

OVERREACTION AND OPTIMISM

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OVERREACTION

- Overreaction is reacting in an overly emotional and forceful way. It shows that the reaction is much more than what is expected and necessary. Overreaction is very much related to stock market behaviour of investor in the market.
- The theory of Overreaction Hypothesis states that people overreact to both good and bad news.
- Investors regularly overreact which leads pushing prices up too high or too low against their fundamentals. So, the markets are not fully rational.

UNDERREACTION

- Under reaction means when people react with lesser expected emotions due to past events that had occurred. They predict future with less reaction because of past events. In case of underreaction, security prices under-react to news such as earnings announcements or any other market or security related news.

RESEARCH REVIEW

- There is overreaction in the stock markets at the expense of long run trends in information relating to past earnings and security prices. Investors earn abnormal profit by taking long positions in undervalued stock and going short of overvalued stocks. Investors tend to overreact to unexpected news and do not follow bayes rule as per Kahneman and Teversky (1982).
- Overreaction effect explained by DeBondt and Thaler (1985) is as follows:

“If for once stock prices overshoot systematically then when they reverse, it should be predictable from the past return data only. There won't be use of any accounting data. Specifically, two hypotheses are suggested:

 - ▣ When Price moves in the opposite direction, it leads to extreme movement in stock price.
 - ▣ More extreme the initial price movement is, results in greater subsequent price movement.”

STRATEGIES TO OVERCOME OVERREACTION BIAS

- **Don't neglect the basics**
- **Understand your body reflexes**
- **Identify the clues**
- **Deep breathing**
- **Past emotions need to be resolved**
- **Know the difference between reacting and overreacting**
- **Learn to be aware of cognitive distortions**

OPTIMISM

- **Optimism** is a term originated from a Latin word *optimum*, which means “best”. Optimism is a positive mental attitude. An optimistic person is the one who expects the best possible outcome in all situations.
- Following are the determinants that lead a person to be optimistically biased:
 - ▣ Their desired end state.
 - ▣ Their cognitive mechanisms.
 - ▣ The information they have about themselves versus others.
 - ▣ Overall mood.

**CONCEPTS
RELATED TO
OPTIMISM**

Psychological Optimism

Dispositional Optimism

**Explanatory style of
Individuals**

**Environment affects
Optimism**

Associations with Health

Optimism and Well-being

PRACTICAL APPLICATIONS

- **Superior Health**
- **Leads to higher achievements**
- **Persistence**
- **Emotional Health**
- **Increased Longevity**
- **Low Stress**

IMPACT OF OPTIMISM BIAS

- The optimism bias can lead to poor decision-making as the optimists tend to look at only the bright side and ignore the dark side.
- Tali Sharot, author of *The Optimism Bias: A Tour of the Irrationally Positive Brain* who is a cognitive neuroscientist claims that many people suffer from this bias across cultures.
- According to Sharot, although optimism bias can lead to poor decision making and thus result in negative outcomes, it increases the chances of well-being as there is a sense of positive anticipation of future outcomes.
- Optimism helps people to follow their goals no matter what.

FACTORS

PROMOTING OPTIMISM BIAS

- Rare events allow individuals to make optimistic opinion about them. As people assume they will not be affected by it like hurricanes, floods, earthquakes.

DISCOURAGING OPTIMISM BIAS

- The factors which reduces optimism bias include when comparison group is kept closer to individual, it is seen that likelihood of event occurring to the person and his friends had no difference, so thus it reduces optimism bias in the individual.

OPTIMISM IN DAILY LIFE

- When you phone rings and you assume it to have a good news.
- One gets less marks in test, but promises oneself to perform better in the next one.
- When your meeting gets cancelled and optimistic person enjoyed that time.
- Optimistic person even after getting paralysis waist down, identifies that he can use his hands for many things.

INVESTMENT STRATEGIES TO MANAGE OPTIMISM BIAS

- ***“Live below your means, and save regularly.”***
- ***“Asset allocation is the key to a successful portfolio.”***
- ***“Compounding contributes significantly to long-term financial success.”***
- ***“Encourage the use of a financial advisor.”***

Thank You

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HERDING BEHAVIOR AND MEAN REVERSAL

Continued...