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THE OPTIMISM PUZZLE

by Mark Pearlman (June 7th, 2011)

Pop Investing explores the intersection of mainstream media and investment practice. It takes discussions from popular culture and applies them to the financial industry in order to better understand investor attitudes and trends.

This week TIME magazine's cover story highlighted a topic of particular interest to investors and their advisors: the optimism bias. In short, humans tend to be more optimistic than realistic, which leads us to make certain cognitive errors. When confronted with the fact that 1 in 2 marriages end in divorce, we nevertheless tend to think our own marriage is likely to succeed.

When applied to investing, habitually overestimating our chances of success is yet another aspect of human psychology hindering our ability to impartially assess financial risk.

Despite evidence that more than 75% of actively managed mutual funds tend to underperform an index fund over a 5+ year period, many investors still choose active management. They believe they will be one of the few investors to consistently outperform.

In addition, our brains are wired to minimize second-guessing. When we make a decision, we value it more. When confronted with two equally attractive options, we automatically upgrade an option once it is chosen. As a result, investors tend to hold losing investments for too long as they cling to their original optimistic investment outlook.

On the whole, however, the tendency for investors to view the glass as half full is actually a good thing. If the glass were always empty investors wouldn't take enough risk, which is critical to meeting long-term financial goals. And in the long run, progress continues to be made across a range of financial markets and human endeavors. International trade creates net benefits for nearly all societies, and game-changing technologies (Internet, cell phones, advances in healthcare) can improve society as a whole. On the other hand, a glass-always-full mentality may lead to taking unwise risks, such as too much leverage, concentration, or liquidity risk.

Advisors can serve as guides to this "optimism puzzle," helping make investors aware of their natural biases and create a framework – such as through an Investment Policy Statement – that makes it difficult for the investor to make "irrational" investment decisions. As Tali Sharot, the author of the TIME article concludes:

> *I believe knowledge is key. We are not born with an innate understanding of our biases. The brain's illusions have to be identified … and then communicated to the rest of us. Once we are made aware of our optimistic illusions, we can act to protect ourselves. The good news is that awareness rarely shatters the illusion. The glass remains half full. It is possible, then, to strike a balance.*

In terms of investment solutions, a practical implication of the optimism bias is to be in the market, but have downside protection – similar to walking outside on a cloudy day, but with an umbrella for protection.

A staple of this "think positive, but prepare for the worst" approach is a properly diversified portfolio, but we also recommend implementing a permanent hedge on a sizeable portion of an investor's equity allocation. Other options include hedged mutual funds such as the Gateway Fund or TFS Market Neutral.

Downside protection is where investors need advisors most, because another side effect of the optimism bias is that investors often fail to fully calculate the impact of a sudden market downturn. The hard truth is in the math: a 20% loss requires a 25% gain to break even and a 50% loss requires a massive 100% gain to restore lost value. Furthermore, studies show that – subjectively, at least – a loss hurts twice as much to investors as a gain helps.

So while it is optimism that allows investors to dream of rosy futures – and put their money at risk to achieve those dreams – it's the advisor's role to recognize that tendency and balance investor optimism with a realistic approach to risk and investing.