Measuring overconfidence in inventory management decisions

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A B S T R A C T
Overconfidence has emerged as a significant explanation of behaviour in diverse managerial settings. In this paper, we explore the relevance of overconfidence for supply chain management by running a series of human experiments within the framework of the classic Beer Game. Unlike previous experimental studies, participants were knowledgeable about supply chain management, either being graduate students in Operations Management or purchasing professionals. Results of the study support the view that overconfidence may lead supply chain professionals to be less careful in the management of inventories and thus incur more costs. A first implication for organizations is that purchasing professionals should be trained to discount their expectations of success by removing this optimistic bias. A second is the importance of providing managers and employees with benchmarks that allow them to assess correctly their performance in relative terms. The study also underlines the effect of environmental uncertainty as an important contextual factor influencing overconfident behaviour.

1. Introduction

Today’s purchasing professionals have to handle complex environments and turbulent markets and often are asked to take decisions under conditions of increasing uncertainty (Harland et al., 2003; Wagner and Neshat, 2010). Recent literature has shown that – under these conditions, individual cognition and personality attributes of the decision maker may become crucial in determining outcomes (Ancarani and Di Mauro, 2011; Bendoly et al., 2010, 2006; Gino and Pisano, 2008; Loch and Wu, 2008; Lu et al., 2015).

Findings gathered from diverse disciplines, such as economics, finance and management have emphasised the relevance of one particular individual bias, namely overconfidence, as a determinant of individual decisions in complex and uncertain environments (Camerer and Lovallo, 1999; Hayward et al., 2006; Li and Tang, 2010; Malmendier and Tate, 2005; Shipman and Mumford, 2011). Overconfident individuals tend to believe that their information or their estimates are more accurate than they actually are, or that they hold superior skills and abilities than average (Moore and Healy, 2008). Uncertainty may encourage overconfidence because decision makers misunderstand the hazards they face (Kahneman and Lovallo, 1993; Park and Santos-Pinto, 2010), or because it provides more room for discretion (Li and Tang, 2010).

Overconfidence has been shown to result in poor performance in different decision contexts. In particular, empirical evidence suggests that overconfidence negatively affects judgment and decision making of managers (Aspinwall et al., 2005; Åstebro et al., 2007; Shipman and Mumford, 2011), leading to over-trading behaviour in the stock market (Odean, 1998), use of more long-term, as opposed to short-term, debt (Ben-David et al., 2007), imprecision of forecast (Hribar and Yang, 2011), and excessive risk taking (Li and Tang, 2010; Simon and Houghton, 2003).

In supply management, overconfidence may bring about negative consequences for risk management, by leading to risk underestimation, to build a limited supply-base, or to forego the use of appropriate procedures in the selection, evaluation and monitoring of external sources. Overconfidence may lead purchasing managers to under-estimate the variance of demand or of lead times, thus inducing them to hold too little safety stock in inventory (Ren and Croson, 2013).

Notwithstanding the potential relevance of investigating overconfidence in supply management, there is a surprising paucity of empirical analysis. Further, we are not aware of any empirical study investigating the interplay between uncertainty and overconfidence in affecting supply chain performance.

In this paper, we address this literature gap by focusing on inventory decisions within a serial supply chain. Specifically, we address the following research questions:

1. Do buyers along a supply chain exhibit overconfidence?
2. Is overconfidence enhanced under conditions of greater environmental uncertainty?
3. What is the impact of overconfidence on inventory

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management?

In order to address the three research questions, we run a series of controlled human experiments using the framework of the “Beer Game” (Forrester, 1958), a business game that is a paradigmatic representation of a serial supply chain (Croson and Donohue, 2002; Nienhaus et al., 2006; Sterman, 1989). Controlled human experiments have recently been acknowledged as a useful methodology to study the impact of behavioural characteristics (including heuristics and biases such as overconfidence) in operations management (Boyer and Swink, 2008; Croson and Donohue, 2002; Knemeyer and Naylor, 2011).

Our experiments compare buyers’ behaviour and performance under two different supply chain scenarios: the first characterised by demand uncertainty, the second featuring both demand and supply uncertainty. Results suggest that – contrary to intuitive reasoning, when uncertainty increases buyers overrate their ability to control for uncertainty, thus holding insufficient inventory and incurring costs of stockouts. This makes it important for organizations to design appropriate monitoring systems and risk plans that apply in cases of higher turbulence and disruption risk, in order to counterbalance any potential optimistic bias of the decision maker. Our experiments also provide evidence that overconfident buyers exhibit a worse performance in terms of costs, size of backlogs, and variance of orders.

