Chapter 6
Overconfidence
Overconfidence

- Tendency for people to overestimate their knowledge, abilities, and the precision of their information, or to be overly sanguine of the future and their ability to control it.

- *Unwarranted* faith in one’s intuitive reasoning, judgments, and cognitive abilities → people think they are smarter and have better information than they actually do
That *most people most of the time* are overconfident is well documented by researchers in the psychology literature.
Overconfidence overview

- Overconfidence Bias
  - [http://www.youtube.com/watch?v=o4wv4RYFuE4](http://www.youtube.com/watch?v=o4wv4RYFuE4)
  - More important issue in our lives...
  - [http://ethicsunwrapped.utexas.edu/series/cases-unwrapped](http://ethicsunwrapped.utexas.edu/series/cases-unwrapped)
Confidence vs. overconfidence

- Confidence: all about having a positive feeling about your skills, knowledge, etc.
- But overconfidence is when you have an inflated sense of your abilities.
- Various manifestations of overconfidence:
  - Miscalibration
  - Excessive optimism
  - Better-than-average effect
  - Illusion of control
Miscalibration: the tendency for people to overestimate the precision of their knowledge.

Measured through calibration tests.

Ask people 50 multiple choice questions.

- Then ask how many right? And compare the two numbers
- If you think you got 25 right… but you only got 15 right
- You appear to be overconfident
- Or use confidence interval approach.
- Suppose individuals are asked to construct 90% confidence intervals
  - e.g., height of Mount Everest: \( \bar{X} \pm 1.65 \frac{\sigma}{\sqrt{n}} \)
  - A percentage of individuals usually less than 90% usually comes up with intervals that bracket true answer.
- This also suggests miscalibration-based overconfidence.
Better-than-average effect

- Many of us feel we are smarter or more skilled than average
- e.g. athletic skill or driving ability
- One researcher surveyed a sample of students, reporting that 82% rated themselves in the top 30% of their group on driving safety.

But only 50% of us can really be better than average.
Evidence suggests that people pick definition of task that suits their purpose.

One factor facilitating a better-than-average belief is that often the exact definition of excellence or competence is unclear.

- Naturally enough, people have in the backs of their minds the definition that will make them look best.
- Take driving. Some might see “best” as most adept at steering; others might see it as most competent at anticipating hazard, etc.
Better-than-average effect (cont.)

➤ Both motivational and cognitive mechanisms are likely behind the better-than-average effect.
  – On the motivational side, thinking that you are better than average enhances self-esteem.
  – On the cognitive side, the performance criteria that most easily come to mind are often those that you are best at.
• Reveals itself when people think that they have more control over events than objectively can be true.
  – E.g. gamblers may think that they can control the dice or the cards.
  – In one experiment, in a gambling contest, subjects made significantly higher bets when they were facing the “schnook” than when facing the “dapper”.
  – Perhaps subjects’ feelings of superiority induced a mindset that they could influence chance events.
Excessive optimism

➢ Present when people’s predictions about the future are unrealistically optimistic.

➢ People assign probabilities to favourable/unfavorable outcomes that are just too high/low given historical experience or reasoned analysis.
  – E.g. winning the lottery (very positive events) or dying of cancer (very negative events)
Excessive optimism and miscalibration can go hand in hand.

- Suppose you purchase a stock
- True distribution for the return on this stock over the next year entails an expected return of 10%, with a 90% confidence range of -10% to 30%
- You (optimistic) distribution, has expectation of 20%, with a 90% confidence range of 10% to 30%
Excessive optimism (cont.)

- Evidence on excessive optimism:
  - Students expect to receive higher marks than they actually do receive.
  - And they overestimate the number of job offers that they will receive.
  - Despite high divorce rates, newlyweds almost universally expect that their marriages will succeed.
  - People often think that they can accomplish more than they actually end up accomplishing: planning fallacy.
Cost of excessive optimism:

– Inability to meet one’s goals can lead to 
  disappointment, loss of self-esteem and reduced 
  social regard

– And time and money can be wasted pursuing 
  goals that are unrealistic
Exercise

➢ Provide an example where someone can be both excessively optimistic and miscalibrated at the same time.
We are not all equally overconfident.

The greatest offenders are men:
- On a survey men and women were asked what they expected the market return and their own portfolio return to be in the following 12 months.
- Both men and women expected their portfolios to outperform the market – but the gap was greater for men.

Also evidence that highly educated, high-income people are more overconfident.
Most people most of the time appear to be overconfident.

But overconfidence does not seem to be universal.

- Underconfidence is common on easy tasks

Also, depending on the metric, it is possible for people to be judged overconfident using one metric but not using another.

- And there is no universally accepted way to measure overconfidence
Why don’t we learn?

- Self-attribution bias retards the learning process by allowing us to embellish our triumphs while forgetting our defeats.

- Hindsight bias says we knew what was going to happen when we really didn’t.

- Confirmation bias may contribute too – this is tendency to search out evidence consistent with one’s prior beliefs and to ignore conflicting data.

- These effects suggest that overconfidence can evolve over time.
Overconfidence may not be all bad

- Research has shown that predictions about the future tend to be more optimistic when:
  - Goals are far off
  - A course of action has been committed to

- When these conditions are met, excessive optimism may be useful in enhancing performance.
Because of overconfidence it is argued that investors trade securities too much.
  – Resulting in excessive volume at level of market

And they are underdiversified.
Managers because of overconfidence:
- Are too ready to enter markets
- Overinvest
- Allow cashflows to dictate investment
- Acquire other companies too quickly
- Take on too much debt