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Banks, battles, and the psychology of overconfidence.

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As we grow older and more experienced, we overrate the accuracy of our judgments.

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In 1996, an investor named Henry de Kwiatkowski sued Bear Stearns for negligence and breach of fiduciary duty. De Kwiatkowski had made—and then lost—hundreds of millions of dollars by betting on the direction of the dollar, and he blamed his bankers for his reversals. The district court ruled in de Kwiatkowski’s favor, ultimately awarding him $164.5 million in damages. But

Bear Stearns appealed—successfully—and in William D. Cohan's engrossing account of the fall of Bear Stearns, "House of Cards," the firm's former chairman and C.E.O. Jimmy Cayne tells the story of what happened on the day of the hearing:

Their lead lawyer turned out to be about a 300-pound fag from Long Island . . . a really irritating guy who had cross-examined me and tried to kick the shit out of me in the lower court trial. Now when we walk into the courtroom for the appeal, they're arguing another case and we have to wait until they're finished. And I stopped this guy. I had to take a piss. I went into the bathroom to take a piss and came back and sat down. Then I see my blood enemy stand up and he's going to the bathroom. So I wait till he passes and then I follow him in and it's just he and I in the bathroom. And I said to him, "Today you're going to get your ass kicked, big." He ran out of the room. He thought I might have wanted to start it right there and then.

At the time Cayne said this, Bear Stearns had spectacularly collapsed. The eighty-five-year-old investment bank, with its shiny new billion-dollar headquarters and its storied history, was swallowed whole by J. P. Morgan Chase. Cayne himself had lost close to a billion dollars. His reputation—forty years in the making—was in ruins, especially when it came out that, during Bear's final, critical months, he'd spent an inordinate amount of time on the golf course.

Did Cayne think long and hard about how he wanted to make his case to Cohan? He must have. Cayne understood selling; he started out as a photocopier salesman, working the nine-hundred-mile stretch between Boise and Salt Lake City, and ended up among the highest-paid executives in banking. He was known as one of the savviest men on the Street, a master tactician, a brilliant gamesman. "Jimmy had it all," Bill Bamber, a former Bear senior managing director, writes in "Bear Trap: The Fall of Bear Stearns and the Panic of 2008" (a book co-written by Andrew Spencer). "The ability to read an opponent. The ability to objectively analyze his own strengths and weaknesses. . . . He knew how to exploit others' weaknesses—and their strengths, for that matter—as a way to further his own gain. He knew when to take his losses and live to fight another day."

Cohan asked Cayne about the last days of Bear Stearns, in the spring of 2008. Wall Street had become so spooked by rumors about the firm's financial status that investors withdrew their capital, and no one would lend Bear the money required for its day-to-day operations. The bank received some government money, via J. P. Morgan. But Timothy Geithner, then the head of the New York Federal Reserve Bank, didn't open the Fed's so-called "discount window" to investment banks until J. P. Morgan's acquisition of Bear was under way. What did Cayne think of Geithner? Picture the scene. The journalist in one chair, Cayne in another. Between them, a tape recorder. And the savviest man on Wall Street sets out to salvage his good name:

The audacity of that prick in front of the American people announcing he was deciding whether or not a firm of this stature and this whatever was good enough to get a loan. Like he was the determining factor, and it's like a flea on his back, floating down underneath the Golden Gate

Bridge, getting a hard-on, saying, “Raise the bridge.” This guy thinks he’s got a big dick. He’s got nothing, except maybe a boyfriend.

Since the beginning of the financial crisis, there have been two principal explanations for why so many banks made such disastrous decisions. The first is structural. Regulators did not regulate. Institutions failed to function as they should. Rules and guidelines were either inadequate or ignored. The second explanation is that Wall Street was incompetent, that the traders and investors didn’t know enough, that they made extravagant bets without understanding the consequences. But the first wave of postmortems on the crash suggests a third possibility: that the roots of Wall Street’s crisis were not structural or cognitive so much as they were psychological.

In “Military Misfortunes,” the historians Eliot Cohen and John Gooch offer, as a textbook example of this kind of failure, the British-led invasion of Gallipoli, in 1915. Gallipoli is a peninsula in southern Turkey, jutting out into the Aegean. The British hoped that by landing an army there they could make an end run around the stalemate on the Western Front, and give themselves a clear shot at the soft underbelly of Germany. It was a brilliant and daring strategy. “In my judgment, it would have produced a far greater effect upon the whole conduct of the war than anything [else],” the British Prime Minister H. H. Asquith later concluded. But the invasion ended in disaster, and Cohen and Gooch find the roots of that disaster in the curious complacency displayed by the British.

