



## ANDRESEN AND ASSOCIATES

P.O. Box 1434 Salinas, CA 93902-1434

Phone: (831) 758-1575 or 1-800-345-9644

Fax: (831) 758-1576

e-mail: PETE@ANDRESENASSOC.COM

WWW.ANDRESENASSOC.COM

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### SEEKING THE POT OF GOLD: THE TRAP OF OVERCONFIDENCE

Insanity has commonly been described as doing the same thing over and over again and expecting a different result each time. If this is so, then most investors could be classified as deranged. A flurry of recent studies by independent research firms such as the Financial Research Corporation and Dalbar Research, has indicated that most investors profoundly underperform the investment markets because of their own investing behavior.

The Dalbar study is the most highly publicized and the most interesting, in part because it is the longest term study available. This study found that the average stock market investor earned average annual returns of only 5.3% from 1984 through 2000, while the S&P 500 Index gave us an average of 16.3% per year for the same period.

We have to take this data with a grain of salt. The years covered in the study were the best years for the S&P 500 in decades. Later, in 2000-2003, the index declined 50%, which profoundly reduced its relative performance. All those other “nobody beats the index” studies have turned out to be quite flawed, because they only study the good years. We need to pay attention to context.

Despite its limited period of study, what the Dalbar study DOES tell us is that the methodology of the average American investor is deeply flawed. It is broken. I will say it again: what the average American investor does to manage his or her investments is often actually damaging to his or her net worth.

Yet, on the other hand, 1% of the US population owns 50% of the financial assets. What is *this* tiny fraction of the American people doing that a large portion of the other 99% is not?

Information like this forces us to admit the obvious: humans are not rational. Like all decisions, investment choices are most often made in a vapor of emotion and inconstancy. Any decision you make is likely to be influenced by an assortment of beliefs as well as facts, even before your emotions take over.

Many of these beliefs are incorrect. It now appears that the few investors who actually succeed have been able to rise above their own mental limitations and emotions and invest without the personal turbulence which appears to cripple so many others.

If you have been a client at Andresen and Associates very long, you know we are fascinated by the requirements of successful investing, and we are constantly seeking to improve. The results prove that we—you, me, all of us together—have largely been able to avoid the psychological pitfalls of the financial markets. Yet, due to our human condition we will always be locked in constant battle with our own animal minds.

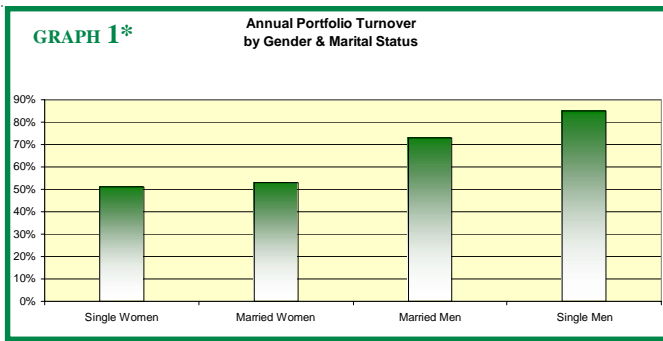
One major influence on our investing behavior is overconfidence. *“Overconfidence” in this situation refers to our constant human universal tendency to believe that a given situation is both more likely to have a positive outcome and be more controllable than it actually is. It is a psychological template that we all use for dealing with an uncertain and potentially threatening world.*

For example, in one published survey, 82% of a rather large sample of college students think they are above-average drivers. Another study, published in the 1988 Journal of Experimental Psychology, revealed that the more information people received on a topic, even if it was useless, the more likely they were to expect a positive outcome.

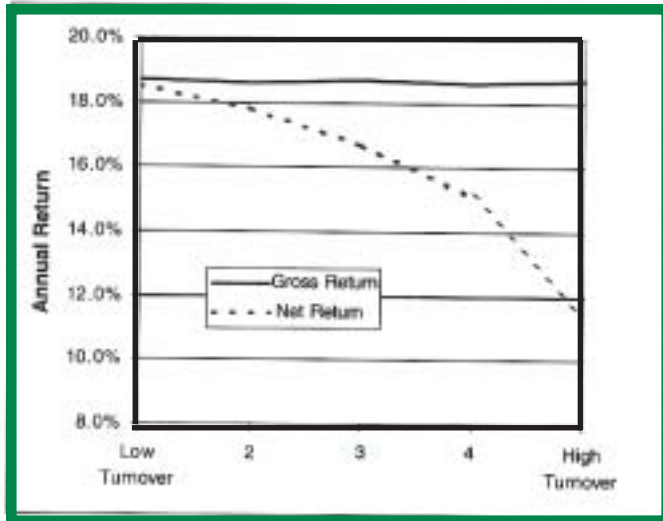
Still another study included the rather charming fact that the odds of winning the California State Lottery are 1 in 18 million. If you bought 50 lottery tickets a week, you would win, statistically, once every 5,000 years. You have a twenty times greater probability of dying from food poisoning after eating sushi than you have of winning the lottery. Ever had sushi? Ever bought a lottery ticket? Congratulations, you’re overconfident.

