

THE ENGINE OF CAPITALISM

The planning fallacy is only one of the manifestations of a pervasive optimistic bias. Most of us view the world as more benign than it really is, our own attributes as more favorable than they truly are, and the goals we adopt as more achievable than they are likely to be. We also tend to exaggerate our ability to forecast the future, which fosters optimistic overconfidence. In terms of its consequences for decisions, the optimistic bias may well be the most significant of the cognitive biases. Because optimistic bias can be both a blessing and a risk, you should be both happy and wary if you are temperamentally optimistic.

OPTIMISTS

Optimism is normal, but some fortunate people are more optimistic than the rest of us. If you are genetically endowed with an optimistic bias, you hardly need to be told that you are a lucky person—you already feel fortunate. An optimistic attitude is largely inherited, and it is part of a general disposition for well-being, which may also include a preference for seeing the bright side of everything. If you were allowed one wish for your child, seriously consider wishing him or her optimism. Optimists are normally cheerful and happy, and therefore popular; they are resilient in adapting to failures and hardships, their chances of clinical depression are reduced, their immune system is stronger, they take better care of their health, they feel healthier than others and are in fact likely to live longer. A study of people who exaggerate their expected life span beyond actuarial predictions showed that they work longer hours, are more optimistic about their future income,

are more likely to remarry after divorce (the classic “triumph of hope over experience”), and are more prone to bet on individual stocks. Of course, the blessings of optimism are offered only to individuals who are only mildly biased and who are able to “accentuate the positive” without losing track of reality.

Optimistic individuals play a disproportionate role in shaping our lives. Their decisions make a difference; they are the inventors, the entrepreneurs, the political and military leaders—not average people. They got to where they are by seeking challenges and taking risks. They are talented and they have been lucky, almost certainly luckier than they acknowledge. They are probably optimistic by temperament; a survey of founders of small businesses concluded that entrepreneurs are more sanguine than midlevel managers about life in general. Their experiences of success have confirmed their faith in their judgment and in their ability to control events. Their self-confidence is reinforced by the admiration of others. This reasoning leads to a hypothesis: the people who have the greatest influence on the lives of others are likely to be optimistic and overconfident, and to take more risks than they realize.

The evidence suggests that an optimistic bias plays a role—sometimes the dominant role—whenever individuals or institutions voluntarily take on significant risks. More often than not, risk takers underestimate the odds they face, and do invest sufficient effort to find out what the odds are. Because they misread the risks, optimistic entrepreneurs often believe they are prudent, even when they are not. Their confidence in their future success sustains a positive mood that helps them obtain resources from others, raise the morale of their employees, and enhance their prospects of prevailing. When action is needed, optimism, even of the mildly delusional variety, may be a good thing.

The chances that a small business will survive for five years in the United States are about 35%. But the individuals who open such businesses do not believe that the statistics apply to them. A survey found that American entrepreneurs tend to believe they are in a promising line of business: their average estimate of the chances of success for “any business like yours” was 60%—almost double the true value. The bias was more glaring when people assessed the odds of their own venture. Fully 81% of the entrepreneurs put their personal odds of success at 7 out of 10 or higher, and 33% said their chance of failing was zero.

The direction of the bias is not surprising. If you interviewed someone who recently opened an Italian restaurant, you would not expect her to have underestimated her prospects for success or to have a poor view of her ability as a restaurateur. But you must wonder: Would she still have invested money and time if she had made a reasonable effort to learn the odds—or, if she did learn the odds (60% of new restaurants are out of business after three years), paid attention to them? The idea of adopting the outside view probably didn’t occur to her.

One of the benefits of an optimistic temperament is that it encourages persistence in the face of obstacles. But persistence can be costly. An impressive series of studies by Thomas Åstebro sheds light on what happens when optimists receive bad news. He drew his data from a Canadian organization—the Inventor’s Assistance Program—which collects a small fee to provide inventors with an objective assessment of the commercial prospects of their idea. The evaluations rely on careful ratings of each invention on 37 criteria, including need for the product, cost of production, and estimated trend of demand. The analysts summarize their ratings by a letter grade, where D and E predict failure—a prediction made for over 70% of the inventions they review. The forecasts of failure are remarkably accurate: only 5 of 411 projects that were given the lowest grade reached commercialization, and none was successful.

Discouraging news led about half of the inventors to quit after receiving a grade that unequivocally predicted failure. However, 47% of them continued development efforts even after being told

that their project was hopeless, and on average these persistent (or obstinate) individuals doubled their initial losses before giving up. Significantly, persistence after discouraging advice was relatively common among inventors who had a high score on a personality measure of optimism—on which inventors generally scored higher than the general population. Overall, the return on private invention was small, “lower than the return on private equity and on high-risk securities.” More generally, the financial benefits of self-employment are mediocre: given the same qualifications, people achieve higher average returns by selling their skills to employers than by setting out on their own. The evidence suggests that optimism is widespread, stubborn, and costly.

Psychologists have confirmed that most people genuinely believe that they are superior to most others on most desirable traits—they are willing to bet small amounts of money on these beliefs in the laboratory. In the market, of course, beliefs in one’s superiority have significant consequences. Leaders of large businesses sometimes make huge bets in expensive mergers and acquisitions, acting on the mistaken belief that they can manage the assets of another company better than its current owners do. The stock market commonly responds by downgrading the value of the acquiring firm, because experience has shown that efforts to integrate large firms fail more often than they succeed. The misguided acquisitions have been explained by a “hubris hypothesis”: the executives of the acquiring firm are simply less competent than they think they are.

The economists Ulrike Malmendier and Geoffrey Tate identified optimistic CEOs by the amount of company stock that they owned personally and observed that highly optimistic leaders took excessive risks. They assumed debt rather than issue equity and were more likely than others to “overpay for target companies and undertake value-destroying mergers.” Remarkably, the stock of the acquiring company suffered substantially more in mergers if the CEO was overly optimistic by the authors’ measure. The stock market is apparently able to identify overconfident CEOs. This observation exonerates the CEOs from one accusation even as it convicts them of another: the leaders of enterprises who make