Think Positive for Higher Profits

For managers, over-optimism can boost firms' profitability and market value and improve company welfare.

Hubris has had many casualties. Underestimated risks characterised the falls of Wall Street banks Bear Stearns and Lehman Brothers. Overconfidence in the highly leveraged game of musical chairs came crashing down when the music stopped in 2007 and 2008. The bubble had grown on the back of the swashbuckling confidence being exhibited by the titans of banking. It didn't end well. But where overconfidence failed those leaders, over-optimism may have a brighter ending.

In his recent paper The Bright Side of Managerial Over-Optimism, Gilles Hilary, INSEAD Associate Professor of Accounting and Control argues it can improve firms' future performance, providing a financial as well as an emotional lift.

Over-Optimism vs. Overconfidence

However, we can start to make claims for over-optimism only after distinguishing it from overconfidence, which researchers have linked to negative outcomes for companies. The difference lies, Hilary says, in the specific miscalculations of each: Overconfidence errs by underestimating the risks of business decisions, while over-optimism is a bias towards larger growth projections than the numbers appear to warrant. "There's a lot of research on overconfidence, less on over-optimism," Hilary told INSEAD Knowledge in an interview.

Hilary and his co-authors (Charles Hsu and Benjamin Segal) isolated and measured over-optimism by comparing major North American companies' quarterly earnings forecasts against their eventual performance as well as analysts' predictions. The researchers also tallied up the occurrences of optimistic language in company press releases. The results found a consistent correlation between beamish forecasts and better-than-expected performance, suggesting optimism stemming from recent successes exerted an upward pull on companies' earnings.

Hilary sees this phenomenon not as a psychological quirk of the managerial personality type but as a predictable product of the business environment. "Suppose you want to start a new plant, and it's based on a new technology. If the technology works, great, then your payoff is a function of the size of your factory – if it doesn't work out, you get zero. The more optimistic you are about the success, the more you invest, and therefore you may get a better result at the end."

It's a principle familiar from auctions, where the most optimistic bidders – those with the highest estimation of the worth of an item on the block – will naturally prevail. The over-optimism principle even applies in Hilary's own sphere of academia, he says. "If you think your paper is more likely to be accepted, then you're going to spend more hours polishing the article."

Dynamic Over-Optimism

The study also shows managerial over-optimism can react dynamically, increasing with the duration and extent of past wins. "When people have been successful in the past, they become dynamically more optimistic. They work harder as a result, and the performance of the firm increases. If you don't suffer from over-optimism, your ultimate result is 10. If you suffer from optimism, you think it'll be 20, and you work hard and you get 15. That's still below 20, but it's more than the 10 you would have got without this bias," Hilary says.

However, it's this dynamic aspect that may be responsible for the eventual burnout Hilary encountered in the data. Generally, the positive effect attributable to over-optimism dwindled after about four quarters, he says. "You become optimistic because you're exceeding expectations, but as you do that you become increasingly optimistic, which means it becomes increasingly hard to exceed your own expectations. And so there's a negative feedback mechanism that makes it hard to sustain the over-optimism."

According to the paper, there are several other factors that can influence the scale and impact of over-optimism. In general, managers tend toward a greater optimism bias in the absence of a good reason not to. But experience has a dampening effect: Used to riding out the ups and downs of the business cycle, CEOs with more quarterly forecasts under their belt tend to make less optimistic projections.

One factor that may not affect over-optimism, Hilary says, is whether a company is public or private. The paper covers only public companies, because their greater reporting obligations made them easily trackable. However, according to Hilary, "if you have to report to anybody, say your board, the same mechanism could be at play. There's no obvious reason it wouldn't work with internal reporting."

Reining It In

Though over-optimism may provide a temporary earnings boost, there's always the danger that if left unchecked, managers could go too far. Researchers are currently looking into how companies may be able to tamp managerial enthusiasm using incentives. One possible way, Hilary suggests, is by writing clauses into contracts designed to discourage forecasts that deviate too greatly from the maths.

And even the more volatile mindset of overconfidence may be turned to companies' advantage, albeit with a certain cynicism. "You can compensate employees less for being overconfident. Set ambitious targets tied to incentives, and if [employees] are overconfident [they'll] work like a dog to reach that objective, and at the end [they] don't get paid."

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