The rest of the paper is organised as follows: Sections 2 and 3 review the relevant literature and present the hypotheses tested. Section 4 describes the experimental design and the measures of overconfidence used in this paper, while Section 5 reports the results of the experiments. Section 6 discusses implications for research and for management. Section 7 concludes with limitations and an agenda for future research.

2. Facets of overconfidence

The concept of overconfidence is an umbrella under which three main psychological effects have been gathered, namely overprecision (or miscalibration), overplacement, and overestimation (Moore and Healy, 2008).

Overconfidence as overprecision refers to the systematic underestimation of the variance of a relevant measure affecting performance (demand, costs, etc.) (Soll and Clayman, 2004; Glaser and Weber, 2007). Conversely, the term overplacement, or better than average effect, applies when the decision maker considers himself to be better than others (Aliche and Govorun, 2005; Larrick et al., 2007; Moore and Healy, 2008). Overestimation holds when the decision maker expresses unreasonable optimism about her performance or chances of success (Griffin and Tversky, 1992), and ability to control (Presson and Benassi, 1996; Thompson et al., 1998).

Over-precise managers underrate the volatility of future cash flows (Shefrin, 2001), exhibit higher trading volumes (Odean, 1998), overweight private signals (Gervais and Goldstein, 2007), and choose a longer-term debt structure (Ben-David et al., 2007). These results entail that mis-calibrated managers estimate future unknowns with probability distributions that are too narrow, either because they overrate their ability to predict the future or because they underrate the volatility of random events (Ben-David et al., 2010). Overconfidence as overplacement of one’s capabilities has been investigated by Malmendier and Tate (2008), who find that overconfident CEOs engage more frequently in unsuccessful mergers and acquisitions. Hribar and Yang (2011) show that overconfident CEOs tend to issue earnings forecasts in the form of point estimates rather than in intervals. Glaser and Weber (2007) find that financial analysts who consider themselves better than average place more orders. Overestimation of one’s chances of success influences entry into competitive markets (Camerer and Lovallo, 1999). With reference to entrepreneurial venture performance, Lowe and Ziedonis (2006) find that, consistently with the overestimation bias, start-ups continue unsuccessful development efforts for longer periods than do established firms.

While overprecision has been the focus of many studies, including one in the supply and purchasing management discipline (Ren and Croson, 2013), there is a relative paucity of research addressing overestimation and overplacement in business studies, and no study in the area of supply and purchasing. Therefore, this study focuses on the overestimation and overplacement of buyers within a supply chain. In competitive environments, where decision makers need to assess their performance not only in absolute terms but also in relation to other competitors, these two dimensions are of particular interest.

There is no agreement among scientists on the factors that activate the three facets of overconfidence described above. The presence of overconfidence and its strength has been associated with psychological, social and contextual factors. Hayward et al. (2006) argue that antecedents of entrepreneurs’ overestimation of the wealth they can generate from their ventures can be found in overconfidence in their knowledge, in their ability to predict, and in their personal skills. Radzevick and Moore (2011) show that the drivers of overconfidence are not only psychological but also social, by showing that competitive pressures in a market exacerbate overprecision.

Among contextual factors, building on upper echelon theory (Hambrick, 2007; Hambrick and Mason, 1984), Li and Tang (2010) argue that managerial discretion is the channel through which overconfidence may be transmitted to organizational performance. In addition, there is evidence that an uncertain environment leads decision makers to believe they hold more information than they actually have (Kahneman and Lovallo, 1993; Lichtenstein and Fischhoff, 1977; March and Shapira, 1987; Park and Santos-Pinto, 2010), thus resulting in overconfidence. In the same vein, Hayward et al. (2006) suggest that overconfidence in own ability to predict is strongest in uncertain environments, while Kumar (2009) finds that investors make larger investment mistakes and systematically overestimate their investment ability when stocks are more difficult to evaluate.

3. Overconfidence in supply management decisions

3.1. Environmental uncertainty and overconfidence

Research has emphasised that more and more often purchasing professionals are called to manage unforeseen adverse events (Kleindorfer and Saad, 2005), or they have to take decisions in the face of complex environments and uncertainty (Harland et al., 2003; Wagner and Neshat, 2010). At the same time, there is evidence that often even large corporations disregard uncertainties, and therefore fail to devise appropriate plans against disruptions or accurately build their supply network. Hence, there are grounds for positing that increased uncertainty in governing supply may exacerbate the detrimental effects of managerial overconfidence.

In the supply management field, Carter et al. (2007) posit that overconfidence (interpreted as overestimation) will lead a buyer to place too much confidence in the process of supplier evaluation
adopted, for instance by mistakenly assuming that a random sample of events is representative of the essential characteristics of a process. Kaufmann et al. (2009), looking at the use of debiasing strategies to enhance the rationality of sourcing in uncertain environments, find evidence that the use of experts in supply management may result in wrong suggestions. In fact, experts themselves can be a source of decision biases when they come to an unwarranted feeling of control, leading to possibly over-optimistic evaluations (Kaufmann et al., 2012).

