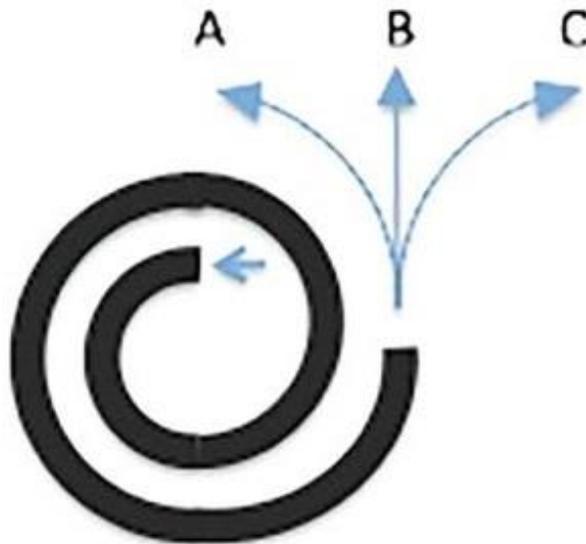


How Confident Are You in Your Financial Future?

Before we get to the financial points of this article, we'd like to start with a little pop quiz on physics. Don't worry, we won't ask you to derive Newton's Third Law of Motion or anything difficult like that. We just want you to take a look at the picture below and answer two simple questions.



The black line in that picture represents a curved tube lying horizontally flat on a table top, and we want you to imagine that we're going to roll a little steel ball through that tube. The entry point will be the blue arrow pointing to the left, and then the ball will curl around through the tube until it reaches the end. Got it? OK, now for our first question:

(1) Along which path will the ball travel after exiting the tube: A, B, or C?

Before we go on, we should pause here to say that we really do want you to answer this question. Just take a quick second to think it through, and decide which path makes the most sense.

Have you settled on an answer? Yes? Ready to move on? OK, then here is your second question:

(2) How sure are you of your answer to the first question?

Are you 100% certain that your first answer is the right answer? Or, maybe, you'd give yourself only 50/50 odds of being right? Maybe 25/75? Or, heaven help you, perhaps you are 100% certain that your answer is wrong?

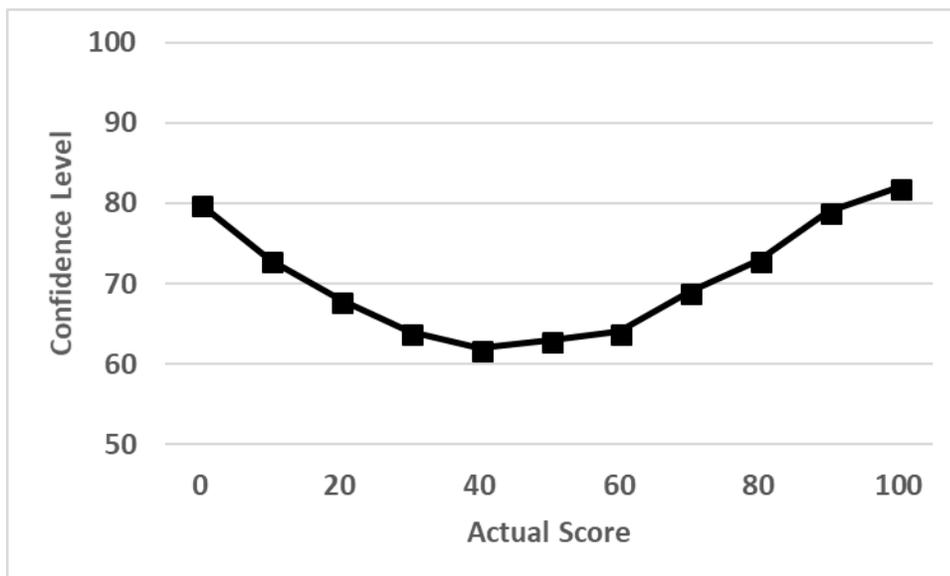
When famed psychologists David Dunning and Justin Kruger, with their colleague Elanor Williams, gave a test comprised of similar questions to hundreds of subjects in the lab, here is



what they found. Some people always selected the correct responses and then stated that they were 100% confident about it: they knew it, and they knew that they knew it.

Others always selected an incorrect response but also stated that they were very unsure of their answers: they didn't know it, but at least they knew that they didn't know it.

The troubling part of [the study](#) was the fact that a great many people selected an incorrect response but then said they were highly confident, sometimes 100% confident, that they were right. In fact, the overall level of confidence exhibited by people who answered every question correctly was indistinguishable from the level of confidence of those who got every question wrong. Or, if you prefer to see that visually, here is what it looks like:



source: Journal of Personality and Social Psychology

This type of curve has become so well-known that it is now referred to as the Dunning-Kruger Curve, after its primary discoverers. Simply put, it states that people with little reason to believe in their abilities have just as much confidence as those who have every reason to believe in their abilities.

From Physics to Finance

“OK,” you might be saying right about now. “It’s mildly interesting that people over-estimate their knowledge of the laws of physics. But what application does this possibly have for me and my financial well-being?”