The invasion required a large-scale amphibious landing, something the British had little experience with. It then required combat against a foe dug into ravines and rocky outcroppings and hills and thickly vegetated landscapes that Cohen and Gooch call “one of the finest natural fortresses in the world.” Yet the British never bothered to draw up a formal plan of operations. The British military leadership had originally estimated that the Allies would need a hundred and fifty thousand troops to take Gallipoli. Only seventy thousand were sent. The British troops should have had artillery—more than three hundred guns. They took a hundred and eighteen, and, for the most part, neglected to bring howitzers, trench mortars, or grenades. Command of the landing at Sulva Bay—the most critical element of the attack—was given to Frederick Stopford, a retired officer whose experience was largely administrative. Stopford had two days during which he had a ten-to-one advantage over the Turks and could easily have seized the highlands overlooking the bay. Instead, his troops lingered on the beach, while Stopford lounged offshore, aboard a command ship. Winston Churchill later described the scene as “the placid, prudent, elderly English gentleman with his 20,000 men spread around the beaches, the front lines sitting on the tops of shallow trenches, smoking and cooking, with here and there an occasional rifle shot, others bathing by hundreds in the bright blue bay where, disturbed hardly by a single shell, floated the great ships of war.” When word of Stopford’s ineptitude reached the British commander, Sir Ian Hamilton, he rushed to Sulva Bay to intercede—although “rushed” may not be quite the right word here, since Hamilton had chosen to set up his command post on an island an hour away and it took him a good while to find a boat to take him to the scene.

Cohen and Gooch ascribe the disaster at Gallipoli to a failure to adapt—a failure to take into account how reality did not conform to their expectations. And behind that failure to adapt was a deeply psychological problem: the British simply couldn’t wrap their heads around the fact that they might *have* to adapt. “Let me bring my lads face to face with Turks in the open field,” Hamilton wrote in his diary before the attack. “We must beat them every time because British volunteer soldiers are superior individuals to Anatolians, Syrians or Arabs and are animated with a superior ideal and an equal joy in battle.”

Hamilton was not a fool. Cohen and Gooch call him an experienced and “brilliant commander who was also a firstrate trainer of men and a good organizer.” Nor was he entirely wrong in his assessments. The British probably were a superior fighting force. Certainly they were more numerous, especially when they held that ten-to-one advantage at Sulva Bay. Hamilton, it seems clear, was simply overconfident—and one of the things that happen to us when we become overconfident is that we start to blur the line between the kinds of things that we can control and the kinds of things that we can’t. The psychologist Ellen Langer once had subjects engage in a betting game against either a self-assured, well-dressed opponent or a shy and badly dressed opponent (in Langer’s delightful phrasing, the “dapper” or the “schnook” condition), and she found that her subjects bet far more aggressively when they played against the schnook. They looked at their awkward opponent and thought, I’m better than he is. Yet the game was pure chance: all the players did was draw cards at random from a deck, and see who had the high hand. This is called the “illusion of control”: confidence spills over from areas where it may be warranted (“*I’m savvier than that schnook”)* to areas where it isn’t warranted at all (“*and that means I’m going to draw higher cards”*).

At Gallipoli, the British acted as if their avowed superiority over the Turks gave them superiority over all aspects of the contest. They neglected to take into account the fact that the morning sun would be directly in the eyes of the troops as they stormed ashore. They didn’t bring enough water. They didn’t factor in the harsh terrain. “The attack was based on two assumptions,” Cohen and Gooch write, “both of which turned out to be unwise: that the only really difficult part of the operation would be getting ashore, after which the Turks could easily be pushed off the peninsula; and that the main obstacles to a happy landing would be provided by the enemy.”

Most people are inclined to use moral terms to describe overconfidence—terms like “arrogance” or “hubris.” But psychologists tend to regard overconfidence as a state as much as a trait. The British at Gallipoli were victims of a situation that promoted overconfidence. Langer didn’t say that it was only arrogant gamblers who upped their bets in the presence of the schnook. She argues that this is what competition does to all of us; because ability makes a difference in competitions of skill, we make the mistake of thinking that it must also make a difference in competitions of pure chance. Other studies have reached similar conclusions. As novices, we don’t trust our judgment. Then we have some success, and begin to feel a little surer of ourselves. Finally, we get to the top of our game and succumb to the trap of thinking that there’s nothing we can’t master. As we get older and more experienced, we overestimate the accuracy of our judgments, especially when the task before us is difficult and when we’re involved with something of great personal importance. The British were overconfident at Gallipoli not because Gallipoli didn’t matter but, paradoxically, because it did; it was a high-stakes contest, of daunting complexity, and it is often in those circumstances that overconfidence takes root.

