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The undermining effects of overconfidence

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One can't be a successful investor without a healthy dose of confidence. To commit your own and others' hard-earned capital requires conviction, and conviction requires confidence. But as with fine brandy or coffee ice cream, too much of a good thing can be problematic.

Social scientists have confirmed time and again that people generally overestimate their abilities and knowledge. More than 80 per cent of drivers think they're among the safest 30 per cent of those driving. More than 85 per cent of my Harvard Business School classmates, when surveyed at their fifth reunion in 1999, said they were better looking than their average classmate. When asked at conferences to write down how much money they will have at retirement versus the amount the average person in the room will have, money managers and business executives consistently judge that they'll end up with about twice the average – also an impossibility, of course.

In life, an abundance of confidence gives us higher motivation, persistence and optimism and can allow us to accomplish things we otherwise might not have undertaken. As an author once wrote, "who wants to read their children a bedtime story whose main character is a train that says, 'I doubt I can, I doubt I can'?"

But overconfidence can hurt investors in a variety of ways, leading to too much trading, sloppy analysis and excessive risk-taking. Brad Barber and Terrance Odean of the University of California, Davis, in extensive studies of individual trading behaviour, have found that investors generally overestimate the precision of their knowledge about a security's value, and the probability that their assessment is more accurate than that of others. The result, Barber and Odean say, is more active trading – "I've got to act on the advantage I have" – but not better performance. They conclude that "those who trade the most realise by far the worst performance".

Another academic study, by Lin Peng of Baruch College and Wei Xiong of Princeton University, has found that overconfident, time-pressed investors put too much weight on market- or sector-level information and not enough on company-specific data. The authors argue that this sloppiness was a key contributor to the internet stock bubble, as investors ignored company specifics and made broadly positive judgments about entire industry sectors – much to their eventual chagrin.

Where am I seeing similar investor behaviour today? Energy. This has been a top-performing sector for many years and, with oil prices hitting new highs again this month, there appears to be no slowdown in sight. Thus, it's not surprising that investors, as they always do, are projecting the immediate past indefinitely into the future – a sure sign of overconfidence.

I'm not suggesting there's a bubble among the stocks of the big oil companies. They are trading at low – even single-digit – price/earnings multiples, so investors are correctly pricing them as the cyclical companies they are. Instead, the stocks to avoid are the ones on the speculative fringe – what I call "froth and nonsense". Two examples, both of which I am short in the funds I manage, are Capstone Turbine, a manufacturer of microturbines that has never been – and I believe has no prospects of ever being – profitable, and KFx Inc. The latter makes claims – highly dubious ones in my opinion – that it has developed a proprietary way of converting low-quality coal to high-quality coal. Speculative, profitless – and, in the case of KFx, virtually revenueless – companies such as these spring up in sectors where there is great investor enthusiasm and almost always – even if the sector ends up doing well – disappear with investors' money.

The best guards against investor hubris? Benjamin Graham's discipline of investing with a significant "margin of safety" is a great start. The consequences of overestimating a company and your ability to analyse it are greatly diminished when you're paying a lot less for it than your analysis shows it is worth.

It's critical to have a disciplined investing approach and stick with it. My checklist includes answering the following four questions affirmatively for any investment we make: Is this well within my circle of competence? Is this a good business? Do I give management high marks on operations, capital allocation and integrity? And, most importantly, is the stock really, really cheap?

It's also important to test your thinking on as many informed and dispassionate listeners as possible. In addition to the benefits of hearing alternative viewpoints, the simple act of articulating an idea is a powerful check on the thoroughness of your analysis. In the end, inaction is a viable alternative. Don't pretend you have your brain fully around an idea when you don't. Save your money for later – there will always be other things to invest in.

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