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## How does Optimism impact on Entrepreneurs' Overconfidence?

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### Abstract

Optimism and overconfidence are well documented cognitive biases in the entrepreneurship literature (see Shepherd et al., 2015). Although these sentiments are typically thought to be almost overlapped, empirical studies make evidence of their different construct (see Trevelyan, 2008, 2011). In the paper at hand we investigate the descriptive and normative motivations inducing misconfidence biases to arise. First, we introduce the definition of optimism as underestimation of the task difficulty to meet a strategic Key Performance Indicator (KPI). Second, we define overconfidence as the tendency to overestimate the probability to achieve an uncertain task. To calculate this probability we set up a prescriptive benchmarking-based model. Third, we spotlight situations in enterprise risk management (ERM) where misconfidence biases in judgment emerge. Complementing Bordley et al. (2015) and Tibiletti and Uberti (2015) results, we show that overconfidence arises in presence of two extreme circumstances: (1) underestimation of task difficulty coupled with extremely poor entrepreneurial projects, and (2) overestimation of task difficulty coupled with extremely good entrepreneurial projects. Our theoretical findings match with accounted biased behaviors recognized among entrepreneurs known as the escalation and de-escalation of commitment effect biases. The study is based on the normative foundation for overconfidence set up by Bordley et al. (2015) and casts light on which circumstances that occurs. Our results have also practical implications. In fact, it is important for entrepreneurs be aware of situations where self-confidence is normatively biased.

**Keywords:** Optimism and Overconfidence, Benchmarking Procedure, Escalation and De-escalation of Commitment, Regulatory Focus Theory, Strategic Key Performance Indicators.

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### 1. INTRODUCTION<sup>1</sup>

Research in entrepreneurship recognizes that entrepreneurs are individuals generally prone to fail in optimism and overconfidence biases (see [1] for an ample review on entrepreneurial heuristics and biases, and specifically [2]; [3]; [4]; [5]). The optimism bias refers to entrepreneurs' tendency to underestimate the difficulty of the goal to meet; whereas overconfidence bias refers to the tendency to overestimate the probability of success of the entrepreneurial project at hand. These cognitive biases are typically thought to be positively interdependent and even overlapped. However supported by empirical studies based on online surveys [6] claims that optimism and

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overconfidence are distinct constructs with no relevant positive association. Extending and complementing this line of inquiry, we delve deeper their differences and explore why entrepreneur rationally engage biased judgements.

First, we give a formal definition of optimism according to the perceived difficulty to achieve the goal. The more the goal is easy-perceived, the higher the agent optimism level; and vice versa for hard-perceived goals. Based on the results of [7] we illustrate the link between the easy/hard goal perception and the agent gain-seeking/loss-aversion attitude.

Second, we suggest a probabilistic definition of self-confidence miscalibration based on the gap in evaluation between the entrepreneur and a well-calibrate external expert. To calculate the subjective probability to achieve the goals we use a benchmarking model under risk (see [7]; [8]; [9]).

Third, we present the main contribution of the paper. We identify situations in enterprise risk management (ERM) where misconfidence biases in judgments emerge. In the stream of research held by [7] and [10], we prove that overconfidence arise in connection with: (1) easy task agent's perception coupled with expected extremely poor entrepreneurial performances, and (2) hard task agent's perception coupled with expected extremely good entrepreneurial performances.

In conclusion, we build a theoretical framework that: (1) sets a different definition for optimism and overconfidence biases; (2) provides foundation for overconfidence conform with the prescriptive Expected Utility theory (see [11] and the descriptive Prospect Theory (see [12]; (3) spotlights circumstances where self-confidence judgement is normatively biased. Our results have also practical implications. In fact, to make mindful evaluations entrepreneurs must be conscious when they are predisposed to fall in misconfidence traps.

The remainder of the paper is organized as follows. In Section 2, we introduce the definitions of optimism and overconfidence. In Section 3 we set up a target-based theoretical model to calculate the probability to achieve the goal. Sufficient conditions for misconfidence in judgement are set out in Section 4. Section 5 sets up future research and concludes the paper.