Several years ago, a team headed by the psychologist Mark Fenton-O’Creevy created a computer program that mimicked the ups and downs of an index like the Dow, and recruited, as subjects, members of a highly paid profession. As the line moved across the screen, Fenton-O'Creevy asked his subjects to press a series of buttons, which, they were told, might or might not affect the course of the line. At the end of the session, they were asked to rate their effectiveness in moving the line upward. The buttons had no effect at all on the line. But many of the players were convinced that their manipulation of the buttons made the index go up and up. The world these people inhabited was competitive and stressful and complex. They had been given every reason to be confident in their own judgments. If they sat down next to you, with a tape recorder, it wouldn't take much for them to believe that they had you in the palm of their hand. They were traders at an investment bank.

The high-water mark for Bear Stearns was 2003. The dollar was falling. A wave of scandals had just swept through the financial industry. The stock market was in a swoon. But Bear Stearns was an exception. In the first quarter of that year, its earnings jumped fifty-five per cent. Its return on equity was the highest on Wall Street. The firm's mortgage business was booming. Since Bear Stearns's founding, in 1923, it had always been a kind of also-ran to its more blue-chip counterparts, like Goldman Sachs and Morgan Stanley. But that year *Fortune* named it the best financial company to work for. "We are hitting on all 99 cylinders,'' Jimmy Cayne told a reporter for the *Times*, in the spring of that year, "so you have to ask yourself, What can we do better? And I just can't decide what that might be.'' He went on, "Everyone says that when the markets turn around, we will suffer. But let me tell you, we are going to surprise some people this time around. Bear Stearns is a great place to be.''

With the benefit of hindsight, Cayne's words read like the purest hubris. But in 2003 they would have seemed banal. These are the kinds of things that bankers say. More precisely—and here is where psychological failure becomes more problematic still—these are the kinds of things that bankers are *expected* to say. Investment banks are able to borrow billions of dollars and make huge trades because, at the end of the day, their counterparties believe they are capable of making good on their promises. Wall Street is a confidence game, in the strictest sense of that phrase.

This is what social scientists mean when they say that human overconfidence can be an adaptive trait. "In conflicts involving mutual assessment, an exaggerated assessment of the probability of winning increases the probability of winning," Richard Wrangham, a biological anthropologist at Harvard, writes. "Selection therefore favors this form of overconfidence." Winners know how to bluff. And who bluffs the best? The person who, instead of pretending to be stronger than he is, actually believes himself to be stronger than he is. According to Wrangham, self-deception reduces the chances of "behavioral leakage"; that is, of "inadvertently revealing the truth through an inappropriate behavior." This much is in keeping with what some psychologists have been telling us for years—that it can be useful to be especially optimistic about how attractive our spouse is, or how marketable our new idea is. In the words of the social psychologist Roy Baumeister, humans have an "optimal margin of illusion."

If you were a Wall Street C.E.O., there were two potential lessons to be drawn from the collapse of Bear Stearns. The first was that Jimmy Cayne was overconfident. The second was that Jimmy Cayne wasn't overconfident enough. Bear Stearns did not collapse, after all, simply because it had made bad bets. Until very close to the end, the firm had a capital cushion of more than seventeen billion dollars. The problem was that when, in early 2008, Cayne and his colleagues stood up and said that Bear was a great place to be, the rest of Wall Street no longer believed them. Clients withdrew their money, and lenders withheld funding. As the run on Bear Stearns worsened, J. P. Morgan and the Fed threw the bank a lifeline—a multibillion-dollar line of credit. But confidence matters so much on Wall Street that the lifeline had the opposite of its intended effect. As Bamber writes:

This line-of-credit, the stop-gap measure that was supposed to solve the problem that hadn't really existed in the first place had done nothing but worsen it. When we started the week, we had no liquidity issues. But because people had said that we did have problems with our capital, it became true, even though it wasn't true when people started saying it. . . . So we were forced to find capital to offset the losses we'd sustained because somebody decided we didn't have capital when we really did. So when we finally got more capital to replace the capital we'd lost, people took that as a bad sign and pointed to the fact that we'd had no capital and had to get a loan to cover it, even when we did have the capital they said we didn't have.

Of course, one reason that over-confidence is so difficult to eradicate from expert fields like finance is that, at least some of the time, it's useful to be overconfident—or, more precisely, sometimes the only way to get out of the problems caused by overconfidence is to be even more overconfident.

From an individual perspective, it is hard to distinguish between the times when excessive optimism is good and the times when it isn't. All that we can say unequivocally is that overconfidence is, as Wrangham puts it, "globally maladaptive." When one opponent bluffs, he can score an easy victory. But when everyone bluffs, Wrangham writes, rivals end up "escalating conflicts that only one can win and suffering higher costs than they should if assessment were accurate." The British didn't just think the Turks would lose in Gallipoli; they thought that Belgium would prove to be an obstacle to Germany's advance, and that the Russians would crush the Germans in the east. The French, for their part, planned to be at the Rhine within six weeks of the start of the war, while the Germans predicted that by that point they would be on the outskirts of Paris. Every side in the First World War was bluffing, with the resolve and skill that only the deluded are capable of, and the results, of course, were catastrophic.

