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RESEARCH ELSEWHERE

Robert A. Olsen

Optimism, Pessimism and Gambling: The Downside of Optimism

By Bryan Gibson and David Sanbonmatsu

Personality and Social Psychology Bulletin, Vol. 30, No. 2, 2004, pp. 49–160.

While this experimentally based research deals with decisions made in a gambling context, it has obvious implications for personal investment behavior. Specifically it suggests that individuals who can be labeled optimists or pessimists, based on the Revised Life Orientation Test, exhibit differential attention to positive and negative information and become differentially "addicted" to gambling. This study does not focus on the reasons why people gamble. Instead it focuses on how and why optimists' behavior differs from pessimists' once gambling has commenced. The authors note that optimists have more positive gambling expectations and even retain them in the presence of losses, by often reframing losses as near wins. Optimists also tend to remember more positive outcome information than do pessimists. Pessimists tend to reduce their betting and expectations after losses and become more focused on negative information. These and other findings appear to have significant implications for such investment behaviors as holding on to losing stocks, insufficient portfolio diversification and the relatively smaller risk premiums on higher risk stocks.

How Do Analysts Use Their Earnings Forecasts in Generating Stock Recommendations?

By Mark T. Bradshaw

The Accounting Review, Vol. 79, No. 1, 2004, pp. 25–50.

Much survey information has suggested that analysts' stock recommendations appear to be based on the use of heuristics rather than rigorous present value techniques. Nevertheless, many economists have refused to believe that this could be true and that such survey results are reliable. This large and detailed statistical study using market based data confirms these prior survey results. Using accounting and stock market data for 4,421 firms, covering the period of 1994 to 1998, the author finds that analysts' stock recommendations are more highly correlated with projected stock values based on price /earnings and earnings growth rate based heuristic models than present value models. In addition, analysts' recommendations are strongly correlated with earnings growth forecasts regardless of the degree to which such growth forecasts appear to be already impounded in stock prices. The study reveals that analysts' recommendations are less useful than value estimates obtained from the mechanical use of present value models. While investment firms maintain that the use of sophisticated present value models is widespread, the author notes that there is not much evidence of such behavior in analysts' recommendations and he discusses why analysts may have other reasons for preferring heuristic based recommendations.

The Profitability of Day Traders

By Douglas Jordan and J. David Diltz

Financial Analysts Journal, November/December, 2003, pp. 85–95.

Using actual brokerage house data, this empirical study estimates the returns realized by approximately 350 Day Traders over the period of 1998–1999. Because this period was one of market gains and because the common wisdom suggests that Day Trading is likely to be most profitable in up markets this study provides evidence of the benefits of Day Trading in a positive market environment. The results reveal that after commissions, 64% of the Day Traders lost money. The distribution of trader profits and losses is left skewed with most losses being less than \$ 10,000. About 14% of the traders realized net profits exceeding \$ 10,000. The average net dollar return over all traders

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was a loss of about $750. These results are generally consistent with a prior, but much smaller study conducted by the North American Securities Administrators Association in 1999. Additional results demonstrate that most day trading is related to movements in the NASDAQ Composite Index and that nationally the number of Day Traders has remained at about 50,000 in spite of the large market decline since 2000.

Self-Framing of Risky Choice

By X. T. Wang

Journal of Behavioral Decision Making, Vol. 17, 2003, pp. 1–16.

Previous research on framing effects has focused on how decision makers respond to exogenously established frames. This laboratory study examined how decision makers themselves spontaneously encode and frame gambles. Subjects were asked to make choices in separate gambles involving monetary and life/death outcomes. In general the hedonic tone of self-framing was biased in a positive direction but with a greater bias in the life/death gambles (more highly valued outcomes were subject to greater positive hedonic bias). Positive outcomes always tended to be more positively framed while negative outcomes were still negatively framed (although less so). Also, the effect of self-framing on risk preference was significant. In particular, positive hedonic self-framing resulted in decreased perceptions of risk and a greater willingness to undertake a gamble. This study suggests that decision makers tend to hedonically bias risk related information, thus adding a new bias to the already known positive biases of (1) unrealistic optimism of the future, (2) exaggerated perceptions of control and (3) an overly positive conception of one's self.

