The Stan Clark Financial Team's

PERSPECTIVES

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Behavioral finance

Optimism, overconfidence and poor investment decisions

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Late in 2009, Vancouver opened the Canada Line in time for the 2010 Winter Olympics. The Canada Line proved a huge success, carrying nearly 200,000 passengers daily during the Olympics, and then exceeding ridership targets ever since. When the project began, planners optimistically estimated costs for the line at $1.3 billion. But the final cost was nearly double at $2.5 billion.

I don't intend this to be a criticism of business practices or how governments spend public money. Rather, I'm giving an example of what Daniel Kahneman, author of *Thinking Fast and Slow*, calls the "planning fallacy": a cognitive malfunction that arises, in part, from our innate human bias toward optimism. In this article I'd like to discuss the planning fallacy – and how optimism can lead to overconfidence and poor investment decisions.

According to Nobel Laureate Kahneman, when we are personally engaged in a task, especially a complex one, we have what he calls an "inside view." That inside view biases us to be more optimistic about our projections and chances of success than an informed outsider might be.

For instance, in one study, U.S. homeowners who optimistically projected the cost of remodelling their kitchens at $19,000 actually ended up paying closer to $39,000. Most people seem to be innately optimistic. It's a bias that serves us well in some areas, like health and happiness. But it can also lead us into making plans and basing forecasts on unrealistic, best-case scenarios, ignoring a host of facts and statistics that may tell us otherwise.

For example, one measure of optimism in a CEO is how much of their company's stock they own. Kahneman reports that it is the most optimistic CEOs who overconfidently make the worst corporate decisions. These CEOs borrow money for growth, rather than raising equity capital. They pay too much for acquisitions. They merge with companies that diminish their focus, increase administration costs and saddle the merged entity with debt.

Optimism and overconfidence also lead inventors and entrepreneurs to soldier on, pouring money, often their own savings, into projects or enterprises that any objective outsider would declare hopeless. Optimism makes us feel more confident than we should. Meanwhile, the planning fallacy can cause us to underestimate how much time or money it will take to succeed.

And what about the world of investing?

Far too many traders, whether individual or institutional, have faith that their knowledge, skills, technology and reading of where the overall market is trending will enable them to *time the market*: to buy low and sell high, and thus profit. But there is no evidence that anyone has ever been successful doing this consistently.

It's clear that optimism suppresses doubt, begets overconfidence and leads to blindness to risk and uncertainty. Optimism promotes faulty planning and poor decision-making. It is part of a combination of biases that influences investors to:

- buy and sell stocks too frequently and too quickly as they attempt to time the market
- hang on to overvalued or losing stocks too long because of short-term loss aversion
- underestimate risks to their long-term investment goals
- confuse luck with skill – just because a stock increased as you predicted doesn't mean that you are the beneficiary of anything other than luck, and
- ignore the long-term trends that are the real strength of the market.

As we've said before and will repeat often, investing for wealth and security is not a short-term activity. It means developing long-term strategies that benefit from the reliable, long-term growth in the value of equities.

And, it's important to make decisions based on objective criteria and information that have not been biased by optimism or overconfident projections. ■

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