One pre-requisite for overconfident attitudes to turn into overconfident behaviour and to affect organizational performance is that the decision maker enjoys sufficient discretionary power. This contention is one of the tenets of upper echelon theory (Hambrick, 2007), which posits that in settings where managers enjoy discretion, their overconfidence matters for organizational success (Li and Tang, 2010). Even if upper echelon theory refers to top executives, it is plausible that this argument may extend to lower level managers, provided they enjoy some degree of discretion, as is the case with professional buyers. Management research provides evidence that discretion is amplified by environmental uncertainty, such as when a market does not provide reliable information, or when ambiguity concerning means-ends is high (Hambrick and Finkelstein, 1987).

Duncan (1972) identifies two dimensions of environmental uncertainty: the simple-complex effect, referring to the number of factors that have to be taken into account in decision-making, and the static-dynamic dimension, pertaining to the variability of the factors relevant for decision making over time. Supply chain can be characterised both by varying degrees of complexity (stemming from numbers of echelons of the chain, number of products exchanged, demand variability, unreliable or long lead times, etc.) (Bozarth et al., 2009) and by different degrees of variability, due to the fact that the factors involved in decision making may change due to several contextual, contractual, and relational conditions (turbulent demand or supply unreliability or disruption).

To the best of our knowledge, there is no ad hoc theory that can fully account for the relation between overestimation and underplacement on the one hand and the two dimensions of environmental uncertainty on the other. In order to derive a testable prediction concerning the impact of environmental uncertainty on overestimation and overestimation, this study elaborates on an acknowledged result in experimental psychology, namely the easy-hard effect (Moore and Healy, 2008). Moore and Healy (2008) show that people overestimate their performance for hard tasks and underestimate it for easy tasks. This is matched by an opposite pattern whereby overplacement is observed in easy tasks and underplacement in hard ones (Brenner, 2003; Larrick et al., 2007; Lichtenstein and Fischhoff, 1977). When formulating a prospective evaluation of performance, individuals have imperfect knowledge about their own performance but even less knowledge about the performance of others. The lack of information about own performance entails that part of the evaluation reflects skills or competence and part reflects errors. The error will make those estimates regressive, i.e. respondents underestimate performance when it is high (which is most likely in easy tasks) and will overestimate it when performance is low (which is most likely in hard tasks) (Erev et al., 1994). The same pattern of overestimation/placement has been reported also in the case when the prospective evaluation refers to ability to control rather than to performance (Thompson et al., 1998).

We conjecture that the same relationship between overestimation and underplacement that has been observed in the easy-hard task comparison will carry over to the case of low-high uncertainty. In fact, hard tasks are not only characterised by complexity in terms of information processing requirements (Moore and Healy, 2008) but also task difficulty increases if probabilistic linkages exist between decisions and outcomes (Campbell, 1988).

H1. In supply management decisions characterised by low environmental uncertainty the buyer exhibits on average overplacement of his/her performance relative to others, whereas with high environmental uncertainty the buyer exhibits on average underplacement.

H2. In supply management decisions characterised by low environmental uncertainty the buyer exhibits on average underestimation of his/her performance, whereas with high environmental uncertainty the buyer exhibits on average overestimation.

3.2. Overconfidence and experience

The managerial and economics literature on overconfidence conclude that overconfidence affects also highly experienced and skilled individuals such as managers (Glaser and Weber, 2007; Li and Tang, 2010; Malmendier and Tate, 2005). In the supply management field, Kaufmann et al. (2009) suggest that although purchasing managers are trained to carry out risk assessment and to apply formal models that aid decision-making, they are not immune from overconfidence. Hada et al. (2013) argue that purchasing managers’ experience reduces the bias they perceive in supplier-selected referrals.

However, these findings contrast with other results reported by the psychological literature on overestimation and overestimation. In fact, several psychological studies report a reduction in overestimation of performance (Griffin and Tversky, 1992; Kioriat et al., 2002; Krueger and Mueller, 2002) and in overestimation (Burson et al., 2006) once the decision maker has acquired skills in the task. Because people may find it difficult to assess their relative performance, skilled individuals who exhibit a better performance do not guess how well they have done, whereas less skilled individuals do not accurately assess how badly they have done (Burson et al., 2006). In psychological experiments, skill is often acquired through repetition of the task, and it is therefore tied to previous experience. A caveat to equating experience with skill acquisition comes from Russo and Schoemaker (1992) who show that a reduction in overconfidence is determined by a timely feedback from previous decisions and accountability of decisions. Therefore, building on the psychological literature, we formulate the following hypothesis:

H3. Experienced individuals exhibit on average less overplacement and less overestimation, provided they receive feedback on past decisions.