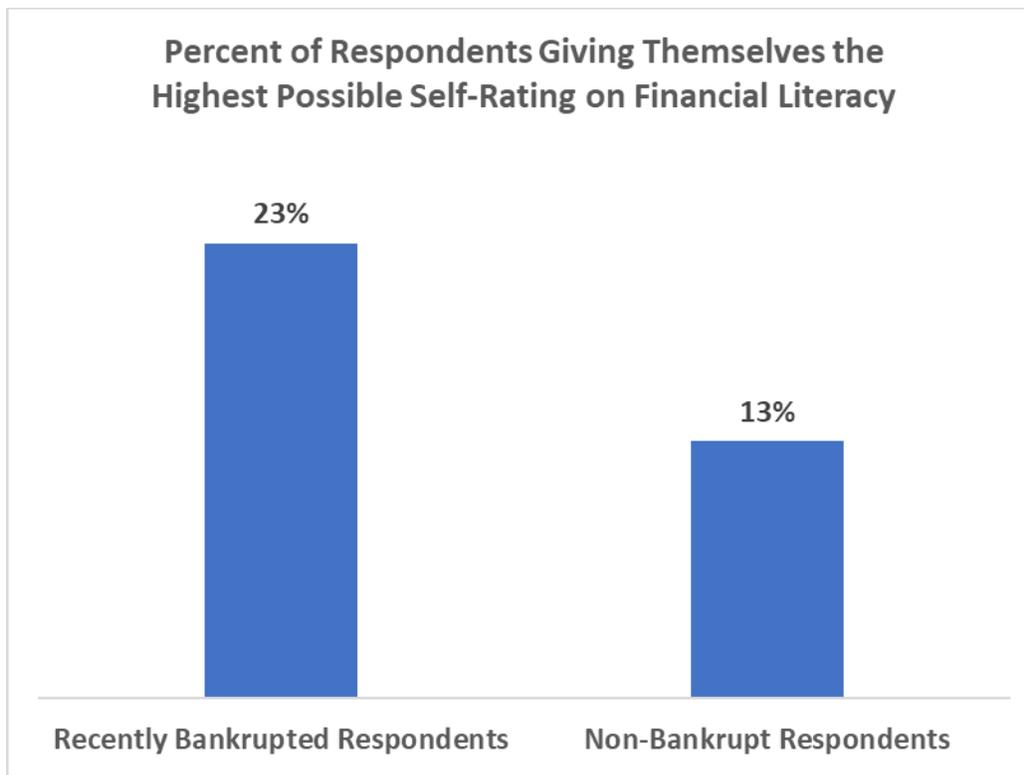
We’re glad you asked. In 2012, [the Financial Industry Regulatory Authority \(FINRA\) and the U.S. Treasury asked 25,000 American adults](#) to (1) rate their own level of financial sophistication, and (2) demonstrate that sophistication.



We're sure that, by now, you can probably guess the results of that survey. Of the 25,000 respondents to the survey, 800 of them had recently declared personal bankruptcy. Fittingly, those recently bankrupted people did quite poorly on the second part of the test in which they were asked to demonstrate their financial literacy by correctly responding to basic questions about interest rates, inflation, and mortgages. Overall, the bankrupt respondents scored in the 37th percentile of the quiz. (By the way, you can [take the quiz yourself](#) if you're curious to see how you would do.)

That seems to make sense, doesn't it? The people who have experienced a personal bankruptcy scored low on a basic quiz of financial literacy. So far, so good.

The surprising part is the result of the first question, which asked each person to rate their own level of financial sophistication. Rather than spell it out for you, we'll let a simple graph do the talking for us:



source: FINRA Investor Education Foundation

Yikes.

Over-Confidence Can Bite Even the Best of Us

“OK,” you might be saying right about now. “It’s mildly interesting that recently bankrupted people over-estimate their knowledge of the laws of finance. But I’m good with money, and I actually am a pretty smart person. What application does this possibly have for me?”



We're glad you asked. There is a psychiatrist who spent decades of his professional life studying gullibility. Why do people fall prey to con artists? Why do people believe the outrageous things they hear on cable news shows? Why do people continue to buy those ridiculous home exercise products promising to give them a set of washboard abs in two months or less?

In 2008 Dr. Stephen Greenspan reached the culmination of this work: a 224-page volume that he published which was entitled "[Annals of Gullibility: Why We Get Duped and How To Avoid It.](#)"

Dr. Greenspan only had about 48 hours to bask in the glow of his significant accomplishment before his heart sank. Two days after his book's publication, he found out the news that his personal financial advisor was being investigated for certain improprieties. As you may have by now guessed, the name of that advisor was none other than Bernie Madoff. Dr. Greenspan, the expert on gullibility, had his portfolio wiped out by the most notorious financial con man of the 21st century.

So no matter how smart you think you are, or how sophisticated you think you may be, tread carefully. There are plenty of pitfalls out there on the road to financial freedom, and you'll have the best chance at arriving safely at your destination if you can avoid them.

The Bottom Line

By the way, the correct answer to our initial physics puzzle is B: the ball would continue rolling in the same direction it was traveling at the precise moment it exited the tube. Most people tend to think the correct answer is A, but that is wrong. If you were one of those answering (or guessing) A, don't worry. At least you'd be in good company. Hundreds of years ago, when the human race was not as sophisticated as it is now in terms of theoretical physics, even great minds such as Leonardo da Vinci thought A was the way the ball would roll.

The ultimate lesson here is not for you to understand the physical laws of motion, but rather to understand the limitations of your own level of confidence, even in subject matters in which you may consider yourself an expert.

So if you did, in fact, guess A for the first question, and if you were 100% convinced that was correct, then let that be a warning to you. Perhaps there are economic or financial laws that you are also misunderstanding, and you wouldn't want to jeopardize your own livelihood by proceeding in a misguided direction. Find a trusted advisor, preferably one with a fiduciary responsibility to serve your interests ahead of his or her own, and chart a course together.



Felipe Garcia, CFA
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