Overconfidence

By Paul Doggett

Overconfidence is the most prevalent of all the human biases that can negatively impact trading performance. Gervais and Odean summed up overconfidence like this: "Though over confidence does not lead to greater profits, greater profits do lead to over confidence."[1]

Over confidence is one of the most studied and understood biases in academic circles but it is not so well understood by the everyday trader. The everyday trader typically over estimates their abilities and skills and this creates overconfidence. When a trade turns out the way we expected it to turn out, it can give us a sense of confidence in our skills and abilities. Sometimes a trade appears to work because of something special that we did, however, it may be that the trade was profitable due to something other than our skill. Perhaps luck. We typically become overconfident when we don't see it this way, but only see our success as a direct result of our skills and abilities.

It is also unfortunate but a fact of life that overconfidence is over abundant in the stock market because of the inherent nature, structure, education and media reporting around financial markets. Trading and investing contains many of the elements which are conducive to fostering overconfidence. In particular, overconfidence manifests itself in people when they are asked to complete complex tasks and process abstract information and this is exactly what traders and investors do on a daily basis.

For example, professional and private investors analyse fundamental data and extrapolate elements of that data, such as the return-on-equity-ratio, two or three years out into the future and this can be a complex task. Also, professional and private technical analysts analyse

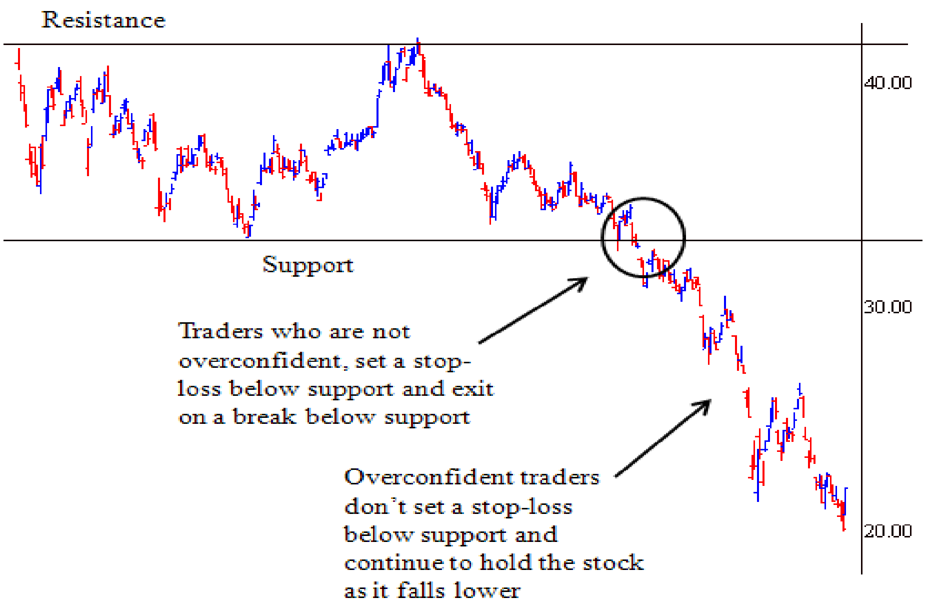
[1] Gervais and Odean (2001 Learning to be Over Confident), Rev. Finance. Stud. (2001) 14 (1): 1-27

technical information such as chart patterns or interpret indicators which requires traders to process abstract information. In both instances, a fundamental and technical approach ask traders and investors to complete complex tasks and process abstract information. Regardless of what approach you take, the evidence suggests that the very nature of reading, understanding and interpreting financial data provides the perfect hot-bed for breeding investor or trader over confidence.

Overconfidence is also most noticeable in a situation that allows a trader to have a stronger perception of control. For traders, this situation is stock picking. When we pick stocks to trade we are in complete control. We may not be good at picking stocks to trade, but nonetheless, we have complete control over which stocks we select to trade and which stocks we reject. Unfortunately, this can create a particular perception of our abilities compared to others in the market and the unfortunate side effect is that if we think that our stock picking skills are better or more developed than the next trader, then we are prone to an over confidence bias which can lead us to take greater risks because we believe our superior stock picking skills provides greater immunity from risk in the market.

Traders and investors suffering from a bout of overconfidence in their stock picking ability and misplaced perception of their immunity from risks because of their superior stock picking skills, are less likely to have a contingency plan in place, such as a stop-loss, to protect themself if things go against them. In the chart below, we see Macquarie Bank (MQG) move sideways for a while. Traditional technical analysis tells us that a break above resistance to the upside is a buy signal and that a break below support is a sell signal or a signal to avoid buying into this stock if you have not already done so.

