PGIM India Mutual Fund

Overconfidence - The Most Dangerous of All Biases

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Dear Investors and Partners,

It is the bias, he says, he would like to eliminate the most if he had a magic wand. But it is built so deeply into the structure of the mind that you couldn't change it without changing many other things – "Overconfidence" is the most damaging among all, says Daniel Kahneman, the Israeli-American author, psychologist, and economist who is known for his work in behavioural economics for which he was jointly awarded the 2002 Nobel Memorial Prize in Economic Sciences.

I have been fascinated by Kahneman's writings and the way he explains the complexities of the human mind in decision making, that I decided to write about this Nobel Prize laureate's tragic demise recently, which has left a void in the field of financial decision making.

In his 2011 book, 'Thinking, Fast and Slow', he talks about the 'two systems' of thought, one instinctive and emotional, the other deliberative and more logical. Now, imagine you're standing in the queue at a grocery store, and you see a display of chocolates by the checkout counter. Without much thought, you grab a bar of your favourite chocolate impulsively. This decision is driven by 'System 1' thinking, which relies on quick, instinctive reactions and doesn't involve much deliberate analysis.

Now, let's consider purchasing a house instead, which involves significant financial investment and long-term commitment— that entails carefully researching factors such as location, property condition, market trends, financing options, and future resale value, etc., and for all this you need to engage using 'System 2', which is more deliberate, thoughtful, unlike the System 1 thinking. Deliberate thinking helps reduce future regret related to important decisions.

Investing for your long-term goals therefore requires one to be slow and deliberate in decision making by taking more than just a few factors into consideration, rather than just using your gut instinct or reacting to a piece of news or data point.

Kahneman stressed that as your intuitive mind is always in default mode to help you take decisions quickly, if rendered in the wrong context like buying a house or making an investment – it can cost you hard because of behavioural biases. And among them the most common and most perilous bias is 'overconfidence', kind of "I know it better" attitude. This is often called as an "illusion of control"— tendency to often overestimate one's own abilities, knowledge, or judgments and underestimate the time, costs and risks involved and particularly the likelihood of negative outcomes, by believing we can "beat the market" through our actions. This can often lead to unhealthy investment behaviours like excessive trading, invest far more money on not so well researched investments and often under-diversification believing in one's knowledge and ability to handle a concentrated set of investments. That's not all, research suggests that overconfident investors may not be well prepared for the future finances as they often overlook the potential risks related to their retirement, like retiring early due to health issues and bearing heavy medical debt, which can have serious long-term effects on one's finances.

But, We Can Deal with Overconfidence

Beating the heat of any behavioural bias is not easy! Kahneman believes that you can slow down and become aware of this, using your conscious and deliberative mind, but the underlying mechanism isn't going to change. Let's see how one can overcome this:

Seek Diverse Perspectives: Encourage critical thinking by seeking alternative viewpoints and considering a range of possible outcomes. To make it simple, imagine before making a purchase for a new mobile phone, you might research online reviews, ask friends or family for recommendations, and visit multiple stores to compare options. You gain insights into the features, quality, and value of different products, helping you make a more informed decision. When picking an investment, this is the exact approach you should take.

Use Data and Evidence: Rely on data-driven analysis rather than intuition or gut feelings when making investment decisions. Taking the similar example of buying a mobile phone, when considering which gadget to buy, you might prioritize specifications like battery life, performance benchmarks, and customer ratings. By relying on objective data and evidence, such as technical specifications, user reviews, and expert opinions, one can evaluate the product's suitability based on concrete information rather than subjective impressions.

Adopt Humility: Despite your research and analysis, there's always a chance that your chosen gadget may not meet your expectations or could have unforeseen drawbacks. Be it buying an gadget or an investment, it's important to acknowledge and respect the limitations of individual judgment and remain open to learning from both successes and failures – also being open to alternative options with changing circumstances depicts humility in decision making.

Consult Experts: If you're uncertain about which mobile best suits your needs, you should seek advice from knowledgeable sales representatives, tech enthusiasts, or professional reviewers. Consulting domain experts can provide valuable insights, recommendations, and technical expertise to help you make a confident and well-informed purchase decision. Engaging with financial advisors can provide objective insights and challenge your assumptions.

At PGIM, our motto is to empower you in this journey, turning the complexities of investing into opportunities for growth and prosperity. Let's make your financial dreams a reality, one thoughtfully chosen investment at a time.

Happy Investing!