3.3. Impact of overconfidence on supply chain performance

An important question arising from the findings that purchasing professionals are affected by overconfidence and that the degree of overconfidence differs when acting in different environments is the following: how does overconfidence relate to the outcomes of their decisions?

One of the areas in which overconfidence may bring about negative consequences for supply management is risk management, which can be affected both in the valuation phase and in the choice of risk mitigation strategies. In the valuation phase, overconfidence leads to risk underestimation, whereby the decision maker may believe that severe disruptions are less likely they actually are and that they can be managed ex post, and that she will do this better than competitors will. Overconfidence as overestimation of one’s own abilities and skills may lead buyers to design their supplier network with a limited supply-base, or to forego the use of appropriate procedures in the selection.
evaluation and monitoring of external sources.

In terms of risk mitigation strategies, inventory management may also be affected. Croson et al. (2008), in developing a theoretical model of the newsvendor, show that overconfidence leads the newsvendor to place suboptimal orders and to earn lower profits than well-calibrated newsvendors. In particular, in high-profit (low-profit) industries, overconfident agents are likely to order fewer (higher) inventories than optimal. Overconfidence may lead purchasing managers to under-estimate the variance of demand or of lead-time, thus inducing them to hold too little safety stock (Bendoly et al., 2010). Thus, the following hypothesis with respect to inventory management within a supply chain can be formulated:

H4. Overconfidence leads to worse performance in inventory management by leading to higher costs.

4. The experiment

4.1. The design

In order to investigate overconfidence in ordering decisions within a supply chain, the “beer game” framework was adopted (Forrester, 1958, 1961). In the classic beer distribution game the supply chain consists of four echelons (retailer-wholesaler-distributor-factory). During the game each i-participant, i \( \{1,...,4\} \), at each t-period, \( t \{1,...,T\} \), places orders, \( O_{it} \), to the immediate upstream supplier. Thus, both games can be assumed to mimic a non-integrated serial supply chain in which each buyer has a single supplier.

All experiments use the same random number seed to generate demand, i.e., \( D_{it} = \{0,1,2,3\} \). The comparison between the control and in S_U treatment. No information sharing about actual demand, inventories, backlogs, and own lead times is allowed among supply chain participants. Communication among participants during the game was strictly forbidden. Thus, both games can be assumed to mimic a non-integrated serial supply chain in which each buyer has a single supplier.

Upon signing up for the experiment, players were randomly assigned to one of the two treatments. First, they were oriented to the rules and objectives of the game by means of a tutorial lasting about 30 min. Then, each player participated in two different beer game sessions of the same treatment, the second taking place about one month after the first. The first repetition of each experiment was considered a sort of warm-up of the game (Wu and Katok, 2006), useful for making the players aware of the rules of the game and of the impact of the interaction with the other players in the same chain. In the second repetition, each player kept the same role he/she had been assigned in the first game but was assigned to a different chain, in order to avoid members of a chain during the first session agreeing on a specific strategy for the next. This would have changed the non-integrated supply chain to a coordinated one.

Two different groups of subjects participated in the experiment: 152 graduate students (76 in the control and 76 in S_U), and 24 professional purchasing managers (all in the S_U treatment). Although the use of students in operations management experiments has been criticised, several studies have provided evidence that experimental outcomes of managers and students in beer game experiments are similar (Croson and Donohue, 2006; Machuca and Barajas, 2004). However, if a manager has a better understanding and greater experience of the principles of inventory management than a student does, he should perform better in the game and exhibit less unjustified optimism about his performance (Bolton et al., 2012). Therefore, comparison of behaviour of students and managers allows the assessment of the impact of
professional purchasing experience on overconfidence and therefore a test of Hypothesis 3.

Student participants were graduates in Operations Management who had already attended Logistics classes, and had a good knowledge of inventory management problems. All of them had previous work experience through internships. Participants were divided equally between men and women, and median age was 24. Purchasing managers were all members of the same multinational organization, 25% were female, 50% of them had been with the same company for over 5 years, and 46% were younger than 35 years.

Graduate students played for a minimum of 36 periods to a maximum of 50, whereas the purchasing managers played for 20 periods due to a time limit fixed by their company. The incentive used in the student game was both monetary and in terms of coursework grades. Participants were instructed that the members of the supply chain team with the lowest total costs (inventory + backlog costs) shared a final prize of €77. In addition, the members of the winning chain received an extra course grade (out of 30 grades). Purchasing managers were instead rewarded with a wellness package.

