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Illusion of expertise in portfolio decisions: an experimental approach

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Abstract

This paper investigates egocentric biases in financial decisions. Subjects first design a portfolio, whereby each combination of assets yields the same expected return and variance of returns. They are then confronted with two alternative portfolios: the average portfolio and the portfolio of one's selected expert. Illusion of expertise prevails if one nevertheless prefers the own portfolio. Using the random price mechanism reveals that most subjects prefer their own portfolio to the average or the expert's portfolio. Illusion of expertise is shown to be stable individually, over alternatives, and for both elicitation methods: willingness to pay and to accept.
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1. Introduction

Psychological evidence suggests that individuals are prone to egocentric biases such as overconfidence, unrealistic optimism, and illusion of control. This evidence is supported by a substantial body of literature that has only recently been considered in financial decision making (see Barberis and Thaler, 2003; Hirshleifer, 2001, for surveys).

In April 2002, an Australian stock-broker was ordered by the Victorian Supreme Court to pay compensation after losing a client's money during the process of "managing" it. The judge said that the broker had "an unrealistic view of his own ability" (Maiden and

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Lampe, 2002, p. 4). Also Nick Leeson, who was the chief derivatives trader at Barings bank in Singapore before bringing it down, overestimated his abilities by thinking he could outperform the market even after severe losses. "I was determined to win back the losses [...] I was well down, but increasingly sure that my doubling up and doubling up would pay off..." (Leeson, 1996, pp. 63–64).

Overconfidence, one exponent of egocentric biases, is regarded as one of the most robust findings in the psychology of judgment (e.g., DeBondt and Thaler, 1995), and it can be defined as a systematic overestimation of the accuracy of one's decisions and the precision of one's knowledge (e.g., Alpert and Raiffa, 1982; Fischhoff et al., 1977, Lichtenstein et al., 1982). Overconfidence has been observed in many professions (see Yates, 1990), is more likely in cases of self-declared expertise (Heath and Tversky, 1991), and is positively related to the personal importance of a task (Frank, 1935).

Psychological research also indicates that individuals tend to be unrealistically optimistic about the future. They judge positive traits to be overwhelmingly more characteristic of self than negative attributes (Alicke, 1985; Brown, 1986). Similarly, positive personality information can be recalled more quickly than negative information (Kuiper and Derry, 1982). Most people also show poorer recall for information related to failure than to success (Silverman, 1964) and rate past task performance more positively than it actually was (Crary, 1966). Additionally, individuals were found to credit themselves for past success and blame external factors for failures (Fischhoff, 1982; Langer, 1975), possibly to preserve an otherwise endangered self-image. People also believe their chances of success at a random task to be greater than objectively justified; this tendency is referred to as illusion of control (Langer and Roth, 1975). Individuals, for instance, simply believe they can skillfully influence and control outcomes of chance events.

In financial decision making, egocentric biases have been studied both analytically and empirically. Theoretical models of overconfidence, for instance, predict excess volatility and trading volume, overreaction to private information signals, and increased market depth (e.g., Daniel et al., 1998; Odean, 1998b). Empirical findings support these predictions; for instance, having analyzed more than 10,000 individual accounts at a large discount brokerage house, Odean (1999) demonstrates that, on average, investors sell securities that outperform those they purchase. In experimental studies, Kirchler and Maciejovsky (2002) show that overconfidence increases with experience but is moderated by the methodology used. Dittrich et al. (in press) demonstrate in an individual investment task that overconfidence increases with the absolute deviation from optimal choice and with task complexity, but decreases with uncertainty. Also, Charness and Gneezy (2003) show that the relation between investment behavior and individual biases is ambiguous; subjects are willing to pay for less ambiguity and more freedom to change their investment, but are less willing to pay for control of the procedure of the chance move.

In two recent empirical studies the importance of psychological factors on financial decision making has been successfully documented: Barber and Odean (2001) investigate the performance of investors who switched from phone-based trading to internet trading. While those traders who opted for internet trading initially beat the market by about 3 percent prior to going online, their performance decreased after going online, resulting in a performance of 2 percent below the market. In line with the predictions of theoretical models on overconfidence (e.g., Benos, 1998; Odean, 1998a), online investors traded too aggressively and less

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