

The Advantages and Disadvantages of Overconfidence in Behavioral Economics

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Abstract: In behavioral economics, overconfidence is a well-researched cognitive bias that has a big impact on how people and organizations make decisions. This essay explores the benefits and drawbacks of overconfidence while emphasizing its double influence on economic behavior. Positively, excessive confidence can encourage risk-taking, entrepreneurship, and daring behavior in people, all of which can promote innovation and economic expansion. It can also boost self-confidence, which in turn can boost motivation, perseverance, and general performance. On the other hand, overconfidence can have serious negative effects, including bad decision-making, underestimating risks, financial errors, and excessive market volatility. It frequently leads to people undervaluing competition, ignoring possible hazards, and ignoring pertinent information, all of which can lead to serious financial and personal losses. The study emphasizes the significance of comprehending the complex consequences of overconfidence in behavioral economics and the requirement for methods to minimize its negative effects while maximizing its positive ones.

Keywords: Behavioral Economics, Overconfidence, Effects.

1. Introduction

The study of behavioral economics integrates knowledge from psychology and economics to better understand how people make decisions in economic situations. Behavioral economics acknowledges that human behavior is frequently impacted by cognitive biases, emotions, and social circumstances, in contrast to classical economics, which assumes that people are rational and always want to maximize their utility. Some of our future behaviors can be predicted by behavioral economics, and it can also have an impact on how we characterize those behaviors and how broadly we can forecast them. Traditional economics differs from behavioral economics in many ways. Compared to the behavioral economics, the foundation of traditional economics is the idea of the "rational agent," who consistently chooses actions that maximize utility. Behavioral economics refutes this theory by showing that biases, emotions, and other psychological factors frequently cause people to make irrational judgments. Thaler had mentioned in his article that while behavioral economics is also grounded in economic theory, it typically places greater emphasis on the implications and impact provided by actual data. Conventional economics is primarily grounded in theory and seeks to optimize economic gains through economic theory. Conventional economics assumes that people can easily obtain and analyze all pertinent information to make the best judgments. Behavioral economics, on the other hand, acknowledges "bounded rationality," which refers to people's limited access to

information, time, and cognitive ability, which frequently results in less-than-ideal decisions. And the foundation of traditional economics is the idea that people's preferences are constant and steady across time. Behavioral economics, however, demonstrates that preferences can be inconsistent. For example, people may make different decisions depending on how an option is presented or may discount future rewards excessively. At the same time, conventional economics assumes that individuals assess risks in a logical manner. According to behavioral economics, people often underestimate probability, placing an excessive value on uncommon events and an insufficient value on likely ones, which can result in irrational risk-taking or aversion. Overconfidence The erroneous estimation of risk probability is the root cause of the theory of overconfidence [1].

Behavioral economics provides a more realistic explanation of people's decisions than does standard economic theory. A more realistic picture of how people act in everyday circumstances can be found in behavioral economics. It explains actions that standard models are unable to explain, such as impulsive purchases, procrastination, and holding onto lost investments. At the same time, different people will have different psychological factors when making decisions. Behavioral economics introduces cognitive biases and emotional factors from psychology, which often play a key role in explaining people's decisions. These elements of behavioral economics are more compelling than those of traditional economics. They give a more thorough framework for comprehending and directing human economic behavior and solve the limitations of classical economics in describing conduct in the actual world [2].

Overconfidence is the state of having more faith than one should have in one's skills, knowledge, and discernment. People's decision-making behavior is influenced by their tendency to exaggerate their correctness and minimize their incorrectness in life, as well as their false optimism about their own ability to succeed. Most people are overconfident in their ability to make predictions, which is one of behavioral economists' most significant discoveries. Overconfidence is a fairly widespread tendency in economic behavior that is prevalent in the sectors of public policy, company management, and investing. To be more precise, they make decisions often, overestimate their own judgment, underestimate hazards, and disregard advice from others. But according to behavioral economics theory, excessive confidence in one's ability to make investments might show up as frequent trading, concentrated investing, underestimating possible losses, and other behaviors. This overconfidence may result in below-market performance and less than ideal investment results. Like this, business executives will over-rely on their own judgment and past performance when making judgments, ignoring competitor threats and market data and taking needless risks with important choices. To comprehend economic behavior and make more informed financial decisions, it is crucial to study the behavioral economics notion of overconfidence. It can offer a convincing justification for why people make irrational actions. In-depth research on the benefits and drawbacks of overconfidence can better assist people in making economic behaviors and decisions and is crucial for the growth and stability of the economy, as well as for the success of individuals and businesses.