The version of the beer game here adopted was developed in a Googledocs® software application which enables Excel® spreadsheets to be shared by the different supply chain members.

4.2. Overconfidence measures

In order to assess the presence of overplacement and overestimation, participants were asked to evaluate their performance prospectively in the “beer game”. Statements and questions used for the purpose were adapted from Glaser and Weber (2007). Since the first repetition of the game was considered as a warm-up, overconfidence statements were elicited at the beginning of the second repetition, i.e. once participants had acquired sufficient experience of the game, and could formulate informed valuations on their prospective performance.

Overplacement was assessed through the following item based on expected prospective performance:

Please, indicate here following which is, in your opinion, the percentage of participants playing in your same role who will complete the game with lower total costs than yours (provide a number between 0% and 100%).

In Glaser and Weber (2007) overplacement was also assessed through an item based on perceived skills, in addition to the one referring to expected performance. This item was not used in our study, since we reasoned that applying a measure of skills was questionable. In fact, skills would have implied pre-experimental experience, and both students and professional buyers had no experience of the beer game before they signed up for the experiment.

The measure of overplacement was calculated for each player simply as the difference between the actual percentage of participants in the same role with lower total costs than the respondent and the percentage expected by the respondent. The measure was then normalised dividing by 100 and this resulted in a range of the measure between −1 and +1, with negative values indicating underplacement and positive values standing for overplacement. In order to allow for players’ small estimation errors, players exhibiting under (over) placement were defined as those whose placement score was lower than −0.1 (higher than 0.1).

A measure of overestimation was derived from responses to the following statement, meant to mimic locus of control questions (Presson and Benassi, 1996):

I never take decisions in the game that may put me at the risk of a stock-out.

Participants in the game provided their assessment on a Likert scale from 1 (=I do not agree at all) to 5 (=I agree completely) of the perceived degree of control over stock-outs, with the actual success of the player in controlling stock-outs. To this end, we clustered the periods of the game in which backlogs had occurred into five groups of the same length (36/5 or 20/5 according to the periods played by students and managers). Thus, for the student (manager) we assumed that if the number of stock-outs was less or equal to 7 (4) this corresponded to a score of effective success equal to 5 (the greatest ability to actually control for the stock-outs), if it was greater than 7 (4) but less or equal to 14 (8), the score was 4, and so on. If the number of stock-outs was greater than 28 (16) the score was 1 (the lowest ability to control for the stock-outs). For each player, we then subtracted the score corresponding to the actual control from the score expected by the respondent, and normalised it, to yield an overestimation index for each player comprised between −1 and +1, as follows: \( \text{NormScore} = (\text{Likert score for expected control} - \text{score for actual control})/4 \). As above, in order to allow for players’ small estimation errors, players exhibiting under (over) estimation were defined as those whose estimation score was lower than −0.1 (higher than 0.1).

5. Findings

5.1. Evidence of overconfidence

In order to test the first two hypotheses concerning overplacement and overestimation and their relation with the degree of environmental uncertainty, Fig. 1 reports the proportion of participants in the beer game who exhibited under/over placement and estimation. The left-hand side of Fig. 1 presents the percentage of players exhibiting over (under) placement. Overplacement is more frequent in the control condition in which uncertainty is lower, thus confirming Hypothesis 1. Differences in the frequency of over and under placement between the two student groups playing in the two conditions are statistically significant by a chi-square test (7.08, p < 0.05). The right-hand side of Fig. 1 reports the percentage of either players who exhibited under- or overestimation. Consistent with Hypothesis 2, overestimation is more frequent when the decision task takes place under conditions of higher uncertainty, i.e. under treatment \( S-U \). The differences in the proportions of under/overestimation for the two students groups are significant by a chi square test (14.15, p < 0.05). Underestimation is the modal behaviour among professionals.

These preliminary results support Hypotheses 1 and 2 and confirm that the pattern of overplacement and overestimation observed under low/high uncertainty is in line with results reported in the literature with reference to easy/hard decision tasks. In addition, results lend support to the hypothesis that the two biases affect also purchasing professionals, who tend to over-rate their performance with respect to others, but to under-rate their ability to control.

In order to get a more nuanced picture of overconfidence, Fig. 2 presents the frequency distribution of the overplacement and overestimation measures for students in the two experiments and for the managers’ experiment. Whereas the analysis based on dichotomisation allows getting a more intuitive picture of overconfident attitudes (how widespread they are), from a managerial point of view it is of interest to assess how much overconfident a decision maker is. In fact, based on the results of the overconfidence literature (Li and Tang, 2010), it is plausible to assume that the negative consequences of overconfidence (if any) will be an increasing function of the degree of overconfidence.
Frequency of Overplacement (Left) and Overestimation (Right)

Fig. 1. Frequency of overplacement (Left) and overestimation (Right).