## **2. OPTIMISM AND OVERCONFIDENCE BIASES IN THE LANGUAGE OF PROBABILITY**

Shepherd et al. [1] provide an extensive review of the several heuristics and biases documented in the entrepreneurial decision-making process. Among others, overconfidence and optimism are recognized key drivers in contributing on either the firm development and success or the firm failure. Optimists are defined as people who tend “to hold positive expectancies for their future” (see [13]) and look at the goals through “rose-tinted glasses” (see the seminal studies of [14] and [15]). Vice versa, overconfident entrepreneurs are defined as individuals who overestimate the probability of successfully meeting their commitments (see [16]). Despite a common believe, [17] has made evidence that no association exists between optimism and overconfidence. To evaluate uncertain projects the entrepreneur has to fix a goal to achieve. However, in real world the commitments are often vague and uncertain. In other words, goals are random variables. It follows that the agent is asked to deliver her personal views in the language of probability.

To explain this point, let start with a couple of examples. A manager has to evaluate a project with an uncertain cash flow. The standard guide-lines in the corporate finance literature suggest to check the financial capital sustainability on the basis of strategic *Key Performance Indicators* (KPIs) (see [18]) as:

1. Return on Equity (*ROE*);
2. Return on Debt (*ROD*);
3. Return on Investment (*ROI*).

Under the assumption of perfect capital market, the *Modigliani-Miller formula* (see [19]) relates the profitability indicator *ROE* of a project with the financial leverage ratios as follows:

$$ROE = [ROI + SPREAD \cdot DER] \cdot (1 - tax)$$

Where

$$SPREAD = ROI - ROD,$$

$$DER = Debt \text{ Equity Ratio} = \frac{Debt}{Equity}$$

*tax* = average tax

Specifically, *Modigliani-Miller's formula* pinpoints the key role played by the quantity  $SPREAD = ROI - ROD$ . It does not only sign the profitability direction of *ROE*, but also emphasizes its value due to its multiplicative effect. A basic condition for financial sustainability of the project is given by:

$$ROI > ROD.$$

If the cash flows of the project are uncertain, *ROI* and *ROD* are uncertain as well. Therefore, above condition needs to be translated in the language of probability. So, instead to check whether above inequality holds, we are asked to calculate:

*the probability that the (uncertain) ROI of the project be higher than the (uncertain) ROD,*

and only if that value is sufficiently high the project will be taken under consideration. A further condition to keep under consideration before undertaking any entrepreneur project is that

$$ROE > OCM$$

where *OCM* is the opportunity cost of holding money, intended as the return of investing in a risk free security - like a treasury bill.

In Section 3 we show an operational way to make the probability calculation. Need to define optimism first.

### 2.1 Optimism: Look at Commitments Through “rose-tinted” Glasses

Intuitively speaking an agent is optimist whether she tends to have a “pinked view” on the commitments. The problem of how an agent calibrates the subjective perception of the task difficulty has been investigated in the last twenty years in the experimental psychology literature see [15], [20] among others. The subjective judgments depend on: (1) the individual cardinal utility capturing risk preferences and (2) the personal “reference point” (see [12]). Then two practical questions arise:

Q1.: *How to elicit the individual cardinal utility/value function?*

Q2.: *How to set the appropriate “reference point”?*

Let start to tackle *Q1*. Let *u* a bounded, increasing (but not constant) and continuous cardinal utility function. As seminaly discussed by [21] in the context of ruin probabilities, without loss of generality, *u* can be normalized so that  $\inf u(x) = 0$  and  $\sup u(x) = 1$ . Then *u* satisfies all the properties characterizing a cumulative distribution function (c.d.f.). As [22, p. 825] states “there are advantages to having the utility function represented by a distribution”, because we can grasp intuitive interpretations. In fact, if *F* denote the c.d.f. of the uncertain target *T*, then

$$u(x) = P(X \geq T) = F(x) \tag{1}$$

See [22, p. 825]. Equation (1) states a fundamental equivalence: the c.d.f.  $F$  of the target  $T$  just coincides with the normalized utility function  $u$ . To put it differently, Equation (1) tells us that we can think of the agent cardinal utility  $u(x)$  as the probability that the uncertain target  $T$  is not greater than  $x$ . We conclude that all information about the agent optimism can be just extrapolated from the perceived shape of the c.d.f. of the target  $T$ .