2. Case Description

Over the last two decades, an increasing amount of research in the fields of management, finance, and entrepreneurship has suggested that overconfidence is the cause of some of the most perplexing actions of economic actors. During the 2008 financial crisis, excessive confidence led many investors and institutions to suffer significant losses. Here is a typical example. The subprime mortgage market grew quickly in the years preceding the financial crisis, and investment banks made money by packaging these loans into intricate financial instruments like Collateralized Debt Obligations (CDO) and mortgage-backed securities (MBS). Investment banks such as Lehman Brothers got enthralled with these products because of their huge returns, and they used excessive leverage (borrowing big sums of money) to increase the possible profits from these investments. Furthermore, their data

experts and management are adamant that the US real estate market will maintain its upward trend and high prices [3]. They continue to think that their company's financial model may assist them navigate market volatility even during a subprime lending crisis. The company's higher management ignores the potential that the market could collapse in extreme circumstances because they rely too much on so-called financial models. These financial models offer strategies for risk hedging that are not appropriate for the current severe situation. Furthermore, the information offered by financial models is based on historical data and could not be relevant under dire circumstances. The management of the company chose to rely on the information provided by the financial models when they need to have taken action to reduce higher investment risks. Lehman Brothers borrowed a lot of money for investments at the same time, hoping to make big profits, because they employed unduly high financial leverage in their financial products. But as the subprime loan default rate spiked and the real estate market crashed, Lehman Brothers' assets started to quickly lose value. This resulted in a major reduction in its cash, and eventually it was unable to continue operating. Finally, the fourth-biggest investment bank in the world, they had enormous losses during the financial crisis. Lehman Brothers filed for bankruptcy on September 15, 2008, making it one of the biggest bankruptcy cases in American history [4].

3. Analysis on the Problem

Even while Lehman Brothers' overconfidence ultimately contributed to its demise, the company's growth process shows that this overconfidence had some significant positive effects on their operations. The first thing to keep in mind is that Lehman Brothers' rapid growth and rise in market share were made possible by an overabundance of confidence, which propelled the company into high-risk and high-reward business ventures. The management gave the business a decisive edge in these high-risk sectors by acknowledging its own management and risk-controlling skills. Under some conditions, overconfident traders may not only survive in the market, but they may also succeed to the point where they surpass "rational" traders [5-7]. Overconfident traders can have a major impact on trading volume, market depth, wealth distribution, and other consequences at the market level. The notable rise in market share, particularly in the subprime loan sector, enabled them to capitalize on the opportunity, and the business subsequently rose to become one of the top investment banks globally, with a notable improvement in profitability. Second, Lehman Brothers was audacious enough to engage substantially in leveraged buyouts and mortgages due to their overconfidence. They generated significant short-term returns by increasing risk management and continuously innovating their financial models. Lehman Brothers' financial reports prior to the crisis demonstrated the company's persistent strong returns from financial derivatives, including subprime mortgage securitization. Enrique had mentioned that when dealing with an agent who exhibits overconfidence, the principal will exert greater effort due to the combined impacts of the wager and the motivational effects of overconfidence. So, the stock prices surged as a result, and investor trust in Lehman Brothers grew dramatically. It's important to note that Lehman Brothers' overconfidence helped them become known to investors as a corporation offering high yields and profits, which attracted a lot of capital investment and investor attention. Lehman Brothers was able to develop into new business models and build a solid financial basis thanks to the infusion of these funds and the attention of investors. Simultaneously, the company's strong performance at the time increased its global brand reach, solidifying its position as an industry leader in the financial sector. Conversely, the corporation has started to foster an internal innovation culture with adequate finance as a starting point. In an effort to find new markets, a number of new financial products were created later on, such as mortgage-backed securities (MBS) and collateralized debt obligations (CDO). As a result, the company's business diversification and income streams increased as it was able to satisfy the various needs of various consumers in the market at the time [8-10]. The final point is that at the time, Lehman

Brothers' economic might and influence made it a top choice for employment in the banking sector. This high-yield, high-return environment attracted many of the industry's best financial expertise. They can contribute significantly to the company's quick development and profitability by offering fresh perspectives on the market and innovative ideas. High bonuses and fast advancement prospects incentivize workers to put in greater effort at work.

