CROWDED THINKING | *market behavior is human behavior*

"I give myself a 63% chance of making it"

You know it's going to be an interesting lunch when someone you're meeting for the first time closes their email with these words. I'm glad he made it because Berkeley Professor Don Moore and his colleagues have produced influential research on the psychology of confidence. Our friend Phil Rosenzweig (*Left Brain, Right Stuff* and *The Halo Effect*) says that Moore's work completely changed his view on confidence when making business decisions.

Professor Moore is also deeply involved in another study that could change how we think about the efficacy of forecasting. The Good Judgement Project is funded through a division controlled by the Director of National Intelligence. This fascinating, potentially game changing research will be discussed in next week's note. In the meantime, let's take a unique look at confidence, both *over and under*.

"They were overconfident" is one of the great throwaway lines when analyzing failure; one can safely begin any post-mortem on a botched decision with that timeless opener. This kind of circular reasoning is so common that we hardly notice it. Failure can be confirmed by definitive outcomes like poor returns or write-offs but blaming a specific mindset *ex-post* is a textbook example of hindsight bias.

Were you overconfident in the quality of your information, or the decisions that flowed from it?

Like so many of the behavioral themes that we look at, confidence is not a black and white, binary issue. If you want to understand how confidence impacts decision-making, then context is critically important.

The survey that usually gets the most traction when explaining overconfidence is the one where an overwhelming majority of drivers believe that they're better than everyone else on the road. This is statistically impossible, of course, which means that readers can knowingly smirk at this *Lake Wobegon effect*, where everyone believes "they're above average".

So there it is: our bias for overconfidence is at the root of all mistakes. Hang on, says Moore, are we really asking the right questions in the right context? He believes that we should be breaking down the analysis of confidence into degrees of *precision, estimation and placement*.

Precision is how sure you are about being correct, as expressed by a probability rating. "I'm 99% sure that the Seahawks will win the Super Bowl". This is an emotionally justifiable claim based on recent history, especially if you're a fan, but it also suggests an improbable degree of certainty given the NFL's competitive structure. Even if your exhaustive analysis suggests that the Seahawks are the best team in every game, they will still win much less than 99% of the time.

Estimation affects how you perceive your ability to influence an outcome. One common mistake involves the *illusion of control*, which is overestimating your capacity to influence a situation where most of the variables are beyond your control. We know our control over outcomes in financial markets is non-existent. But we can control our investment process, the people we work with and, to some degree, client expectations about performance.

Placement means to what degree you think you're better than average. However, for our purposes, a question that clarifies the right context would be:

For what reasons do I believe that my analysis is better and more informed than my competitors?

Sometimes you need to admit (if only to yourself) that your placement, or *edge*, in certain market environments is relatively small. But most of us compete on a relative basis. So overplacing your confidence could be seen as a coping mechanism when we're dealing with periods of uncertainty.

And what's wrong with this, really? If precision and estimation are tempered by cautious reality, then a measured dose of overplacement should be viewed favorably.

I asked Moore for more guidance: *what would he do in our position?*

He didn't hesitate: "look for candor about what can't be controlled before a final decision is made, and a willingness to calibrate on precision".

Calibrating on precision is another way of saying that your degree of certainty about a decision should be flexible as new information emerges. Moore also suggests asking a pointed question about specific plans and forecasts:

How will failure be recognized before it becomes obvious to an outsider?

If the implicit response to this question is a look of confusion or derision, don't ignore those cues. Unfortunately, the most deceptive communicators answer this question with unwavering confidence because they worry that calibrating sounds weak.

If we're honest with ourselves, we'll admit that we're more reassured by someone who displays a high degree of conviction. As Moore says "confidence is compelling to others because in the absence of information to the contrary, observers assume it reflects superior ability".

What we need to remember is that there's usually a lag between an initial forecast and when definitive results appear. A consistently high degree of confidence can not only fill this gap, it can also delay the recognition that someone is, for lack of a better phrase, *full of it*.

The most disturbing implication of Moore's research is that supreme confidence is resilient. Even as contrary information begins to emerge, the reputation of confident people is not immediately damaged. A bold story can delay a truthful reckoning if we haven't prejudged the precision and estimation of the storyteller.

Understanding the psychology of confidence is a critical skill when you're making or analyzing forecasts. Next week's note about Don Moore's involvement in the Good Judgement Project will provide a real world example.

Epilogue

In my own experience, the allure of resilient, powerful confidence is dangerously strengthened by the appearance of false modesty. I saw the *Telecom Cowboy,* Bernie Ebbers, speak at a conference in late 1999. It doesn't spoil my story to remind you that Ebbers is now doing time in a federal prison after his conviction in the largest accounting fraud in U.S. history before Bernie Madoff came along.

Ebbers was supremely confident. Wearing cowboy boots and jeans, his silver pompadour and matching beard made him look like a cross between Kenny Rogers and the man in the Dos Equis beer commercials.

Although the stock of his company, WorldCom, was up over 7,000% in the 1990's, his story was beginning to unravel. After an attempt to purchase a major competitor fell through, word was leaking out that the technical integration of dozens of acquisitions was proving to be a massive failure. Ebbers didn't really deny the charges; instead he proudly stated that he wasn't a 'tech guy' and that Wall Street just didn't 'get it'. There were golf claps all around. *Did I mention the stock was up 7,000%?*

Aside from his reassuring feistiness, the self-made billionaire aura that surrounded Ebber had legs. He was a former milkman from Edmonton before receiving an athletic scholarship to a Mississippi college. He was coaching basketball before he started Worldcom with a business plan sketched out on a napkin, of course. His modest home and Sunday school teachings always seemed to round out the narrative.

This bravado and bootstrap image bought him more time. It would be another 18 months before fraud allegations revealed his story to be a deceptive ruse. Only then would we regularly hear that he owned Canada's largest ranch, a massive yacht called the *Aquasition,* and that his billion dollar stake in the company was secured by margin loans approved by the board.

Proving, once again, that Edmund Burke was right when he said:

"Whoever undertakes to set himself up as a judge of Truth and Knowledge is shipwrecked by the laughter of the Gods".

A Status-Enhancement Account of Overconfidence, Journal of Personality & Social Psychology, July 2012 Cameron Anderson, Berkeley; Sebastien Brion, University of Navarra; Don A. Moore and Jessica A. Kennedy, Berkeley

The Trouble with Overconfidence, 2007: Don Moore, Carnegie Mellon; Paul Healy, The Ohio State University

When overconfidence is revealed to others: Testing the status-enhancement theory of overconfidence, September 2013: Jessica Kennedy, Wharton School; Cameron Anderson and Don Moore, Berkeley

James McKeough, CMT
Pavilion Global Markets
jmckeough@pavilioncorp.com
604-261-1311 office | 604-805-6369 mobile
www.crowdedthinking.com