Consumer Confidence and Stock Returns: What Sentiment Tells Us

By Kenneth Fisher and Meir Statman

Journal of Portfolio Management, Fall 2003, pp. 115-127.

This brief paper examines the statistical relationship between measures of consumer confidence, stock market bullishness and stock market returns for the period 1989 to 2002. The authors find that changes in consumer confidence, as measured by both the University of Michigan Consumer Confidence Index and the Conference Board Consumer Index, are positively correlated with changes in market bullishness, as measured by the American Institute of Individual Investors. On the other hand, changes in institutional investor bullishness are uncorrelated with changes in consumer confidence. There is also a strong positive relationship between changes in stock prices, as measured by the many stock indexes and consumer confidence. There is strong reason to believe that increases in stock prices should lead to increases in consumer confidence via wealth effects and expectations of an improving economy. The authors suggest that the correlation between confidence and bullishness, on the part of individual investors, is a consequence of investors not being aware that both confidence and stock price are leading economic indicators and not being sufficiently aware of the forward looking nature of stock prices.

Intuitive Evaluation of Likelihood Judgment Producers: Evidence for a Confidence Heuristic

By Paul C. Price and Eric R. Stone

Journal of Behavioral Decision Making, Vol. 17, 2004, pp. 39–57.

Many studies have investigated the nature and source of decision making overconfidence. This study is unique in that it focuses on the influence of advisor overconfidence on the selection of an advisor by a client. Using laboratory experiments, the authors find that client subjects preferred an overconfident advisor to a better calibrated one. These results indicate that the clients do not evaluate prospective advisors in ways consistent with formal analyses of likelihood judgment accuracy. Additional analysis indicated that the client subjects used an advisor's level of confidence as a signal of his or her level of knowledge and expertise. While clients rightly assume that more competent advisors are likely to be more confident, this group of experiments suggests that clients may be predisposed to rely too heavily on such a "Confidence Heuristic" when selecting an advisor.

The Relationship Between Expertise and Evaluative Extremity: The Moderating Role of Experts' Task Characteristics

By Markus Brauer, Paula Niedenthal, Patrick Chambres, Angelique Chatard-Pannetier

Journal of Personality and Social Psychology, Vol. 86, No. 1, 2004, pp. 5–18.

Many previous studies have indicated that experts gather and process information differently from novice decision makers. A by- product this research is the observation that some experts tend to be prone to providing more extreme estimates or forecasts than others. The authors of this research conducted laboratory studies which suggest that a primary cause of differences in judgment extremity is the nature of the expert's judgment task. Advisory Experts are described as those who primarily explain the strong and weak points of alternatives and leave the decision to the client. This type of expert primarily engages in "featural processing" whereby they break down the gestalt of a stimulus into component features. Alternatively, Performance Experts take opinions but then take action themselves. They primarily engage in "configural processing" whereby the information processing tends to be more holistic and focused toward a single conclusion. A series of increasingly natural tasks revealed that the Advisory Experts tended to issue less extreme predictions and have more moderate opinions. The authors suggest that this occurs because featural processing makes the Advisory Expert more aware of the possible interactions among problem elements and he or she thus arrives at a more fully reasoned and less extreme evaluation. In an investment environment, the Advisory Expert is much like a Financial Planner whereas the Performance Expert is more like a stock analyst.

Good Reasons Sell: Reason-Based Choice Among Group and Individual Investors in the Stock Market

By Brad Barber, Chip Heath, Terrance Odean

Management Science, Vol.49, No. 12, 2003, pp. 1636–1652.

The authors note that many studies indicate that decision makers prefer to simplify the decision task in complex decision situations. This leads to "reason based decisions" wherein multiattribute weighting is replaced with an emphasis on a single or a few best (defensible) reasons for choosing an alternative. The authors also discuss how and why reason based choice is more frequent among groups than individuals. Combining brokerage firm data with accounting and market data in a field study format, the authors find that the investment decisions of individuals, and especially investment clubs, appear to be driven by an emphasis on past performance related "reasons." In particular, they find that investment choices are associated with investment in stocks of companies that have been previously identified as "most admired." The most admired companies were identified from Fortune's Survey of most admired firms or by superior past rates of return or earnings growth. In either case, additional analysis indicated that investing on the basis of a good reason (in this case, admiration) did not yield superior future financial performance.