We are now ready to face Q2. In the last twenty years, this question is became a central one in the experimental and theoretical economics, see [23].

We have to distinguish between the *objective* and *subjective* reference point:

- *The objective reference point: the median*

In experimental research the most common “reference point” is the *median* of the distribution of possible outcomes; see [24]. Let remind the definition. Given a random target  $T$ , the value  $m$  such that

$$P(X < m) < 0.5 \text{ and } P(X \geq m) \geq 0.5$$

is called a *median* of  $T$ . The median thus defined always exists, and is unique. Alternative definitions are possible, but they yield the same value when the distribution of  $T$  is continuous and unimodal. Hereafter we consider only targets with unimodal distributions.

- *The subjective reference point: the mode*

Let assume the target  $T$  a unimodal<sup>2</sup> random variable with mode  $M$ . As a consequence, the correspondent c.d.f.  $F(x)$  defined on the support  $(a,b)$ , turns out to be an S-shaped c.d.f., that is convex for  $x \in (a,M)$  and concave for  $x \in (M,b)$ . The concavity switching point is in correspondence of the mode  $M$ . To find out the agent perceived reference point we use formula (1). According to Prospect Theory (see [12]), the subjective reference point corresponds to the subjectively perceived “knock-out” value that divides the domain of the perceived losses from that of the perceived gains. By (1) the agent utility  $u$  coincides with the c.d.f.  $F$ , so  $u$  is S-shaped with the concavity switching point in correspondence of  $M$ , as well. In conclusion, the *agent reference point* is just *the mode M*.

As discussed in [7] the definition of hard-perceived and easy-perceived task is given on basis of the gap between the target most likely value delivered by the agent, i.e. the mode  $M$ ; and that delivered by an external expert, i.e. the median  $m$ .

Intuitively, if the value  $M$  expressed by the agent is lower than that  $m$ , then the agent feels the *target easier* than the external expert does; in such a case the agent is called an *optimistic* individual. Vice versa if  $M$  is higher than  $m$ , the agent is called a *pessimistic* individual. If  $M$  and  $m$  coincide then the agent is called a *well-balanced in judgement* individual (see Figure 1).



**FIGURE 1:** Hard-perceived target, symmetric-perceived target and easy-perceived target.

<sup>2</sup> If  $T$  is not strictly unimodal, let  $M$  be the midpoint of the modal set.

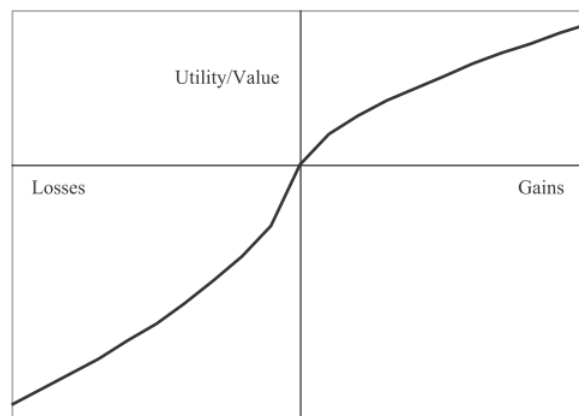
A simple condition for testing the presence of optimism or pessimism is offered by the so-called van Zwet mean-median-mode inequalities; see [25]. Let a unimodal continuous target  $T$  with mean  $\mu$ , median  $m$  and mode  $M$ . Then:

- a) if the agent is pessimist, then  $\mu \leq m \leq M$ ;
- b) if the agent is optimist, then  $M \leq m \leq \mu$ ;
- c) if the agent is well-balanced in judgement, then  $T$  is symmetric and  $\mu = m = M$ .

