Fundamentals of behavioral finance: Overconfidence bias

How overconfidence can lead to bad outcomes—and how advisors can nip it in the bud

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Key takeaways

- Overconfidence bias is the tendency for a person to overestimate their abilities.
- It may lead a person to think they're a better-than-average driver or an expert investor.
- Overconfidence bias may lead clients to make risky investments.
- Advisors might be able to counter overconfidence bias by encouraging clients to make room for other perspectives.
- A "pre-mortem" strategy may also help clients take a more measured approach to making financial decisions.

In this series, we explore some of the most common biases exhibited by investors, and discuss how advisors can help their clients overcome them. This article takes a close look at a powerful cognitive bias: **overconfidence bias.**

What is overconfidence bias?

Most people tend to overestimate their skills, whether it's changing an electrical outlet or managing their own finances. Consider that some 73% of Americans consider themselves to be better-than-average drivers, according to a recent AAA survey.[1] Behavioral finance has a name for this ego-driven tendency: overconfidence bias.

At a glance: Overconfidence bias

Head or Heart?
Overconfidence bias is cognitive. It describes people's tendency to over estimate their abilities.

Who has overconfidence bias?
Advisors say...*

Generation	Share
Generation X	31%
Millenials	29%
Baby Boomers	22%
Silent Generation	3%

The big problem:
Thinking you're better than average may fuel risky decisions.

65% — **65%** of Americans think they have above-average intelligence**

73% — **73%** of Americans think they're better-than-average drivers***

How advisors can help:
Introducing perspectives and possibilities the investor hasn't considered.

* Cerulli Associates, "BeFi Barometer 2020." Survey. July 2020.
** "65% of Americans believe they are above average in intelligence: Results of two nationally representative surveys" Heck,Patrick R., Daniel J. Simons, Christopher F. Chabris. July 2018.
*** American Automobile Association, January 2018.

In investing, overconfidence bias often leads people to overestimate their understanding of financial markets or specific investments and disregard data and expert advice. This often results in ill-advised attempts to time the market or build concentrations in risky investments they may consider a sure thing.

Why does it matter?

The overconfidence bias tricks the brain into believing it's possible to consistently beat the market by making risky bets. But the evidence shows that even financial experts with powerful tools at their disposal can have difficulty outpacing the market. Case in point: A 2019 Morningstar report found that only 23% of all active funds beat their passively managed peers over the most recent 10-year period.[2]

It should be no surprise, then, that for the average investor, overconfidence can potentially be a pathway to poor portfolio performance. Beyond that, clients' overconfidence may also lead them to overestimate their tolerance for risk, resulting in investment strategies that don't truly align with their needs. Add to these dangers the high costs of buying and selling assets, and the potential damage of overconfidence on clients' pocketbooks—and psyches—cannot be underestimated.

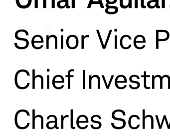
What can you do about it?

The overconfidence bias can be countered in a number of ways. One starting point is to encourage clients to make room for the perspectives of other people, from family members and friends to your financial team. While we often overestimate our own abilities, we tend to be more objective when considering the decisions of others.

Another strategy is to walk clients through past investment decisions and discuss how they worked out. Demonstrate, if applicable, how overconfidence led to poor outcomes over time, and compare these outcomes with the results the client might have achieved with a more realistic approach.

Finally, consider asking the client to perform a "pre-mortem." This process, popularized by Nobel Prize-winning economist and psychologist Daniel Kahneman, involves imagining potential outcomes from a future perspective—perhaps 5 or 10 or 20 years down the line. Start by imagining that the investment strategy you're considering has succeeded, and from this imagined point in the future, think through all the reasons it has done well. Then imagine that the same strategy has underperformed, and think through all the reasons it hasn't achieved success. This exercise may help people see potential risks and missteps that they might have overlooked in their excessive optimism.

Taking these steps has the potential to help protect clients from making poor investment decisions. And that, in turn, can build a deeper well of trust and strengthen your advisor-client relationship.



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Home bias | Recency bias | Loss aversion bias

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[1] American Automobile Association, January 2018.
[2] Morningstar Associates, "Morningstar's Active/Passive Barometer" December 2019.

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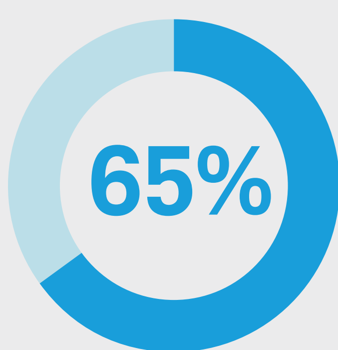

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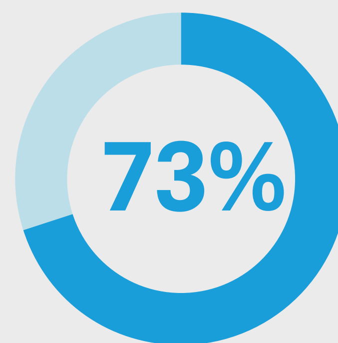

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