You Can't Handle the Truth

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by Larry Swedroe

That is the famous line Jack Nicholson shouted at Tom Cruise in the film "A Few Good Men." Evidence from the field of behavioral finance suggests investors can't handle the truth – many delude themselves about their own skills and performance. The ability to delude oneself leads to persistent and costly investment mistakes. Consider the following.

In 1965, 50 drivers were asked to rate their skill and ability the last time they were behind the wheel. About two-thirds said they were as least as competent as usual. Many even described their most recent drive as "extra good." What is particularly interesting about this study performed by two psychologists was that all the participants had ended their last driving trip in an ambulance. Police reports showed almost 70% of the drivers were directly responsible for their crashes, almost 60% had at least two past traffic violations, a similar number had totaled their cars, and almost 50% faced criminal charges.[1]

This data may seem strange in light of the unique group of participants. However, overconfidence is an all-too-human trait. The same psychologists interviewed people with clean driving records and found that over 90% believed themselves to be above average.[2]

Overconfidence

In a *New York Times* article, professors Richard Thaler and Robert Shiller noted that individual investors and money managers persist in their belief that they are endowed with more and better information than others, and they can profit by picking stocks.[3] This insight helps explain why individual investors believe they can:

- Pick stocks that will outperform the market.
- Time the market so they're in it when it's rising and out of it when it's falling.
- Identify the few active managers who will beat their respective benchmarks.

Even when individuals think it is hard to beat the market, they are confident they themselves can be successful. Here is what noted economist Peter Bernstein had to say: "Active management is extraordinarily difficult, because there are so many knowledgeable investors and information does move so fast. The market is hard to beat. There are a lot of smart people trying to do the same thing. Nobody's saying that it's easy. But possible? Yes."[3] That slim possibility keeps hope alive. Overconfidence leads investors to believe they will be among the few who succeed. Consider the data from a study on individual investors.

Money magazine conducted a study on more than 500 individual investors. Almost 30% stated their portfolios had outperformed the Dow Jones Industrial Average over the previous 12 months. About one-third stated their portfolios had risen between 13 and 20%, another third stated they earned between 21 and 28%, and about one-fourth stated they earned at least 29%. Four percent admitted they had no idea what they had earned. Over that period, the Dow actually returned more than 46% and outperformed more than three-quarters of all the investors.[4] Now consider the evidence from a similar study.

The study, Positive Illusions and Forecasting Errors in Mutual Fund Investment Decisions, sought the answer to the question, "Why do investors spend so much time and money on actively managed mutual funds despite the fact the vast majority of these funds are outperformed by passively managed index funds?" The authors concluded the reason is that investors delude themselves. They found most participants had consistently overestimated both the future performance and past performance of their investments. In fact, more than a third who believed they had beaten the market had actually underperformed by at least 5%, and at least a fourth lagged by at least 15%. Biases such as this contribute to suboptimal investment decisions.[5]

Let's turn now to the results of the study, "Why Inexperienced Investors Do Not Learn: They Do Not Know Their Past Portfolio Performance."[6] The authors, Markus Glaser and Martin Weber, analyzed the actual performance of the online brokerage accounts of individual investors. Following is a summary of their findings:

- Investors are unable to give a correct estimate of their own past portfolio performance. The correlation coefficient between return estimates and realized returns was not distinguishable from zero.
- People overrate themselves. Only 30% considered themselves average. Investors overestimated their own performance by an astounding 11.5% a year. And portfolio performance was negatively related with the absolute difference between return estimates and realized returns – the lower the returns, the worse investors were when judging their realized returns. It seems likely investors are unable to admit how badly they have done. While just 5% believed they had experienced negative returns, the reality was that 25% had done so.
- On average, investors underperform relevant benchmarks. While the arithmetic average monthly return of the benchmark was 2.0%, the mean gross monthly return of investors was just 0.5%. And more than 75% of investors underperformed.

Psychologists have also found that investors who have the "I'm in charge feeling" have an even greater ability to delude themselves. A study of U.S. retirement plan investors who could either choose their own mutual funds or permit someone else to decide for them found that both groups deluded themselves about their performance. The investors who allowed others to make the selections on their behalf *only* overstated their returns by more than 2%. The group that was "in charge" overstated returns by almost 9%.[7]

Possible, Not Likely

It is certainly possible for investors to outperform the market. However, the evidence demonstrates that the vast majority would be better off simply accepting market returns. At the very least, investors should know the odds of outperforming. For example, S&P Dow Jones Indices SPIVA U.S. Mid-Year 2020 Report found that over the 15-year period ending June 2020, 87% of large-cap funds and 81% of midcap and small-cap funds underperformed their benchmark S&P indices. In just three (large value, midcap growth and small growth) of 18 categories did less than 80% underperform. In no case was the percentage of underperformers below 73%.

Unfortunately, it seems most investors delude themselves about those odds. One reason might be that they are unaware of the evidence. Another is that they don't know their own track records. This type of self-delusion helps to explain why investors exhibit the common human trait of overconfidence. Most people want to believe they are above average. Thus, the disconnect investors have between reality and illusion persists.

Before concluding, I want to share my personal favorite story on investor overconfidence. If anyone deserves to be confident of their skills, it seems logical it would be the members of the Mensa (high IQ group) investment club. The June 2001 issue of Smart Money reported that the Mensa investment club returned just 2.5% over the previous 15 years, underperforming the S&P 500 Index by almost 13% per year. Warren Smith, an investor for 35 years, reported that his original investment of $5,300 had turned into $9,300. A similar investment in the S&P 500 Index would have produced almost $300,000. One investor described their strategy as "buy low, sell lower."[8] The Mensa members were overconfident their superior intellectual skills would translate into superior investment returns.

The moral of the tale

It is important to measure your investment returns and also compare them to appropriate benchmarks. Doing so will force you to confront reality rather than allow an illusion to undermine your ability to achieve your financial objectives.

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[1] Jason Zweig, *Your Money & Your Brain*, pp. 85-86 (Simon & Schuster 2007)

[2] Jonathan Fuerbringer, "Why Both Bulls and Bears Can Act So Bird-Brained," *New York Times*, March 30, 1997

[3] Jonathan Burton, Investment Titans (McGraw-Hill, 2000)

[4] *Money*, “Did You Beat the Market?” (January 1, 2000)

[5] Don Moore, Terri Kurtzberg, Craig Fox and Max Bazerman, “Positive Illusions and Forecasting Errors in Mutual Fund Investment Decisions,” Harvard Business School Working Paper 99-123.

[6] Markus Glaser and Martin Weber, “Why Inexperienced Investors Do Not Learn: They Don't Know Their Past Portfolio Performance,” Finance Research Letters, July 21, 2007

[7] Zweig, p. 102

[8] Eleanor Laise, “If We’re So Smart, Why Aren’t We Rich?” *SmartMoney*, June 2001.