The alphabetical/counter-alphabetical order among mean, median and mode offers a user-friendly test for optimism/pessimism measuring<sup>3</sup> (see Figure 1).

The intuition behind follows. Optimistic agents perceive the goal as an easy task, and set the *subjective* reference point, i.e. the mode  $M$ , smaller than the *objective* one, i.e. the median  $m$ ; and vice versa pessimistic agents perceive the goal as a hard task and set the subjective reference point, i.e. the mode  $M$ , higher than the objective one, i.e. the median  $m$ . If the agents have symmetric-perceived opinions, the subjective and objective reference point coincides.

Due to the equivalence (1) between the target c.d.f. and the agent utility function, [7, Theorem 2.] state the equivalence between the easy/hard target perception and loss aversion/gain seeking attitude. On the loss domain the utility function is convex that shows the agent gain seeking attitude, whereas on the gain domain the utility function is concave that exhibits the agent risk aversion (see Figure 2).



**FIGURE 2:** A S-shaped utility/value function.

Above is also related with the regulatory focus theory (see [24] and [27]). If individuals have a *promotion focus*, they exhibit risk-seeking attitude and are endowed with a convex utility function. Alternatively, if they have a *prevention focus*, they display risk-aversion and are endowed with a concave utility function.

### **3. OVERCONFIDENCE: MISCALIBRATION OF THE SUCCESS PROBABILITY**

Since the seminal studies of [14] and [28, page 5] confidence miscalibration has been documented and studied in social sciences. [29] distinguish three different facets of confidence miscalibration: (a) the misconfidence, i.e. a fallacious confidence in own performance; (b) the overplacement or 'better-than-average' effect, i.e. the misconfidence in own performance relative to others; and (3) the overprecision, i.e. the tendency to have excessive trust in forecasting

<sup>3</sup> Note that van Zwet inequalities are only necessary conditions for optimism and pessimism, see [26] for counterexamples and [7] for technical details.

future uncertainty. In the following, we focus on (1) the self-misconfidence. We say that an agent gives a “misaligned judgement” when her personal evaluation of the probability of success is misaligned respect to that expressed by the external expert. A crucial point turns out:

*How to measure the probability of meeting the target?*

To achieve this objective, we draw upon the benchmarking procedure.

The benchmarking procedure originally proposed by [8] indicates an operational way to calculate the probability that an (uncertain) project  $X$  overcomes the (uncertain) target  $T$ . This prescriptive target-based model satisfies [11]’s and [30]’s axiomatization through a probabilistic and intuitive interpretation of the expected utility of a lottery  $X$ . [31] prove that the expected utility of a lottery  $X$  can be read as the probability that  $X$  outperforms a stochastically *independent* target  $T$  with c.d.f.  $u$ , i.e.

$$P(X \geq T) = Eu(X) \quad (2)$$

where  $E(.)$  is the expectation operator. This interpretation shows the key advantage in using the benchmark-procedure: the subjective beliefs about the probability of successfully meeting the target coincide with the expected utility of  $X$ . In conclusion all we need to calculate (2): (a) the perceived c.d.f. of the uncertain target index  $T$  (corresponding to  $ROD$  in the example in Sec. 2); and (b) the c.d.f. of the uncertain financial index  $X$  of the project (corresponding to  $ROI$  in the example in Sec. 2).

#### 4. WHEN DOES MISCONFIDENCE OCCUR?

Using [7, Theorem 3.] sufficient conditions for misconfidence biases can be stated. For explanatory purposes, we word them in the frame of the example described in Sec. 2.

