
Staying on guard against overconfidence

Weekly Market Compass: It's important to stay prepared for whatever the market may bring

Aug 24, 2020 | Kristina Hooper, Chief Global Market Strategist

It's August in New England for the Hooper family, which means hot summer days, barbecues, and lots of time in the water. Every year at this time, my thoughts turn to the iconic movie "Jaws," which, as regular readers of this blog may remember, is another summer tradition for me. The book came out when I was still a toddler, and the movie soon after, so I must confess that I have never felt comfortable swimming in an ocean in my entire life. In fact, I recall reading the book as a child in the car as we drove from New York to Florida for a beach vacation – and declaring after a particularly frightening chapter that I was ready to turn around and go home.

I have even gone so far as to watch the documentary on the making of the movie, which was surprisingly interesting. The most shocking thing I learned from the documentary is that the movie's producers – who had a track record of making successful films – initially wanted to use a real great white shark to give this movie authenticity.¹ But great white sharks cannot be trained – and no amount of film-making confidence or business acumen could overcome this simple fact. So instead of holding a casting call for great white sharks, the film's director instead ordered the construction of a fake shark, and the rest is history.

Sharp-eyed readers may remember that I first told this story last August, in order to illustrate a behavioral finance concept called "overconfidence bias." Put simply, this is the tendency by people to overestimate their ability to control a situation, leading them to make decisions that are far riskier than they estimate. In the summer of 2019, I saw overconfidence bias at work in the Trump administration's efforts to control the terms of global trade, even though global free trade is a delicate, almost fragile interrelationship between many different economies. Today, I revisit this story because I'm concerned that the strong stock performance we've seen since March, especially the new high made by the S&P 500 Index last week, may lead investors to draw some unwarranted conclusions about the future direction of the market – and to make potentially risky decisions about their portfolios in response.

On one hand, we can't become overconfident and assume that the threat of a correction is over – that the market has overcome the impacts of the coronavirus and is destined to remain strong. On the other hand, we also shouldn't be overconfident and assume that a correction is imminent – that the market is destined for a fall simply because it's recently been strong. Ditto for gold prices; some see the massive rally as a sign the momentum will continue, while others assume gold will sell off soon because of the steep run-up. In short, investors shouldn't be overconfident in whatever scenario they expect.

I believe the best antidote for overconfidence bias is to have a long-term investing plan – one that includes being very well-diversified. That means broad diversification across a variety of asset classes as well as broad diversification within those asset classes. By keeping your eye on your long-term goal – and staying prepared for both positive and negative market movements along the way – you may be less tempted to take the bait and change strategies when you believe the current might change direction.

There is a lot coming up this week, even though it is the dead of August.

- In the US, all eyes will be on the Republican National Convention (RNC) and the Kansas City Fed's Annual Symposium in Jackson Hole. In terms of the RNC, this is the convention of the incumbent party, and so I don't expect any dramatic policies to be unveiled at the convention - although I never say never. I will be watching the Jackson Hole Symposium especially closely, given the prominent central bankers in attendance, the critical topics being discussed, and the potential for them to lay the groundwork for important monetary policy decisions. In particular, Federal Reserve (Fed) Chair Jay Powell will be discussing the monetary policy framework review that the Fed has undertaken. I believe Powell may go so far as to announce a new inflation targeting policy, or at least hint at it. We could also hear central bankers from around the world discuss how they would respond monetarily to trade policy, which I believe is worth addressing given the current state of trade tensions.
- We will also soon get some important sentiment indicators, including consumer confidence and business climate in the eurozone, as well as US consumer confidence from the University of Michigan. With the virus continuing to spike in places around the world, business and consumer confidence may be an important determinant of where the economy goes this fall.

Source

¹Source: mentalfloss.com, "How Malfunctioning Sharks Transformed the Movie Business," June 20, 2015

Important information

Diversification does not guarantee a profit or eliminate the risk of loss.

The S&P 500® Index is an unmanaged index considered representative of the US stock market. The opinions referenced above are those of Kristina Hooper as of **Aug. 24, 2020**. These comments should not be construed as recommendations, but as an illustration of broader themes. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions; there can be no assurance that actual results will not differ materially from expectations.