

*Beyond a certain point,
more information
doesn't help and infact
can create a dangerous
situation*

THE PROBLEM OF OVERCONFIDENCE

"It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so"

– Mark Twain

Paul Slovic, a famous psychologist, set up an experiment with a set of experienced handicappers (people who bet on horse racing events) to study the effect of information on decision-making. From 40 horse races from the past, he collected 88 data points about each horse in each of those events. The experiment consisted of predicting the winners of those 40 races for 4 consecutive rounds using the data given (of course without giving the names of the horses and the jockeys). In the first round, each handicapper was asked what they considered the five most important data points about the horse to forecast the winner and were provided those details. The handicappers were then asked to provide their forecast of the winner for each race along with their confidence level (between 0% - 100%) in the prediction. In the first round, the handicappers were on an average 17% accurate and their average confidence level was 19%.

In round two, they were provided with 10 data points of their choice; then 20 in round three; and 40 data points in round four. How do you think they would have fared in their accuracy? Surprisingly, there was no change in accuracy. The extra information provided had on an average had no impact on the accuracy of the forecasts. However, their confidence level doubled. In the first round, the handicappers confidence was well calibrated with their accuracy. However, they became overconfident as they got more and more information. Beyond a certain point, more information doesn't help and infact can create a dangerous situation. A person betting with high confidence (influenced with more information) and low accuracy will soon lose all his money. Overconfidence affects decision making regarding

When faced with complex situations, we must use our subjective judgement in determining the answer and its probability. But most of us display too much faith in our guestimates and keep our range narrow

investments too. Most of the time, people are overconfident about stock picking as well as market timing.

TRADING STOCKS

I attended the Behavioral Finance class at the Amsterdam Institute of Finance under Professor Hersh Shefrin, one of the renowned academicians in the field. One of the assignments given by the professor was to answer a set of questions by giving a range with 90% confidence (such that the answer will lie between the low and the high guess). A 90% confidence level can be understood in the following way: We had to answer 10 questions in a way that we should be able to get atleast 9 right. To give you a flavor of the questions, here are two of them:

1. What is the diameter, in miles, of the moon?
2. In what year was Wolfgang Amadeus Mozart born?

The test was designed not to understand what you know, but to understand how confident you are about what you think you know. When we got the answers, the average accuracy of the class turned out to be around 65% vis-a-vis the targeted 90%. Prof. Shefrin told us that we were like any other class he taught. We were clearly overconfident as we kept the range of our guesses too tight.

When faced with complex situations, we must use our subjective judgement in determining the answer and its probability. But most of us display too much faith in our guestimates and keep our range narrow. Let's take a complex calculation of determining the intrinsic value of a company's equity. There are so many elements of the business that need to be predicted to forecast a long-term revenue, profit and cashflow trajectory of the company. Add to that, we must choose the right valuation method and then the right valuation range of the selected method. Despite its inherent complexity, investors and analysts insist on determining one price as the fair/target price of the company. Even in the book, "Security Analysis", Graham and Dodd don't insist on a definitive intrinsic value of a company. "... It is a great mistake to imagine that intrinsic value is as definitive and as determinable as is the market price", they write. We haven't even

It is difficult to determine a medium to long term trend of the market. It is even more difficult to time the interim tops and bottoms. Here too, overconfident investors, who try to time the market, tend to trade more and end up with lower returns

added the concept of reflexivity here where the actions of market participants can impact intrinsic values and keep it fluctuating.

A lot of investors put too much faith in their ability to precisely forecast target prices and hence fluctuations in the stock price keep them trading around those numbers. Terrence Odean (one of the leading researchers in behavioral finance) shows that overconfident investors—who believe that the precision of their knowledge about the value of a security is greater than it actually is—tend to trade more frequently. And furthermore, that investors who trade more frequently tend to have inferior outcomes on an average.

MARKET TIMING

In one of the presentations from Jason Zweig (a renowned financial writer, author and columnist), I found a small experiment that I sometimes use during my workshops on investment psychology. I have a set of cards; 80% of them are Green and 20% Red. I draw them one by one and the audience must guess the colour of the card that will be drawn next. People obviously try to guess a Red being drawn after a short run of Greens. I haven't had anyone calling all the cards right. Then I give them the math: the person who guesses 'Green' all the time will be right 80% of the time. However, in your attempt to guess that rare 'Red', if you call the cards wrong 20% of the times, the accuracy drops to 68%. The audience doesn't know the number of cards I am carrying, and the sequence is random. With very little information available, the audiences' belief in their ability to time the 'Red' correctly shows overconfidence. The same goes for market timing. It is difficult to determine a medium to long term trend of the market. It is even more difficult to time the interim tops and bottoms. Here too, overconfident investors, who try to time the market, tend to trade more and end up with lower returns.