Fig. 2. Overplacement (left) and overestimation (right).
A within-treatment analysis confirms the pre-dominance of overplacement and underestimation for the low uncertainty game (Fig. 2(a) and (b)). In the case of the S_U treatment, the difference between the two measures of overconfidence is less marked (Fig. 2(c) and (d)). There is relatively more underestimation than underplacement, however there is also a high proportion of respondents who marked over-placed themselves with respect to others.

The between-experiment comparison with respect to overplacement shows that respondents exhibiting underplacement increase with uncertainty (Fig. 2(a) and (c)). A regression of the overplacement measure on the treatment variable returns a coefficient that is positive but not statistically significant. The between treatment comparison for overestimation confirms the pattern reported in the case of the easy-hard effect proposed in the literature, namely that overestimation increases with uncertainty (Fig. 2(b) and (d)). A regression of the overestimation measure on the treatment variable (presence/absence of supply uncertainty) returns a positive and significant coefficient (beta = 0.29, p < 0.00).

Analysis of the S_U treatment condition allows a test of Hypothesis 3 through the comparison of students and professionals. These latter participated only in the S_U version of the game. Purchasing professionals exhibit overplacement less frequently than graduate students do, and are better able to evaluate their position with respect to others, consistent with Hypothesis 3. The difference in the frequency of over/under placement is statistically significant (17.96, p < 0.01). However, still over 30% of managers exhibit overplacement in their evaluations, thus confirming that overconfidence is a problem affecting also professionals. Professional buyers exhibit overestimation less frequently and underestimation more frequently with respect to the student group, with the difference being significant under a chi-square test (32.36, p < 0.01). This again confirms Hypothesis 3 concerning the impact of experience in related tasks. The very high frequency of underestimation among professional buyers indicate that they tend to underestimate their ability to manage inventories.

In summary, overplacement diminishes with uncertainty and a significant proportion of professional buyers Underplace their performance, although these effects are not statistically significant. Our measure of overestimation supports the hypotheses concerning the effect of environmental uncertainty and professional experience. Overestimation increases with uncertainty, while professional buyers exhibit a sort of reverse confidence bias, since they underestimate their prospective performance.

5.2. Impact of overconfidence on supply chain performance

The presence of overplacement and overestimation do not represent per se evidence that overconfidence affects supply chain performance. In order to test if overconfidence worsens Beer Game outcomes (Hypothesis 4), we consider three different measures of performance: costs (inventory + stock-out costs) for each echelon, backlogs occurred in the game, and variance of orders during the game calculated over a horizon of 36 periods. Regression analysis was used to explore the relation between each of these dependent variables and a set of explanatory variables, including the measures of overplacement (Over_placement) and overestimation (Over_estimation) described above.

A well-known outcome of Beer Game experiments is the so-called Bullwhip Effect (Sterman, 1989; Croson and Donohue, 2002), whereby the variance of orders escalates as one moves up the supply chain. This implies that role played in the chain (retailer, wholesaler, distributor, and factory) is a powerful determinant of performance. To keep this variability into account, separate linear regressions were run for each echelon.

Besides overconfidence measures, the other explanatory variables used were:

1. Supply Uncertainty (0=control, 1=S_U) accounting for outcome differences caused by the different degree of uncertainty in the environment associated with the two experimental conditions.
2. Average Backlog per period of the upper echelon with respect to the one considered in the equation (Backlog_S), capturing the fact that in any serial supply chain outcomes are not determined solely by individual ordering and inventory decisions but also by the behaviour of other participants. In particular, backlog costs are bound to be affected by the inability of upstream layers to supply their customers, due to insufficient stock.
3. Confidence measures of the supplier in the customer's equation (Over_placement_S and Over_estimation_S). These variables keep into account the team-dependence of costs. In fact, an overconfident supplier may hold fewer inventories and incur backlogs more frequently, leading to higher costs not only for himself but also for the customer.

The regression analysis refers only to the experiments involving graduate students. The different length of the game for the two sub-groups (36–50 periods for students and 20 periods for professional buyers) makes overall costs not strictly comparable. At the same time, the small size of the buyers’ group makes it unsuitable to run a separate regression analysis.

