The Pitfalls (and Benefits) of Overconfidence

Imagine that you are at an interview for your dream job. The interviewer says, “I have 100 applicants for this job. Tell me why I should choose you.”

You are an appropriately confident person, not an overconfident one. So, you say: “Honestly, I don’t know. I don’t know the qualifications of the other 99 applicants relative to mine. Some may be more qualified than me, and some may be less qualified. My best estimate is that my qualifications are average, placing me in position 50 or 51 among your 100 candidates.”

You can take pride in being appropriately confident, but you just blew your interview and your chance to be selected for your dream job.

The person likely to be selected for your dream job is an overconfident one. That person says: “I am the perfect person for this job! And I will work day and night to make your company and you successful! You will be proud of hiring me!”

Confidence Shortcuts and Overconfidence Errors

There are three types of confidence shortcuts and overconfidence errors as classified by psychologists Don Moore and Paul Healy: *estimation, placement and precision*.[1] We use confidence shortcuts effectively when objectively assessing and placing the appropriate level of confidence in estimation, placement and precision.

We commit *overconfidence errors* when we place too much confidence in them and *underconfidence errors* when we put too little faith in them.

Placement shortcuts and overplacement errors are about ranking ourselves as average, below average or above average. The person not selected for his dream job applied a placement shortcut objectively.

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Without information about his qualifications for the position relative to those of his 99 rivals, he objectively estimated that his qualifications were average. The person selected for the job was likely overconfident, placing herself above average despite having no information about the capabilities of her 99 rivals.

Overplacement can be useful in getting jobs and more. Indeed, people who commit overplacement errors enjoy higher status than modest people who underestimate their abilities or place themselves objectively.[2]

Moreover, people who commit overplacement errors maintain their high status even when their overplacement errors are revealed.[3] These are illustrated in an old FedEx commercial from 2007.

The commercial shows a manager, a man with a chiseled face and strong chin, sitting at the head of a conference table and exclaiming, "We have got to cut costs, people! Ideas?!"

A man with a baby face and weak chin aimlessly gestures and suggests meekly, "We could open an account on FedEx.com, save 10% on online express shipping."

Gesturing forcefully, the manager responds with authority, "Okay, how about this? We open an account on FedEx.com, we save 10% on online express shipping!"

"You just said what I said, only you did *this*," the baby-faced man protests, gesturing aimlessly once more. The manager answers, "No, I did *this*," as his hand comes down in a quick chopping movement. The other people around the table nod approvingly, and one says, "*This* made all the difference."

Moore and Healy noted that while *under-placement* is common, it's not as common as *overplacement*. *Overplacement errors* are likely when contemplating *easy* tasks, whereas *under-placement errors* are likely when considering *difficult* ones.

For example, driving is easy, prompting many people to overestimate their driving skills. A frequently cited study reported that 93% of American drivers commit overplacement errors, ranking themselves, on average, as above-average drivers.[4]

Likewise, investors who believe that succeeding in trading is as easy as driving are prone to overestimate their abilities compared to other investors.

Investor Overconfidence May Lead to Poor Financial Decision-Making

Overplacement in investing is dangerous. A commercial for a brokerage firm specializing in foreign exchange (forex) trading shows a man in the lobby of an office building.

"Where am I going?" he asks. "To a place where a man's success is determined not by the color of his credit card but by the position he took on the Aussie dollar in the face of rising commodity prices. I'm going where I can trade currencies on a platform that is as smart as … I am. I'm going to trade the world!"

The man's overconfident statements are followed by this voice-over: "It's your world. Trade it at [the particular forex trading company]. Forex trading involves substantial risks and is not suitable for all investors."

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Forex trading, presumably, is suitable for people as overconfident as the man in the commercial. Yet we know that amateur traders in forex markets lose more often than they win.

Framing and confirmation errors precede overconfidence as pitfalls to investors. Good framing shortcuts direct us to frame trading as playing tennis against a possibly better opponent on the other side of the net rather than playing tennis against a training wall. Good confirmation shortcuts direct us to assign equal weights to evidence confirming our trading skills and evidence disconfirming them.

We commit framing errors when we frame trading as playing tennis against a training wall and confirmation errors when we assign greater weight to evidence confirming our trading skills than evidence disconfirming them.

Helping Overconfident Clients Avoid Poor Investment Outcomes

Advisers can do well for their clients by serving as patient teachers, explaining the dangers of overconfidence and the preceding dangers of framing and confirmation errors.

Endnotes

[1] Paul J. Healy and Don. A. Moore, "The Trouble with Overconfidence," *Psychological Review* 115, no.2 (2008): 502-517.

[2] Cameron Anderson, Sebastien Brion, Don A. Moore, and Jessica A. Kennedy, "A Status-Enhancement Account of Overconfidence," *Journal of Personality and Social Psychology* 103 (2012): 718–735.

[3] Jessica A. Kennedy, Cameron Anderson, and Don A. Moore, "When Overconfidence Is Revealed to Others: Testing the Status-Enhancement Theory of Overconfidence," *Organizational Behavior and Human Decision Processes* 122 (2013): 266–279.

[4] Ola Svenson, "Are We All Less Risky and More Skillful than Our Fellow Drivers?" *Acta Psychologica* 47, no. 2 (February 1981): 143–148.