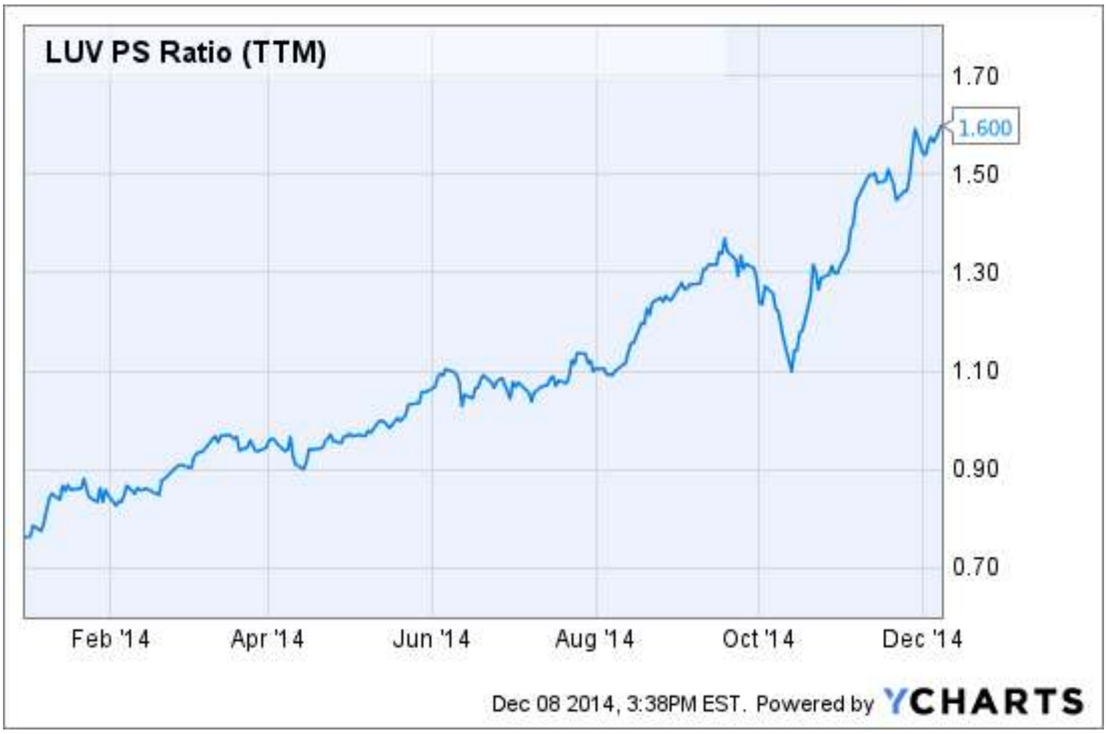
How To Guard Against Overconfidence In Investing

A quick turn of the dials on the YCharts Stock Screener produces a list of the S&P 500 stocks ranked by year-to-date return, and if you bought one or more of the stocks at the top of the list – among them Southwest Airlines (LUV), Electronic Arts (EA) or Edwards Lifesciences (EW) -- congratulations.

Congratulations -- and perhaps it's also a good time to recheck your original analysis. Southwest at $19 early this year is a lot different than at $42 lately. So, some investment research seems in order. The price-to-sales ratio on Southwest has roughly doubled this year. If you bought it at 0.8, would you buy it again at 1.6? Perhaps you would. But merely congratulating yourself on a wise choice – and then sticking with it – could invite some losses.

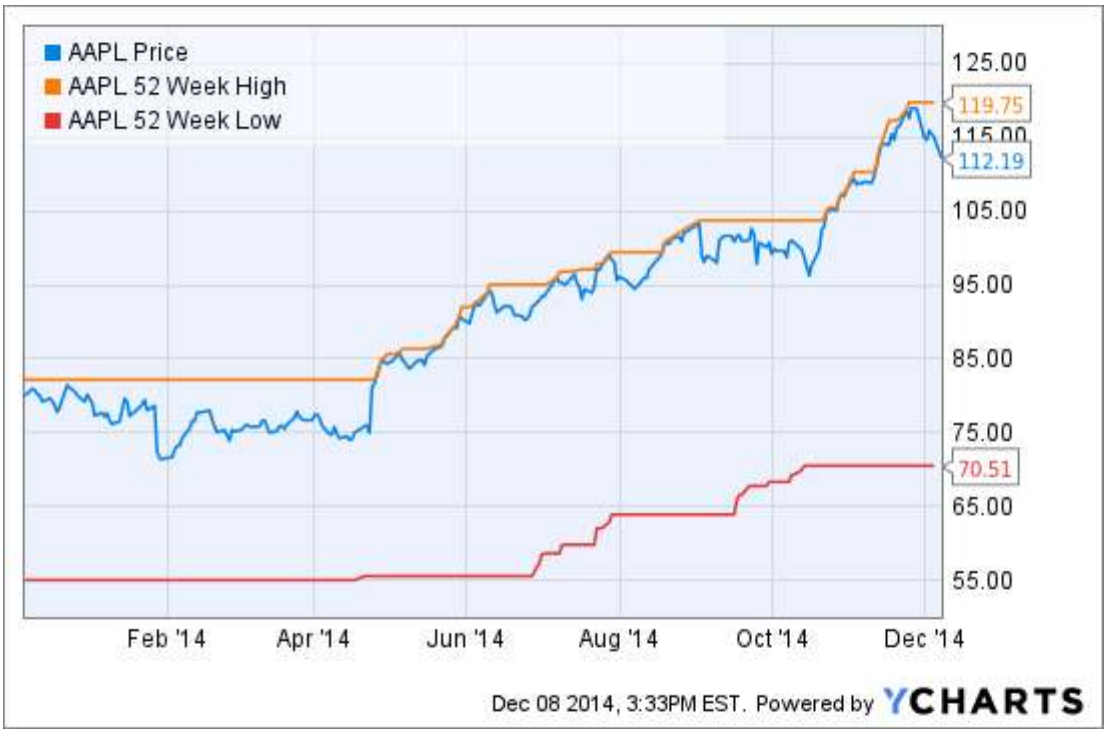


LUV PS Ratio (TTM) data by YCharts

Studies have shown success in investing can contribute to overconfidence, at times leading investors to stick with a winner even when it becomes too expensive. (We're not rendering a conclusion on Southwest here, merely using it as an example for explanation.) Overconfidence, of course, is everywhere. One particular study from 2006 found that nearly 75% of 300 professional money managers said they delivered above-average performance. And much of the rest copped to merely delivering average results. Statistically impossible!

We're all hardwired to be overconfident. That's a cognitive bias that is at play in any market and applies to both bulls and bears. You can be just as overly confident when you know a big correction is coming as you are that the current bull market is destined to keep on its merry way. The challenge is to build in systems that help you periodically reassess based on the fundamentals.

Overconfidence is just one of the behavioral investment biases covered in a YCharts White Paper on the subject. Clicking on the link in this paragraph allows you to download a free copy.



At YCharts there are virtually hundreds of different charts you can create to give your investments an "overconfidence" check. For example, if you spied value in Apple (AAPL) a year ago when the haters were running amok, you are now sitting on a nice gain just when the hedge funds have reportedly reignited their love affair with Apple, which has gained nearly 50% in 12 months, before a recent selloff. Could Apple keep at it? Of course. But nothing breeds confidence like outperformance. And yet as this chart shows, the recent rally has once again created a wide gap between the current price and the 52-week low.

That's not to suggest Apple is ripe for a fall. But like many stocks today hitting new all-time highs, the time has never been better to make sure your assumptions aren't being clouded by your all-too-human proclivity to be overconfident.