Overconfidence plagues both “bracketologists” and investors

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March 23, 2018

This is a great time of the year. Warren Buffett’s always insightful annual letter to shareholders of Berkshire Hathaway is published in late February, followed by the glorious basketball extravaganza that is the NCAA’s™ March Madness™.

Berkshire and Quicken Loans pulled off a brilliant publicity coup in 2014 by announcing a contest, open to the public and limited to 15 million entries, offering a $1 billion prize for a perfect bracket. Berkshire is big in insurance (GEICO and General Reinsurance), so Buffett is expert on probabilities/odds and insuring mega-losses.

Never accept a wager offered by Buffett and don’t sell when he’s buying (or vice-versa).

Buffett wouldn’t share his calculation, but a Stanford professor ran a simulation indicating with 15 million brackets, there was a 1-in-4.5 billion chance of selecting a perfect bracket. By comparison, the odds of winning the Powerball lottery are “only” 1-in 292.2 million.

Predictably, there was tremendous media hoopla, but no winner. Buffett pocketed the insurance premium and Quicken got the publicity and financial information of 15 million prospects.

Like many “elite” college basketball programs, the public contest was a “one-and-done” phenomenon. However, since Buffett is a huge basketball fan, the contest is now run as the world’s richest office pool, open to all 375,000 Berkshire employees.

To win the grand prize of $1 million/year ***for the rest of your life***, all you have to do is pick the winner of every first- and second-round game (48 games—a 1-in-2 million chance, according to FiveThirtyEight). If nobody picks the first-round correctly, the employee with the most wins collects $100,000. This year, 40,240 employees correctly picked Rhode Island to upset Oklahoma, with the last 8 eliminated (and splitting the $100,000) when #13 seed Marshall defeated #4 seed Wichita State.

According to *The New York Times (NYT)*, researchers in behavioral finance have found securities markets useful for analyzing “judgement under uncertainty” and “decision under risk,” applicable to understanding how cognitive biases impact investors and basketball fans.

Hindsight bias refers to our ability to misremember past decisions in ways that make us look smarter. ***Attribution bias*** means when things turn out well, we attribute the outcome to our skills. When they turn out poorly, we blame outside forces beyond our control. ***Confirmation bias*** is our tendency to give too much weight to information that supports our existing beliefs and discounting the rest.

Our most insidious bias is ***overconfidence.*** According to the *NYT*, Nobel Prize winner Daniel Kahneman said, “the confidence we experience as we make a judgement is not a reasoned evaluation of the probability it is right. Confidence is a feeling, one determined mostly by the coherence of the story and by the ease with which it comes to mind, even when the evidence for the story is sparse and unreliable.”

In the academic paper, “Boys Will Be Boys: Gender, Overconfidence and Common Stock Investment,” University of California professors Brad M. Barber and Terrance Odean stated that in difficult, complex tasks like finance, men are more overconfident than women. Indeed, they found men act on their unfounded overconfidence by excessively trading (significantly more than women), to their financial detriment.

As Mark Twain said, “It ain’t what you don’t know that gets you in trouble. It’s what you know for sure that just ain’t so.”

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