Jimmy Cayne grew up in Chicago, the son of a patent lawyer. He wanted to be a bookie, but he realized that it wasn't quite respectable enough. He went to Purdue University to study mechanical engineering—and became hooked on bridge. His grades suffered, and he never graduated. He got married in 1956 and was divorced within four years. "At this time, he was one of the best bridge players in Chicago," his ex-brother-in-law told Cohan. "In fact, that's the reason for the divorce. There was no other woman or anything like that. The co-respondent in their divorce was bridge. He spent all of his time playing bridge—every night. He wasn't home." He was selling scrap metal in those days, and, Cohan says, he would fall asleep on the job, exhausted from playing cards. In 1964, he moved to New York to become a professional bridge player. It was bridge that led him to his second wife, and to a job interview with Alan (Ace)

Greenberg, then a senior executive at Bear Stearns. When Cayne told Greenberg that he was a bridge player, Cayne tells Cohan, "you could see the electric light bulb." Cayne goes on:

[Greenberg] says, "How well do you play?" I said, "I play well." He said, "Like how well?" I said, "I play quite well." He says, "You don't understand." I said, "Yeah, I do. I understand. Mr. Greenberg, if you study bridge the rest of your life, if you play with the best partners and you achieve your potential, you will never play bridge like I play bridge."

Right then and there, Cayne says, Greenberg offered him a job.

Twenty years later, the scene was repeated with Warren Spector, who went on to become a co-president of the firm. Spector had been a bridge champion as a student, and Cayne somehow heard about it. "Suddenly, out of nowhere there's a bridge player at Bear Stearns on the bond desk," Cayne recalls. Spector tells Cohan, "He called me up and said, 'Are you a bridge player?' I said, 'I used to be.' So bridge was something that he, Ace, and I all shared and talked about." As reports circulated that two of Bear Stearns's hedge funds were going under—a failure that started the bank on its long, downward spiral into collapse—Spector and Cayne were attending the Spingold K.O. bridge tournament, in Nashville. The *Wall Street Journal* reported that, of the twenty-one workdays that month, Cayne was out of the office for nearly half of them.

It makes sense that there should be an affinity between bridge and the business of Wall Street. Bridge is a contest between teams, each of which competes over a "contract"—how many tricks they think they can win in a given hand. Winning requires knowledge of the cards, an accurate sense of probabilities, steely nerves, and the ability to assess an opponent's psychology. Bridge is Wall Street in miniature, and the reason the light bulb went on when Greenberg looked at Cayne, and Cayne looked at Spector, is surely that they assumed that bridge skills could be transferred to the trading floor—that being good at the game version of Wall Street was a reasonable proxy for being good at the real-life version of Wall Street.

It isn't, however. In bridge, there is such a thing as expertise unencumbered by bias. That's because, as the psychologist Gideon Keren points out, bridge involves "related items with continuous feedback." It has rules and boundaries and situations that repeat themselves and clear patterns that develop—and when a player makes a mistake of overconfidence he or she learns of the consequences of that mistake almost immediately. In other words, it's a game. But running an investment bank is not, in this sense, a game: it is not a closed world with a limited set of possibilities. It is an open world where one day a calamity can happen that no one had dreamed could happen, and where you can make a mistake of overconfidence and not personally feel the consequences for years and years—if at all. Perhaps this is part of why we play games: there is something intoxicating about pure expertise, and the real mastery we can attain around a card table or behind the wheel of a racecar emboldens us when we move into the more complex realms. "*I'm good at that. I must be good at this, too,*" we tell ourselves, forgetting that in wars and on Wall Street there is no such thing as absolute expertise, that every step taken toward mastery brings with it an increased risk of mastery's curse. Cayne must have come back from the Spingold bridge tournament fortified in his belief in his own infallibility. And the striking thing about his conversations with Cohan is that nothing that had happened since seemed to have shaken that belief.

“When I left,” Cayne told Cohan, speaking of his final day at Bear Stearns, “I had three different meetings. The first was with the president’s advisory group, which was about eighty people. There wasn’t a dry eye. Standing ovation. I was crying.” Until the very end, he evidently saw the world that he wanted to see. “The second meeting was with the retail sales force on the Web,” he goes on. “Standing ovation. And the third was a partners’ meeting that night for me to tell them that I was stepping down. Standing ovation, of the whole auditorium.” ♦

ILLUSTRATION: BRUCE ERIC KAPLAN