On the other hand, even though overconfidence has advantages, the enormous dangers it carries could always hinder the growth of the business. It is obvious that the management's overconfidence in their investment choices was the primary cause of Lehman Brothers' bankruptcy. Their overconfidence was evident in their overly positive assessment of market prospects as well as in their overconfidence in the company's management ability. What is most notable, first and foremost, is Lehman Brothers' overconfidence in the real estate market. They were adamant that the US real estate market would keep growing. Their continued involvement in the subprime mortgage industry and their substantial holdings of financial derivatives were the results of their upbeat outlook. Nonetheless, it is evident that the company's management failed to identify the subprime loan market's vulnerabilities and disregarded possible market risks. The subprime market had raised the warning long before the financial catastrophe. The overconfidence exhibited by Lehman Brothers' management simply misled investors into thinking that the crisis wouldn't have an impact on the company's growth. It is apparent that investors have opted to trust the firm's management, continuing to spend their capital in the company because they believe in it and hope to reap great returns. Second, the company's excessive dependence and trust in complicated financial models contributes to its overconfidence. Extensive real-world validation of data models can sway people's cognitive views to the extremes and breed overconfidence in the models.

However, these models are unduly reliant on past data and specific normal market conditions, and therefore are unable to adequately reflect risks in severe scenarios. Excessive reliance in financial risk models has caused businesses to significantly underestimate the possibility of market downturns and consequent losses. When these models fail to accurately foresee market crashes, organizations struggle to cope once a crisis occurs. There are other subtle types of overconfidence that are harder to spot than these two blatant examples. Of them, the most common is the application of unduly high leverage. High leverage can increase investment returns, but only if the corporation can borrow a sizable sum of money to make the loan. Companies such as Lehman Brothers may experience a loss of liquidity following a market downturn involving high-leverage assets. You run the danger of losing everything if you lose, much like in a high-stakes game of chance. If you win, the benefits are substantial. One of the main factors that contributed to Lehman Brothers' bankruptcy was the company's employment of excessively confident, high-leverage operations, which can leave a business extremely vulnerable to changes in the market. Furthermore, by 2007, the subprime mortgage market was the subject of multiple warnings, and most financial institutions started to cut back on their holdings of high-risk assets. Lehman Brothers ultimately became insolvent because it disregarded these warning signs. Despite grave warnings from the market, the management continues to support the company's investment strategy and disregards risk assessments from both internal and external sources. Their steadfast conviction that they are already a market leader and are competent to manage market crises bigger than other financial institutions is another factor. Lehman Brothers overestimated investors' dedication to their money, which brings us to our conclusion. Stated differently, the corporation has consistently maintained the belief that it can always generate sufficient funds to handle market crises. Lehman Brothers is viewed by most investors as the most dependable alternative during an economic downturn because they have already secured a sizable market share. Lehman Brothers thought they still had a reciprocal trust game going with investors despite the crisis. However, when the crisis occurred, investors' purpose was to figure out how to make money, rather than simply trusting the company's management. As a result, the business thinks

they can borrow money or sell assets to raise enough money even in a crisis. In actuality, the company's liquid fund reserves are far insufficient to support them during the sharp swings in a market crisis. It is apparent that in the event of a severe downturn in the market, their assets will be exceedingly difficult to sell, and their liquid cash will soon exhaust, culminating in bankruptcy.

4. Suggestion

The demise of Lehman Brothers serves as evidence that an overabundance of confidence can have disastrous effects on financial markets and businesses. Numerous lessons can be learned from their failure to help businesses and financial institutions steer clear of similar hazards. To begin with, it should be noted that in order to prevent using unduly solitary risk assessment methods, businesses and financial institutions must create a diverse risk management framework. Simultaneously, it is imperative to guarantee that these models and frameworks undergo periodic updates in order to sustain their efficacy in diverse market contexts.