Let  $ROD$  an uncertain target with median  $m$ . Suppose that an external expert declares equal to  $m$  the most likely value for  $ROD$ . Let  $ROI$  is the financial index chosen to measure the financial attractiveness of the uncertain project at hand. Let  $ROI$  is independent of  $ROD$ . Then if the agent perceives that:

- a) *the most likely value for  $ROD$  is smaller than  $m$  (i.e. she faces an easy-perceived target) and the support of  $ROI$  belongs to  $(-\infty, m]$ , i.e. the expectancies on the financial project outcomes are very bad, or*
- b) *the most likely value for  $ROD$  is greater than  $m$  (i.e. she faces a hard-perceived target) and the support of  $ROI$  belongs to  $[m, +\infty)$ , i.e. the expectancies on the financial project outcomes are very good,*

*then the agent exhibits **overconfidence** on the probability that  $ROI > ROD$ . And vice versa, if the agent perceives that:*

- c)  *$ROD$  is greater than  $m$  (i.e. she faces a hard-perceived target) and the support of  $ROI$  belongs to  $(-\infty, m]$ , i.e. the expectancies on the financial project outcomes are very bad, or*
- d)  *$ROD$  is smaller than  $m$  (i.e. she faces an easy-perceived target) and the support of  $ROI$  belongs to  $[m, +\infty)$ , i.e. the expectancies on the financial project outcomes are very good,*

*then the agent exhibits **underconfidence** on the probability that  $ROI > ROD$ .*

Clearly, above results on misconfidence in succeeding targets can be extended to other statements involving different strategic KPIs, as for example, that the probability that ROE be superior to the opportunity cost of holding money.

Immediate evidences turn out. The optimism attitude and the overconfidence bias are distinct constructs. That is consistent with [6] and [17] empirical studies, where the association sign between these two biases is not clear. The very gears in moving towards over/under confidence are: (1) the expected performances of the uncertain project measured by ROI as in the example in Sec. 2; (2) the attitude of believing in having to face an easy/hard task. In experimental psychology, conditions a) to d) are related to cognitive biases as follows:

a) Overconfidence in handling with very-poor projects is commonly associated with the “*escalation of commitment effect*” (see the seminal studies of [33]). That is also referred to the “*sunk cost fallacy*” that is the misleading behavior that guides managers to invest resources into failing businesses. This bias is also set in relation with the “*hot-hand fallacy*” (also known as the “*hot hand phenomenon*” or “*hot hand*”). That is the false belief that an entrepreneur who has once experienced success has a greater chance of further success in the future, although the project at hand displays realistic poor expectancies. These circumstances correspond to *case a*).

b) Dealing with hard-perceived tasks coupled with very good expectancies on the outcomes (see *case b*) may drive ambitious managers to be overconfident. That is commonly explained as an effect of the “*desirability bias*” that influences the evaluation of desired event occurrence (see e.g. [34]).

c) When pessimism in evaluating the target difficulty is associated to poor expectancies on the project outcomes, a loss adverse entrepreneur tends to be underconfident in successfully meeting the target (see *case c*). That tendency may be explained by the influence of “*pessimism bias*” that induces the “*status quo effect*”. That is related also with the loss and gain asymmetry in judgment according to the statement that “*losses loom much than gains*” see [12, page 279]. Another possible motivation can be blamed to the “*de-escalation effect*” that typically occurs when the task is perceived extremely difficult (see [34]).

d) Underconfidence detected in *case d*) can be explained by the “*de-escalation effect*”, as documented by [35]. An easy-perceived task may reduce the “goal attainment” and consequently cause disaffection in achieving the goal.

## 5. CONCLUSION AND FURTHER RESEARCH

This paper is a part of the growing literature on the impact of behavioral biases on entrepreneurial decision-making process (see [1]). Specifically, we focus on the optimism and overconfidence biases. We contribute to the literature in various ways.

First, we introduce a formal definition for optimism, as the tendency to underestimate the difficulty of the task to achieve, and then we define overconfidence, as the tendency to overestimate the probability of meeting the commitments. Second, we identify a practical method to calculate the subjective probability to achieve a given task. Third, we identify circumstances where inconsistencies in self-confidence arise.

Our results have also practical implications. In fact, being conscious of being normatively influenced by cognitive biases is essential to take mindful decisions. However, on the path of [17] further empirical studies direct to measure the matching between theoretical findings and real-life evidences are needed and are left to future agenda.

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