Sideways Trend Channel



A trader who has been watching this stock move sideways for several months may consider buying into MQG with the view that if support holds at around $33 a share, then it might bounce back towards the $40 level. But if support is broken to the downside, they will exit. An overconfident trader is less likely to set a stop-loss on a technical downside break and have any strategy to alert them to the fact that the stock is probably going to move lower once support is broken. They fail to look at mitigating the risk because they are overconfident in their stock picking ability and don't think that they need to have a contingency plan if it all goes wrong.

We see that the trader who is not overconfident has a chance to exit the stock shortly after support is broken to the downside. But the overconfident trader, is likely to continue to hold onto the stock with the view that it will bounce back. Of course, the stock may bounce back in a year's time or in ten years time. This is the great unknown factor and it is the factor which becomes the greatest gamble of all. The trader who exited MQG doesn't take that gamble of sitting and holding onto the losing position for an unknown number of years before they can get their money back.

Overconfidence like that demonstrated here is a result of a certainty illusion – that is the trader is certain that they are right and the market is wrong and they believe that if they are given enough time, then the market will prove them right. Researchers Fischhoff, Slovic and Lichtenstein found evidence supporting the theory that people operate under a certainty illusion which is a belief in one's own infallibility[2]. This means that people are overconfident in their ability to make the right calls in the market and overconfident that they will not make the wrong call (because they are infallible).

In a follow up study, Slovic found that even when people are wrong, they can still remain confident in their opinion because they have underestimated their own vulnerability to a variety of risks[3]. We see this time and time again in the market when people buy stocks which are in a strong downtrend or they buy into the market when the broader market is weak.

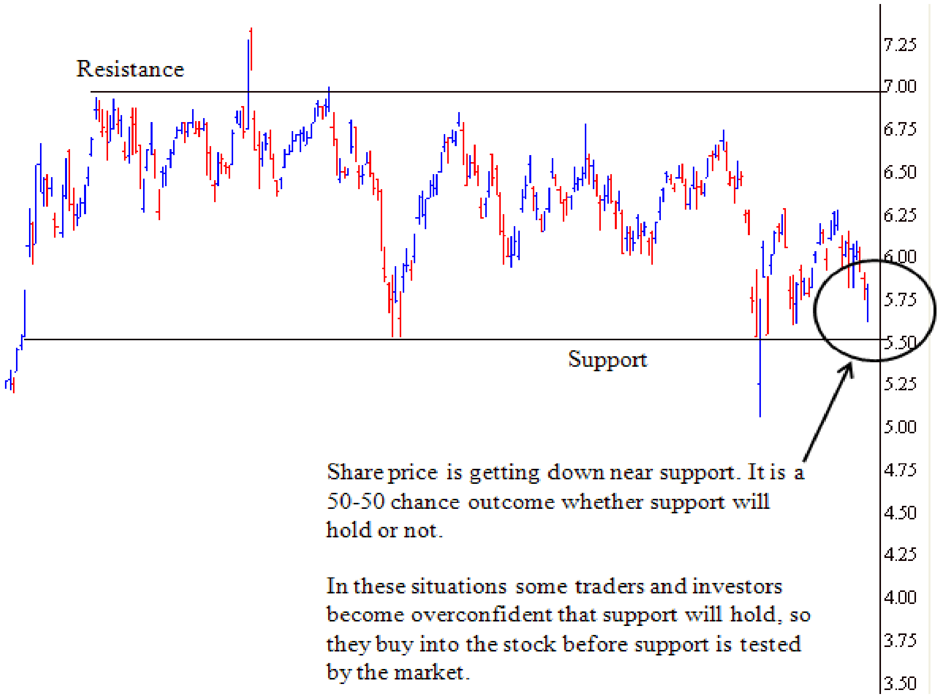
Lichtenstein and Fischhoff found that overconfidence is greatest when accuracy is near chance levels, for example in a 50 – 50 chance outcomes[4] such as that shown in Fig. 6.2.

