Emotions Series: Optimism

By Meir Statman, Ph.D.

We chuckle when we hear second marriages described as triumphs of optimism over experience, but now we have empirical evidence that the description is true. Financial economists Manju Puri and David Robinson (2007) studied the link between optimism and life choices, including marriage, occupation, and investments. They found that optimists indeed are more likely to remarry than realists.

Optimism, even if unrealistic, is mostly a blessing. Optimists, wrote psychologists Shelley Taylor and Jonathan Brown (1988), are happier than realists. Optimists recover faster from surgery and they adjust more smoothly to major life transitions such as leaving home for college, looking for a job, or healing after a divorce. Optimists respond to negative feedback with a positive sense that they are good, skillful, and effective people, whereas realists perceive the same negative feedback as accurate and integrate it into their sense of themselves. But unrealistic optimism can wreak havoc on investment portfolios and financial security, leading optimistic investors to diversify too little, trade too much, and trust luck to bail them out.

Puri and Robinson (2007) measured people's optimism by comparing their subjective estimates of how long they will live with estimates presented by insurance companies in actuarial tables and calculated from objective data such as age, gender, and health. Puri and Robinson defined optimists as people whose subjective estimates of how long they will live are higher than the objective estimates displayed in actuarial tables.

They found that the proportion of optimists among the self-employed is higher than their proportion among wage-earners. They also found that optimists, whether self-employed or wage-earners, have a more positive attitude toward work than realists. Optimists work longer hours, anticipate longer work careers, and are more likely to think that they would never retire. Puri and Robinson's findings about the investment behavior of optimists are especially interesting.

In their portfolios, optimists allocate to equity about the same proportion as realists do. But optimists are more likely than realists to concentrate their equity in a handful of individual stocks rather than in a diversified portfolio of stocks. The positive outlook of optimists leads them to become stock-pickers in the belief that their skill or luck would deliver better returns than the returns delivered to realistic investors by diversified portfolios. But, unfortunately for optimists, the investment arena is one arena where the advantage goes to realists. In that arena it pays to perceive negative feedback accurately.

In “The Diversification Puzzle,” I (2004) noted that many investors hold only handfuls of stocks rather than diversified portfolios and calculated the losses suffered by such investors in the extra risk that comes with the lack of diversification. These losses can be substantial, amounting to several percentage points of return per year. Similarly, in “Do Investors Trade Too Much?” Terrance Odean (1999) calculated the losses that investors suffer as they trade individual stocks. Those who trade lag those who buy-and-hold, and those who trade the most lose the most.

Unrealistic optimism afflicts individual and institutional investors alike. Optimism led subprime home buyers to sign on mortgages with escalating monthly payments. All will be fine, they thought. I have the house I always dreamed of and, somehow, by luck, I’ll find the extra money I need when my mortgage payments escalate. Surely the value of my house would continue to appreciate and I would be able to draw the extra mortgage money through refinancing. Many such homeowners now are losing their homes.

Optimism also afflicted institutional investors, including Bear Stearns, Merrill Lynch, and Citigroup. They and others overloaded themselves with subprime mortgage-backed securities. Yes, they must have thought, some subprime borrowers are likely to default on their loans, but not many. Besides, home prices surely will continue on their way up and, just in case, we have the more senior tranches of the mortgage-backed securities. It turned out that luck did not bail out these institutional investors. Many now are losing their jobs.

Pension funds often are swept by optimism. When investment times are good, pension fund managers are tempted by optimism to cut back on fund contributions and overload asset classes that have done well in the recent past, whether hedge funds, private equity, real estate, or emerging market stocks. Like optimistic entrepreneurs who are sure that a new venture would come along if current ones fail, optimistic pension fund managers believe that their chosen investments will deliver the returns they promised to their beneficiaries.
Typical high-net-worth investors are optimists. Many are successful entrepreneurs and professionals whose drive was accelerated by optimism. Optimism is indispensable to money managers. How else could money managers promise to deliver index-beating returns when, in reality, most money managers trail indexes? Optimism led Long-Term Capital Management to leverage its bets beyond prudence, and optimism led Amaranth to concentrate its leveraged bets on energy.

It is difficult, probably impossible, to turn optimists into realists. Moreover, it might be unwise to turn optimists into realists. Optimism is like the accelerator in a race car. It propels investors toward their goals. But a good investment race car needs good brakes to stop it when an obstacle is in the way and it needs a fence to constrain it if the brakes fail.

Typical high-net-worth investors are optimists. Many are successful entrepreneurs and professionals whose drive was accelerated by optimism. Such investors find it hard to let off the accelerator and learn to use the brakes. Investment consultants and financial advisors should teach such investors to use the brakes and construct the safety fence. Investment consultants can guide optimistic clients to diversified portfolios that do not vanquish optimism and the quest for greater riches but provide protection from losses that young investors can overcome but older investors cannot. Similarly, investment consultants can build for pension funds liability-driven investment tracks that feature realistic liabilities and goals and plan the investment race such that the odds favor reaching the finish line rather than crashing midway.

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References

Editor’s note: This is the sixth in a series of articles about emotions and the lessons they hold for investment advisors and their clients.