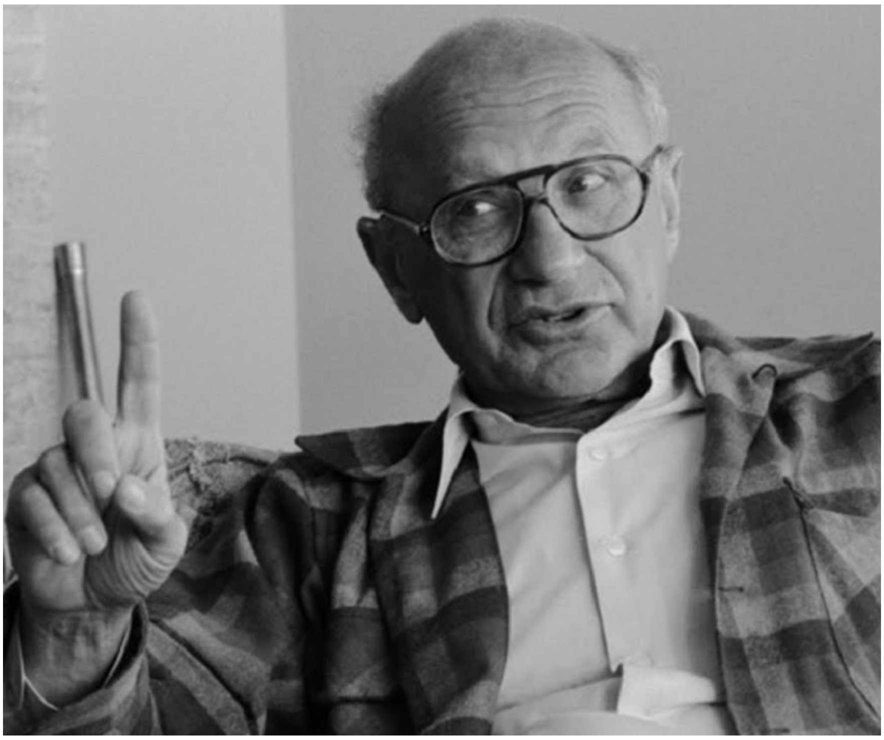
So you think you're an economic hotshot?

Think you're better at predicting successful investment outcomes than your peers? You might indeed be a whizz, or you might have fallen prey to the Dunning-Kruger effect.



The renowned economist and Nobel Prize Winner, Milton Friedman

Source: Wikipedia

Will gold go up, when will the dollar fall? If you're an investor, you could well be making decisions you think will make you richer. But what are you basing your actions on? Are you a highly experienced trader? Do you have the insight of such economic luminaries as Milton Friedman (pictured) or Paul Krugman? Or, do you feel you've just got that extra bit of knowledge and skill that sets you apart from your peers? While the idea that we naturally tend to favour our own personal abilities won't be news to many, that feeling could just be an illusion.

Ample confidence

Research has shown that people of lower abilities, indicated by scoring in the bottom quartile on tests of humour, grammar and logic, are more likely to feel they're highly competent at a task. This is called the Dunning-Kruger effect after the two psychologists who carried out the studies.

The effect happens, say these doctors of psychology, because without a higher level of skill or knowledge, people can't accurately assess their own level of ignorance or even realise they don't have all the skills they think they do. As David Dunning puts it himself in the Pacific Standard: '*In many cases, incompetence does not leave people disoriented, perplexed, or cautious….Instead, the incompetent are often blessed with an inappropriate confidence, buoyed by something that feels to them like knowledge*." And he goes on to suggest that this is particularly true of people managing their finances.

Is ignorance bliss?

Much work has been done on this, not least the 2012 US National Financial Capability study which asked around 25,000 people to rate their own financial knowledge. Interestingly 800 of these respondents had filed for bankruptcy and their actual financial literacy was tested. They didn't do well on the latter, coming in the 37th percentile, on average. But despite this, they rated their overall financial knowledge more positively than others. As Dunning says in his article for the Pacific Standard: "*An ignorant mind is precisely not a spotless, empty vessel, but one that's filled with the clutter of irrelevant or misleading life experiences, theories, facts, intuitions, strategies, algorithms, heuristics, metaphors, and hunches that regrettably have the look and feel of useful and accurate knowledge.*"

Similarly, 2015's National Financial Capability study asked people how good they were at day-to-day financial matters, 42% gave themselves a perfect score – yet 29% of these respondents engaged in costly credit card behaviours, such as paying late fees, and 12% had a current account that was overdrawn.

This was also seen in people who were provided with 15 financial terms, while some of which were completely made up. Dunning and his colleagues discovered that those who believed they understood money matters also claimed to be aware of some of those fictitious phrases, such as 'pre-rated stocks', 'fixed-rate deduction' and 'annualised credit'. In fact, some 93% of participants claimed they knew at least one of those fake concepts. It doesn't mean they're liars, says Dunning, suggesting such 'over-claiming' is an honestly held belief.

Expert touch

Of course, actually being an expert doesn't automatically translate into great returns. In addition to the Dunning-Kruger effect, similar tendencies are seen in areas of finance that haven't been predominantly only found in those of lower social or intellectual skill. An interesting study shows how gut feelings can prove to be more useful than expertise despite our expectations or assumptions. In this study, both stock market professionals and laypeople were asked to provide thirty-day forecasts for twenty stocks. All predicted that laypeople would be correct in their predictions half as many times as experts.

The results were interesting though. Possibly unsurprisingly laypeople provided correct predictions 50% of the time or were, by chance, right half the time and wrong the other half. Experts however were only right 40% of the time. As the German psychologist, Gerd Gigerenzer, explains in his book, experts based their predictions on complex information and faced heavy competition amongst themselves causing them to select stock picks that varied widely. Not everyone could be right so, by chance, more of them were wrong. Laypeople relied more on gut instinct which paid off in this case.

Making sense

These tendencies or expectations aren't failures. In many cases, they can explain why sometimes unexpected or non-rational actions can make a lot of sense. It's logical to back ourselves or to expect more from experts. But the Dunning-Kruger effect also has some pretty blunt truths for many, the upshot being that knowing a little could be worse than knowing nothing at all.