---

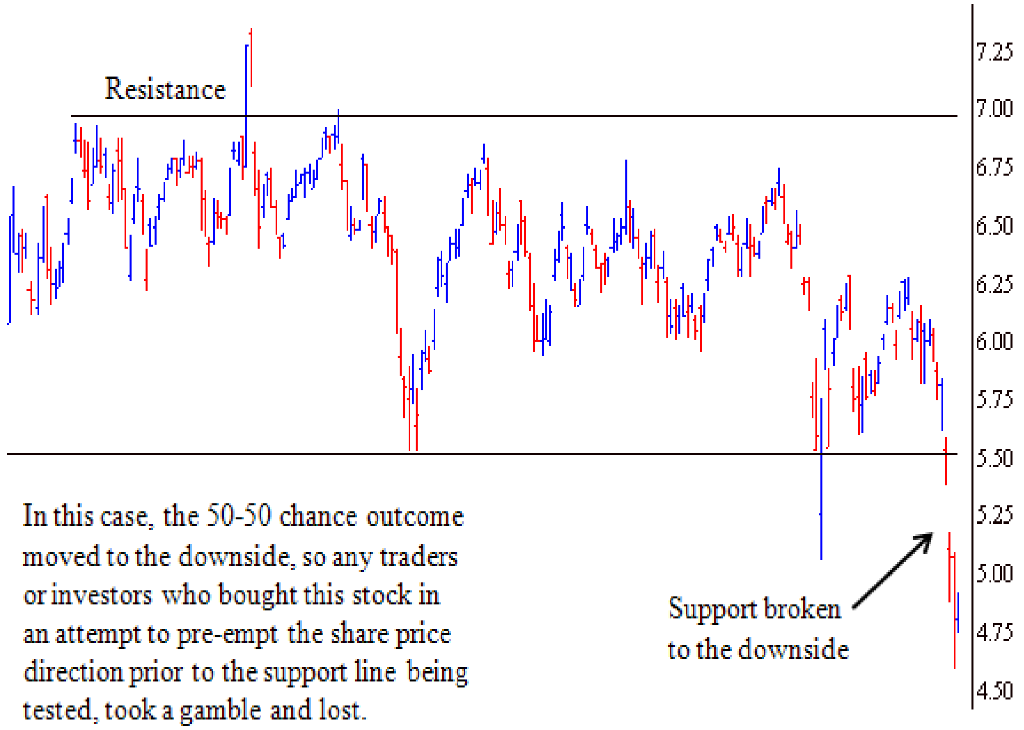
[2] Lichtenstein, S. and Fischhoff, B. (1977). Do those who know more also know more about how much the know? *Organizational Behavior and Human Performance*, *20*, 159-183.

[3] Slovic, P. (1984). Risk theory: Conceptual frames for understanding risk taking in young drivers. In R. Blackman et al. (Eds.),*Proceedings of a conference on adolescent risk taking behavior* (pp. 17-25).

[4] Lichtenstein, S. and Fischhoff, B. (1977). Do those who know more also know more about how much the know? *Organizational Behavior and Human Performance*, *20*, 159-183.



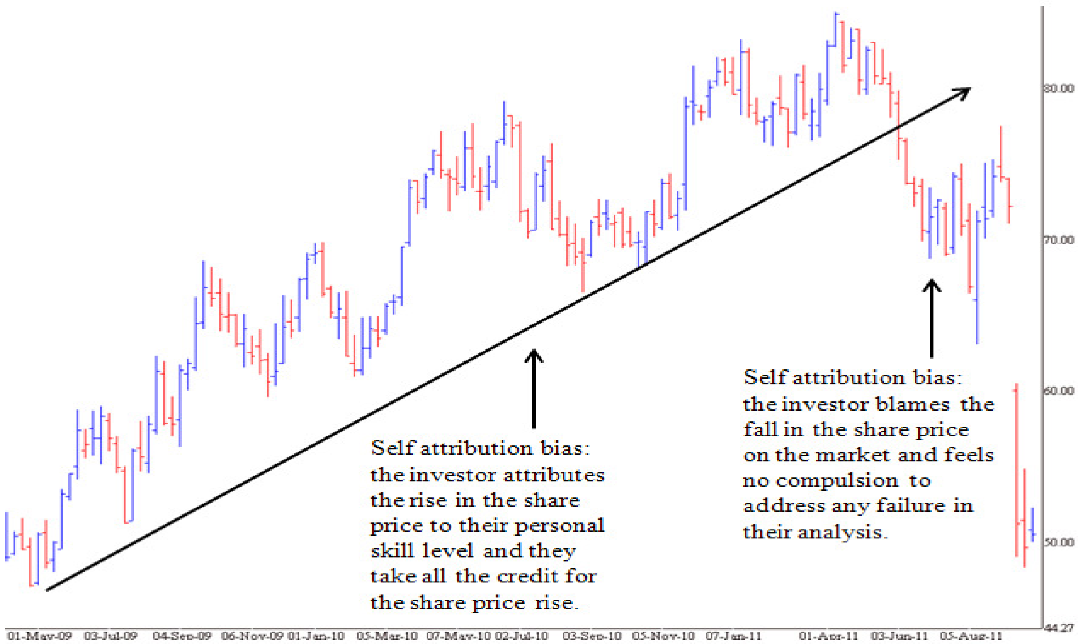
Whenever a stock price is near support or resistance lines, but has not yet broken to either the upside or the downside, it is a 50-50 chance outcome and in these situations, traders and investors are often tempted to take a punt on the stock going one way over the other before it has happened, rather than waiting for confirmation after the event.