Recently several studies have been published which present some astounding data about how overconfidence affects our investment choices. In 2001, MIT’s *Quarterly Journal of Economics* published a report by Professors Barber and Odean. Using a giant sample of 78,000 individual investors, it was revealed that single men trade 67% more than single women, and thereby REDUCE their returns relative to the women’s returns by 1.44% per year. (GRAPH 1)

This information is important because it reveals that investors routinely demonstrate a gender-influenced bias towards overconfidence. If this were not so, then trading rates would be the same, and GRAPH 2 would not look like it does.



**GRAPH 2\*** ANNUAL RETURNS BY PORTFOLIO TURNOVER



Overconfidence may be a simple requirement of the human existence. It is also regarded as a virtue, especially in men. We are taught from childhood to take risks like Donald Trump, to dream big like Bill Gates, and to believe that “if you don’t succeed, try and try again.” Overconfidence has been a winning aspect of American society. In repeated tests, the more unclear the information, the more murky or fast-moving the situation, and the more immeasurable the outcome, the more likely we are to be overconfident. In life it may lead us to success and acclaim. In our investing it may lead us to ruin.

Overconfidence is the meat and potatoes of the flawed American investment culture. Wall Street is a vast self-promotion machine bent on ripping us off, and they do this repeatedly, insistently, and chronically, by appealing to our overconfidence. Wall Street wants us to believe that greater risks, more information, and above all more ACTIVITY will produce greater results. However, if the information is flawed and the risks are skewed against the individual investor, then their product must be seen as hucksterism. Not so? Look at **GRAPH 2**, once again from the study by Barber and Odean.

What this means is that the more we trade, the more we LOSE money. The investors who think they have the most control are in fact deluding themselves. But that is not what you see when you watch the ads on TV, is it? Those savvy, sexy, self-directed models in the ads do not look so cool once you realize that they are, on average, losing money when compared to us mutual fund investors. Meanwhile, the brokerages making money are growing rich from trading charges. And, as you might conclude from the first graph, if men trade more than women, it is also true that they lose more when they are active traders. For these macho guys, more risk definitely does not equal more reward.

Perhaps we should rename “overconfidence” as “overcompetence”. It appears that the most active traders have vastly higher incomes than average, \$74,000 versus the average of \$32,000. Yet they also spend an average of \$2849 per year on additional trading costs for the privilege of underperforming. My interpretation of this data is that these people are genuinely highly competent at their chosen professions, as proven by their higher incomes. They then extend this feeling of competence beyond its realistic realm into the world of investing. Their genuine sense of empowerment in their profession becomes overconfidence when extrapolated into the world of finance.

Why do some mutual fund managers and money managers trade actively? I would argue that they do so to project an image of competence and attractive aggression. Some of the best managers are in fact very passive traders, yet I sometimes hear from clients that these managers are not aggressive enough. “They aren’t DOING anything!” is a complaint I hear at least annually. So active traders are doing all this churning to attract clients and publicity, not garner higher returns. The data simply does not exist to support the concept that higher trading volume results in higher returns.

What can WE do with this information? We are all human. We all face an uncertain world, and by necessity, we must all rely on the psychological phenomenon of overconfidence to some degree. However, let us not allow this overconfidence to blind us. Let us remember that our mind will bend reality to fit its needs, and our brain should remain focused on the realities of investing. These realities are often not what the public images of investing show us. Despite what we see on TV, NOT altering the portfolio is often the best choice. And finally, we need to remember that slow and steady wins the race!

At Andresen and Associates, our professional ethos is centered on providing successful, disciplined, morally unambiguous money management for the individual investor. In other words, we want to be on the same side of the table as our clients, and we want to employ the proven habits of that successful 1% who succeed in growing wealthy. Sometimes these habits are contrary to what the public perceives as wealth building. We don’t care. Enabling our clients and ourselves to live a rich life in all its dimensions is our sole concern. 🍀

*\*(as rendered from the book “The Psychology Of Investing” by John R. Nofsinger. Dry to read, not particularly well written, but packed with information.)*