How Does Overconfidence Affect Individual Decision Making

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2003-2004

Introduction

A large number of firms entering the industry are not able to maintain their competitiveness even in the short run and fail. There are also many business project failures which seem to be a result of managerial incompetence. However, managerial overconfidence may be one of the major reasons for these failures instead. In their paper "Overconfidence and Excess Entry: An Experimental Approach" Colin Camerer and Dan Lovallo focus on overconfidence as reason for business failure.

Our experiment has been initially prompted by, and is in a sense, a follow-up of Camerer and Lovallo's work. We conduct an experiment addressing the same phenomena studied in their work. However, in designing our experiment, besides for the significance of overconfidence in shaping human behavior, we have also attempted to test for the significance of several other factors which may potentially affect individuals' overconfidence. These factors are:

- gender
- previous relevant experience / background
- time, i.e. the evolution of the overconfidence trend *with* time and *over* time spans of different lengths

We believe that overconfidence is higher *before* the relative skills are measured than *after*. Namely, that the individuals adjust their expectations downwards even before the actual results of their performances are known. In our view, overconfidence may also be higher for males than for females. We are also concerned with the significance of the length of the time span over which one's beliefs about her overconfidence are formed as well. Our initial expectations are that the further in time one's ability is tested, the more confident she is about her relative performance.

Conclusion

The main finding of the paper is that people's overconfidence is higher *before* the relative skills are measured rather than *after*. Indeed, after their skills are measured, the subjects converge from overconfidence close to their real rank. However, we also found that the further in time one's ability is tested, the more confident she is about her relative performance which suggests that excess entry may be due to wrong estimation of one's relative skills. Contrary to our expectations, the results of the experiment also imply that overconfidence does not differ with gender, but there is a significant correlation between level of overconfidence and the person's previous relevant background record. The last result may, however, be characteristic to the specific sample of students choosing to come to CERGE-EI to attend the Preparatory semester – those female students who attend have already attained a certain level of education which is higher than the average, and this may have an impact on their confidence in their own abilities relative to the rest of the sample. In our second experiment we proved the results from our initial round and demonstrated that overconfidence could be a persistent phenomenon in people's behavior despite the eventual readjustment of expectations