Gervais and Odean found that self serving attribution bias engenders overconfidence in traders[5] which basically means that if you buy a stock and it goes up in price, you will attribute the share price rise to your skills and personal, exceptional analytical skills. On the other hand, if the stock price falls, you will blame it on the market. You will not blame it on yourself or have any compulsion to reflect upon your own analysis or actions, which saw you, buy into the stock just prior to it falling lower. Overconfident traders often exhibit high self esteem and when confronted with failure they are likely to convince themselves that the fault lies elsewhere. Figure 6.4 shows how a hypothetical trader may apply attribution bias to a rise and a fall in the same stock.

[5] Gervais and Odean (2001 Learning to be Over Confident), Rev. Financ. Stud. (2001) 14 (1): 1-27

Fig. 6.4 COH weekly chart



Overconfidence leads to aggressive trading strategies such as over trading which lead to poor performance. Barber and Odean[6] found a cyclical pattern in overconfident traders which I'm sure you will recognize. It goes like this. The overconfident trader strikes it lucky with a profitable trade, then he or she immediately attribute this success to their above average trading ability. Next, they take the aggressive step to sell the profitable stock to free up their money and to buy another stock. However, the next stock they buy typically falls in value. This doesn't happen once or twice, but many times over and a cyclical pattern of selling profitable trades only to replace them with losing trades begins to emerge. We saw the same pattern develop in our discussion on the disposition effect.

---

[6] Barber, B., and T. Odean, "Trading is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors." Journal of Finance, 55, (2000) pp. 773–806

Barber and Odean found that on average, the next stock pick made by the trader in these situations performed around 5% worse than the stock which was just sold! We know that traders typically attribute the poor performance of the follow-up trade to bad luck or dirty tricks of insiders or the big boys pushing the smaller players in the market around. There are a myriad of excuses you can use to blame somebody else for your losses in the market. You can read all the whinges, gripes and complaints for free on many internet stock forums.

The same can be said for charts and technical analysis. If you are a dedicated chartist, you would most likely put a lot of credibility into your charts and in particular, into your analysis of those charts. But in order to remain level headed and uninfluenced by the overconfidence bias, you have to remain objective and seek out the strength of the evidence at hand and not become overly influenced by the strength of the credibility you place upon your personal analysis of the chart. It's all part of the mental tug of war.

A number of practical steps that you can apply to help you avoid overconfidence are listed below.

Practical Steps

1. The most basic of course is to firstly, become aware that overconfidence exists as a trap for traders and secondly, learn to read the signs that you have fallen into the trap.

2. The signs of overconfidence are:

- Over trading
- Ignoring other influential signals in the market
- Becoming more confident while your trading decisions are becoming more inaccurate

- Becoming less concerned about managing risk
- Trying to complicate your trading style as a means of digging yourself out of a hole

3. Remain disciplined when it comes to managing risk. At the first sign of reckless risk management, pull yourself back into line – you have become overconfident.
4. Remind yourself that your success is not entirely due to your abilities and remind yourself that your failures have everything to do with your lack of abilities
5. Limit yourself to one trade a week or a fortnight to curb the overtrading
6. Put in place a contingency plan in case you are wrong in one of your trading decisions
7. Don't assign a percentage of how accurate you believe you are in making any of your trading calls
8. Don't try to forecast then decide to wait for as long as it takes to see your forecast come true. If the evidence is going against your forecast, abandon the forecast.
9. Don't over rate your performance to yourself, your friends and your family and don't over rate it anonymously on a chat forum on line. Avoid it all together.
10. Don't try to over complicate your processes because this has a tendency to make us overconfident in our predictions and decisions as well
11. Leave your ego and your emotions at home.

This article is based on material in the author's book, Trading Psychology: Winning the Mental Tug of War on Stock Market