Table 1 summarises regression results by reporting standardised coefficients and p-values in parenthesis for each of the twelve equations (4 echelons X 3 measures of performance) estimated. We discuss the cost equation first. The coefficient for the S_U treatment is always positive and statistically significant except for the distributor, pointing to the fact that higher uncertainty generally translates into higher costs. The overplacement coefficient is positive and statistically significant for all echelons but for the distributor, whereas the overestimation coefficient is a significant determinant of costs only for the Retailer. This latter finding is of interest recalling that the overestimation measure in this study refers to expected ability to control the occurrence of backlogs. The significance of overestimation only for the retailer may capture well-known result of beer game studies; the retailer fails to estimate the variance of external demand, thus under-estimating the risk of running out of stocks. Consequently, orders to the upper echelons will be too small in the first phase of the game, setting in motion unstable dynamics of the chain, whereby upper echelons will present increasing variability of orders. The overconfidence of the supplier is statistically significant only for the retailer and for the overestimation measure, pointing to the fact that generally costs depend mainly on the management of own inventory, rather than on backlogs created by the mismanagement of supplier’s inventory. Consistent with this finding, backlogs of the upper echelon are a statistically significant determinant of costs only in one equation. The backlog equation provides substantially similar results.

In the variance of orders equation uncertainty always leads to higher volatility of orders, while there is mixed support for the impact of overconfidence measures. Consistent with previous literature on the beer game, the variance of orders is strongly affected by the upper level backlogs.

6. Discussion

Results from the beer game experiments provide answers to the three research questions relating to the overconfidence exhibited by buyers, the impact of environmental uncertainty on
overconfidence, and the impact of overconfidence on inventory management. Results in both experimental manipulations (low/high uncertainty) provide evidence that decision makers exhibit overconfidence in their ordering decisions. Further, the study underlines the effect of uncertainty as a relevant contextual variable affecting the presence and strength of overconfidence. Finally, the study supports the view that overconfidence may lead purchasing professionals to be less careful in the management of supplies and thus incur more costs. In what follows, we discuss each of these results, and derive implications for academic research and supply management.

6.1. Buyers’ overconfidence biases

Previous experimental research on overconfidence in supply management built on the behaviour of undergraduate students with little knowledge of inventory management (Ren and Croson, 2013). In this experiment, both graduate students, with knowledge of supply and inventory management, and purchasing professionals exhibit confidence biases. This finding aligns with other disciplines that have found evidence of overconfidence in the decisions of professionals (Malmendier and Tate, 2005; 2008; Odean, 1998). However, purchasing professionals exhibit less overconfidence than students do, lending support to the hypothesis that professional experience matters (Burson et al., 2006) (Hypothesis 3).

The experiments show that both students and professionals overrate their performance relative to others, whereas they mostly underestimate their ability to control backlogs. This overplacement/underestimation pattern is in line with previous findings in the literature (Moore and Healy, 2008). In particular, according to Griffin and Tversky (1992), overplacement arises because the performance of others is considered to be predictable from their traits, needs and interests. In our experiments, this predictability is plausible both for students and professionals, since they knew their group of peers. Conversely, underestimation derives from the fact that predicting own behaviour/performance is perceived as more difficult, because it is considered contingent on changing external circumstances.

The inability to assess own performance with respect to others has interesting consequences in supply management settings. In competitive environments, where success depends on rank in the population, but where information about the abilities of others may be imprecise, individuals may be able to evaluate themselves in absolute terms but not in relative terms (Grieco and Hogarth, 2009). Inability to assess performance in relative terms may lead to weak efforts to improve the competitive position. This study suggests that this will be true not only when purchasing professionals face more complex and uncertain environments. A first implication for organizations is that buyers should be trained to discount their expectations of success by removing these optimistic biases (Carter et al., 2007). A second is the importance of providing buyers and employees with benchmarks that allow them to assess correctly their performance in relative terms (Russo and Schoemaker, 1992).

With reference to underestimation, our experiments show that it is noticeable among purchasing managers with respect to graduate students. Although the stronger underestimation among professionals should be subject to further research, since the length of the game played by managers was shorter than for students, we conjecture that managers hold larger inventory because they perceive backlogs as a professional failure and not simply an extra cost in the game.

6.2. Environmental uncertainty affects overconfidence

The experimental design compares two decision scenarios differing for uncertainty the buyer faces when deciding his/her order. Consistently with previous literature (Kahneman and Lovallo, 1993; Li and Tang, 2010; Park and Santos-Pinto, 2010), the two facets of overconfidence relate to the degree of environmental uncertainty. More precisely, as predicted by Hypothesis 1,

<table>
<thead>
<tr>
<th>Table 1. Relation between Performance Measures and Overconfidence (number of chains = 38).</th>
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<tbody>
<tr>
<td>Variables</td>
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<tr>
<td>Supply Uncertainty (S_U)</td>
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<tr>
<td>Over_placement</td>
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<tr>
<td>Over_estimation</td>
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<tr>
<td>Over_placement_Supplier</td>
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<td>Over_estimation_Supplier</td>
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<tr>
<td>Backlog_Supplier</td>
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<tr>
<td>R²</td>
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*p < 0.10, **p < 0.05, ***p < 0.01.
overestimation is relatively more frequent when uncertainty is higher, whereas overplacement is more frequent under lower uncertainty (Hypothesis 2), although this latter effect is weaker. As far as supply management research is concerned, the overestimation result lends support to Carter et al. (2007) who posited that buyers might exhibit overconfidence in the process of supplier evaluation when probabilistic information is vague.

