs investors of the ability to remedy the problem. Only education has the potential to overcome the related problems of incompetence and overconfidence. Unfortunately, it seems that most investors would rather go through life blissfully ignorant than spend the time to educate themselves on the science of investing.

Behavioral finance is a fascinating field, providing us with many insights into investor behaviors that help explain many of the anomalies that financial theory cannot explain on its own. It also helps explain many of the mistakes investors make.

We thank you for your continued trust and business and look forward to seeing and speaking with you soon!

Transitions Wealth Management, LLC