Furthermore, in case of dire circumstances, the business ought to have a specialized risk assessment organization to replicate any market hazards. The recommendations made by models and frameworks should not be taken at face value; instead, unique situations need to be examined carefully. This can improve the company's capacity to react to volatile market situations and help it avoid having blind faith in its risk control capabilities. Second, businesses and financial institutions require specialist review panels to evaluate important company choices and have the courage to challenge the bold choices made by management. This can stop the management from making decisions that could upset the company's decision-making process because they are overconfident. Management staff in large commercial enterprises are especially vulnerable to the development of certain biases, including overconfidence. They might decide poorly as a result. A mature business needs a structure that is willing to challenge and disagree in order to guarantee the thoroughness and logic of the management's choices. In order to avoid blind optimism, larger organizations should foster a cautious corporate culture as opposed to overconfident management and a high-risk, high-reward corporate culture. Encouragement of employees to retain a sensible and cautious attitude, remain vigilant in the face of large returns, and impartially evaluate each transaction is crucial during employee training. Rewarding employees appropriately is possible even when they voice legitimate concerns about risks. By using these steps, you can avoid the overconfidence that comes with hopeless thinking and promote a positive atmosphere for risk assessment. Of course, the unnecessarily high leverage and high-risk bets made by Lehman Brothers must be brought up. Businesses should examine the percentage of high-risk investments on a regular basis and set realistic limits on leverage. Although a corporation using high leverage can reap significant rewards, it must take precautions to prevent systemic collapse due to losses resulting from high leverage failures. For the organization, managing the leverage ratio is essential because it helps shield it from significant damage that could result from reckless actions brought on by overconfidence. The market had already warned about Lehman Brothers' overconfidence a year prior, but they disregarded the indications. This suggests that rather than being unduly secure in their internal assessments, the company's management should carefully monitor external market signals and third-party viewpoints. The business may occasionally engage outside companies to evaluate its risk management plans and make modifications in response to their input. Particularly for management, which frequently finds it difficult to retain reasonable judgment at all times, fixed thought patterns within the organization cannot help maintaining objectivity in all scenarios. Third-party companies' suggestions and opinions can assist the corporation in overcoming overconfidence and reconsidering internal decision-making concerns. The last thing to say about these financial institutions and enterprises is that they should preferably create a thorough emergency plan and practice emergency drills frequently to mimic a market crash, liquidity constraints, and other severe problems. Such drills can test a company's capacity to respond to major events, just as many

schools do earthquake and fire drills to make sure they can prevent widespread losses in real scenarios. It's critical to make sure the business can move quickly to limit losses in the event of a catastrophe. The business is now much better equipped to handle unforeseen risks, which can help reduce losses brought on by overconfidence.

5. Conclusion

In the field of behavioural economics, overconfidence has major drawbacks in addition to possible benefits. Positively, excessive confidence can spur creativity, support audacious decision-making, and help people and organizations achieve lofty objectives. It encourages risk-taking and optimism, two traits that are frequently required for innovations, business endeavors, and market leadership. Numerous psychological and economics research show that people typically overestimate their abilities, performance, and attractive personality attributes, which leads to an excessive amount of confidence. People that are overconfident can exude confidence in others, which can bring in talent, investors, and clients because of their apparent clarity and vision. Overconfidence can have significant negative effects as well as short-term positives.

Overconfidence can result in bad decisions because people and organizations tend to overestimate their skills, underestimate risks, and overlook warning indicators. It frequently leads to taking on too much risk, making poor financial decisions, and not being well-prepared for unfavorable events, as the failure of Lehman Brothers demonstrates. Moreover, overconfidence can lead to costly mistakes and systemic failures by reducing critical thinking, blind spots, and the promotion of a corporate culture that rejects opposing viewpoints. Knowing how to strike a fine balance between confidence and overconfidence is essential to behavioral economics. Although confidence is essential for advancement, excessive confidence left unchecked can have disastrous results. In order to reap the rewards while reducing the dangers, people and organizations must practice strong risk management, foster a culture of caution and critical assessment, and resist the temptation to overestimate their own skills. Overconfidence biases can be identified and addressed in order to help us better negotiate the complexities of economic decision-making and provide more sustainable results.

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