The experiments also contribute to theory since they have allowed testing whether the easy-hard tasks comparison described by Larrick et al. (2007) and Moore and Healy (2008) extends to lower-higher uncertainty settings in inventory management. Results suggest that probabilistic linkages between decisions and outcomes are perceived by the decision maker as characterised by more complexity in terms of information processing requirements.

From a managerial viewpoint, it is noteworthy that in higher uncertainty conditions players become significantly more overconfident in their ability to control backlogs. These results suggest that when locus of control is high buyers will underestimate their abilities, whereas when locus of control is low, such as in turbulent markets or with unreliable suppliers, buyers will overrate their chances to control for disruptions. Although higher levels of uncertainty lead to a decrease in overplacement, still a significant portion of players (about 50%) exhibit overplacement, thus suggesting that this facet of overconfidence is also at issue under uncertainty. Therefore, it is important for organizations to design appropriate monitoring systems and risk plans that apply in cases of high turbulence, in order to counterbalance any potential optimistic bias of the decision maker.

6.3. Overconfidence and inventory management

This study is the first to have explored the impact of overconfidence on purchasing decisions within a serial supply chain. Regression analysis shows that costs of different tiers of the supply chain are positively related to measures of overconfidence, thus confirming Hypothesis 4 and general findings from other disciplines according to which overconfidence leads to suboptimal decisions. Thus, the study suggests that the psychological characteristics of decision makers matter for organizational performance, thereby extending to operational activities such as inventory and ordering decisions, the findings of Upper echelon theory (Hambrick, 2007) concerning the "hubris" of CEOs (Li and Tang, 2010; Malmendier and Tate, 2005).

Next, overconfident behaviour often substantiate into higher risk taking (Li and Tang, 2010; Simon and Houghton, 2003). Experimental results show that this is true also in inventory management, since overconfident individuals incur not only more costs (which may stem from higher inventory) but also more backlogs, thus showing that higher costs are determined by insufficient stock. Therefore, overconfident buyers increase the risk of a breakdown of the supply chain and put the reliability of their firm at risk. Further, since overconfidence affects also the variance of orders, it qualifies as one of the behavioural causes of the "bullwhip effect" (Sterman, 1989), which is considered a key determinant of supply chain costs.

Finally, regression analysis suggests that it is the overconfidence of the decision maker that affects performance the most, whereas the overconfidence of the upstream tier of the chain has an insignificant effect. This entails that if each tier's decision maker correctly assesses her own performance and her standing with respect to competitors, this should minimise the impact of possible biases existing in the supply chain.

7. Limitations and future research directions

This study has presented the results from human experiments aimed at analysing the impact of overconfidence on inventory decisions. Experiments represent a useful approach since they allow isolating causal links and capturing behavioural characteristics that cannot be easily reconstructed from field data. In addition, the use of multi-player business games is important to detect network effects in interdependent decisions. While these represent the opportunities offered by human experimentation in the operational management discipline, the challenge remains that of ascertaining that high internal validity is not at the cost of low external validity. To this end, higher external validity can be achieved either through the involvement in experiments of professionals, or by comparing field outcomes and experimental results.

In the light of the above line of reasoning, some limitations of this study may provide direction for future research. First, future research may combine building ad hoc experiments with the undertaking of field studies to complement experimental evidence. This multidisciplinary approach may be useful to investigate the relevance of overconfidence also for supply management decisions other than inventory management (supplier selection, supply chain integration, etc.). Second, it would be of interest to widen the sample of purchasing professionals involved in the experiments, taking into account contextual factors (firm/purchasing department size, sector of activity, seniority, etc.) and different cultural/education background in order to better understand the interplay between overconfidence and individuals' training. In fact, the small number of professionals involved in the present study led to their exclusion from regression analysis.

Finally, behavioural studies generally isolate the effect of a single bias/heuristic on behaviour. However, individuals exhibit complex personalities, experiences, and attitudes that affect their behaviour. Thus, it is important to explore whether interactions exist among overconfidence and other behavioural characteristics, for instance, risk attitudes and/or reciprocity, and to identify their joint impact. The investigation of behavioural issues in supply chain management is today acknowledged as extremely relevant, as witnessed by the growing attention paid by the literature. Research efforts in this direction will enrich the study of organizations, but also will suggest ways to innovate supply management.

References


