BEHAVIORAL FINANCE 101 - OPTIMISTS & PESSIMISTS

What role do emotions play in our decision-making? This series on "Behavioral Finance" explores the ways in which certain emotional biases may impact our financial decisions.

Optimism

How would you rate yourself as a driver? According to one study, as many as 80% of drivers believe they are more skilled than the average driver – but, of course, this is impossible, since the concept of "average" means that half the drivers must actually be worse than the average.

Optimism is a good thing – not a bad thing – but overly optimistic individuals tend to think bad things only happen to other people. Such an illusion can damage their investments because of a failure to acknowledge and plan for the potential for adverse consequences. And, this is not limited just to investing; it can show up in other areas, such as not obtaining sufficient insurance or delaying retirement or estate planning decisions.

Optimists frequently overestimate their skills and knowledge. They believe they are smarter and more in control than is really the case – so*optimism* is linked to the emotional bias of *overconfidence.* And, overconfidence gets fueled even more due to the self-attribution bias, which is the tendency for people to credit success to themselves ("aren't I smart?") while assigning blame for failures to external reasons (the market, the economy, bad advice, etc.).

Overconfidence causes us to take excessive risks, but many people also take imprudent risks because they don't know they are taking them – they have not – or don't know how – to accurately recognize and measure risks or to assign realistic probabilities to them. Overconfidence also causes us to be too highly confident in our overly precise predictions.

With investments, overconfidence leads to frantic, excessive trading. In one study, when an investor sold a stock and immediately bought another, the stock that was sold achieved a 3.5% better return in the following year than the stock that was bought – and this was before even considering trading costs and tax consequences. Men are particularly afflicted with overconfidence and trade too often. Women investors often do better than men simply because they don't trade as often.

Pessimism

But for every optimist who sees the glass as half-full, there is the pessimist who views it as half-empty. Pessimists bring their own unique risks and problems to planning. A pessimist will have a negativity bias and is always waiting for the other shoe to drop. After the recession of 2007-2008, the stock market bottomed in March, 2009 and experienced a significant rebound since then – but many investors missed the rally because of their pervasive fear of another huge decline being just around the corner. They are like the Pigpen character from the Peanuts comic strip, always walking around surrounded by a cloud of dust.

Negativity bias causes investors to put more weight on bad news than on good. Some might view this as simply being realistic, but this bias causes you to ignore any possibility of reward and only see all the things that can go wrong. This type of thinking, fed by our news media, leads to “catastrophizing” everything, constantly focusing on the worst possible outcome of a situation. A 2% drop in the stock market is not viewed as something that routinely happens but is described with words such as “plummeting,” “nose dive,” “collapsing,” or “crashing.”

There is something in our nature that tends to overestimate the importance of commonplace events while under estimating the significance of truly important events.

While an overconfident optimist working for a technology company may believe in their special talents to sniff out superior investment opportunities in that sector, the pessimist will only see the challenges and competition facing their employer or the entire industry and tend to shy away from any investment in the very area that they know most about.

Dealing with Optimistic and Pessimistic Tendencies

How do we deal with the optimist and pessimist biases?

Both need to hear different viewpoints and to try and keep things in perspective. Both must watch their tendency to filter out any news or information that doesn’t agree with their existing view of the world. The optimist may have to remind themselves that they are not as smart as they might think and that bad things can happen to them also. The pessimist needs to recognize that dire predictions usually don’t happen and even if they do, the severity of the outcome rarely matches the fear. As the economist Paul Samuelson once put it: “The stock market has called nine of the last five recessions.”

In what ways does behavioral finance impact your decisions? We’re here to help as you plan for your future.

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