BEING MORE CALIBRATED

Overconfidence leads to mistakes in investment decisions and also to investors taking too many risks. Investors need to be mindful of the general tendency of human beings to be overconfident and thereby practice humility. There are ways to correct this bias at the source itself:

The ideal path in the middle path where the investor takes decision based on well calibrated range of forecasts coupled with well thought out probabilities

- **Confirmation bias** – When people believe something to be true, they seek out only the information that conforms to their views. Due to this bias, the investors overestimate their knowledge and tend to make investment decisions with overconfidence. This bias can be handled by seeking out counter arguments to our own ideas. In a team of professionals, a person can be assigned to play the role of devil's advocate to highlight what can go wrong in the proposed idea.
- **Availability Heuristic** – Another important source of overconfidence is the Availability Heuristic: a tendency to assume that our memories are a representative sample of reality. We give importance to issues which we can retrieve in our mind with ease and discount events that are outside of our immediate recollection. We jump to conclusion quickly using short cuts and do not estimate the probability of the events correctly. To handle this heuristic, investors need to follow a set process which involves collecting the right sample data and calculate probabilities correctly. Anchoring to the long-term base rates of occurrence of a particular event and then adjusting from there to incorporate new information is also a good way to handle this bias.
- **Recent successes or illusion of superiority** – Charlie Munger says “Bull markets go to people's heads. If you're a duck on a pond, and it's rising due to a downpour, you start going up in the world. But you think it's you, not the pond.” Being successful at one investment can lead to illusion of superiority and overconfidence in the ability to consistently deliver favorable results. In such situations, individuals are less likely to listen to others or disregard opposing opinion. It is important that investors keep an investment journal to later analyze and dissect the outcome between luck and skill thereby aiding better decision-making.

Optimism, confidence and conviction are important in investment decision making, but in the right measure. An investor who is less accurate and overconfident will quickly lose money. On the other hand, an investor who is highly accurate but too much in doubt is also not in a good position. Such an investor may just sit on the sidelines and not invest at all. The ideal path is the middle path where the investor takes decision based on well calibrated range of forecasts coupled with well thought out probabilities. Happy Investing!



NIMESH CHANDAN

**HEAD – INVESTMENTS, EQUITIES
CANARA ROBECO**

Nimesh Chandan is Head-Investments, Equities at Canara Robeco. He has almost two decades of experience in the Indian Capital Markets. Nimesh has been with Canara Robeco since 2008 and in his current role, he guides the equity team in providing a strategy for various equity funds. He is a keen follower of Behavioral Finance and has developed tools and processes which help improve the investment decision making process. He also conducts workshops wherein he presents the concepts of Behavioral Finance to investors and financial advisors under a series called 'The Money and the Mind.'

ABOUT STOIC INVESTOR:

The word “Stoic” is used to describe someone who remains calm under pressure and avoids emotional extremes. For the purpose of this newsletter we refer to the “Stoic investor” as an investor who is realist (avoiding extreme optimism and extreme pessimism), resilient (withstand difficult conditions) and rational (who acts with logic and reason).

Disclaimer:

The information used towards formulating this document have been obtained from sources published by third parties. While such publications are believed to be reliable, however, neither the AMC, its officers, the trustees, the Fund nor any of their affiliates or representatives assume any responsibility for the accuracy of such information and assume no financial liability whatsoever to the user of this document. This document is strictly confidential and meant for private circulation only and should not at any point of time be construed to be an invitation to the public for subscribing to the units of Canara Robeco Mutual Fund (CRMF). **Please note that this is not an advertisement or solicitation for subscribing to the units of CRMF.** The views expressed herein are only personal in nature and does not constitute views or opinion of Canara Robeco Asset Management or Canara Robeco Mutual Fund. The document is solely for the information and understanding of intended recipients only. Internal views, estimates, opinions expressed herein may or may not materialize. These views, estimates, opinions alone are not sufficient and should not be used for the development or implementation of an investment strategy. Forward looking statements are based on internal views and assumptions and subject to known and unknown risks and uncertainties which could materially impact or differ the actual results or performance from those expressed or implied under those statements.

**Mutual Fund investments are subject to market risks, read all
scheme related documents carefully.**