

By Dennis Jacobe and David W. Moore

Cutting Through the Noise

The UBS Index of Investor Optimism

The world is full of financial information. The preponderance tends to create a kind of white noise, however, that obscures the facts that best describe the way the economy really functions.

During the mid-1990s, it became obvious that the number of US investors was growing rapidly. It also seemed apparent that the impact of investors as a group on the performance of the economy was increasing along with their numbers. Despite these trends, no effort was being made to measure and monitor investor opinions and perceptions of the economy systematically—a deficiency in sharp contrast to the many well-established efforts to measure and monitor general consumer opinions.

In 1996, UBS and Gallup formed a partnership to correct this situation. The idea was to create a new instrument that would systematically track investor perceptions of the economy, based on the theory that investors, not the public at large, move markets. In October 1996, a baseline study was done, and the first results of the new *Index of Investor Optimism* were reported to the public.

For the *UBS Index*, an investor is defined as a male or female head of household with investments

totaling \$10,000 or more. In 1996, about one in three households qualified as investors based on this definition. By 2003, the proportion had increased to about 40%.

Average investors—those having between \$10,000 and \$100,000 of investable assets—account for about two-thirds of all investors. That is, about one in four American households (two-thirds of the 40% who qualify as investors) is an average investor. Households having investments of \$100,000 or more are classified as substantial investors. They account for about one-third of all investors and about one in seven American households.

Gallup interviews a random sample of 1,000 US investors during the first two weeks of every month, and the results are reported on the last Monday of the month. The survey methodology is the same as that used for the Gallup Poll.

Seven questions are used to construct the *Index of Investor Optimism*. Each asks respondents to indicate whether they are very or somewhat optimistic, very or somewhat pessimistic, or neither optimistic nor pessimistic about each of the items.

The questions are designed to measure two dimensions of optimism. The *personal dimension* includes the following three questions:

- Overall, how optimistic or pessimistic are you that you will be able to achieve

your investment targets over the next 12 months?

- Overall, how optimistic or pessimistic are you that you will be able to achieve your investment goals over the next five years?

- How would you rate your ability to maintain or increase your current income over the next twelve months?

The *economic dimension* is based on the following four questions:

I would like to ask you to think about factors that could affect the overall investment environment over the next 12 months... [A]s far as the general condition of the economy is concerned, how would you rate...

- Economic growth?
- The unemployment rate?
- Performance of the stock market?
- Inflation?

Index scores are calculated for each dimension and then summed to produce the overall *Index*. Responses to each question are assigned scores on a scale from +2 to -2, going from very optimistic to very pessimistic. A zero is assigned to the middle value and to don't know responses.

For example, a person who is very optimistic on the first question of the personal dimension, somewhat opti-

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mistic on the second question, and somewhat pessimistic on the third question would have a total score on that dimension of 2 ($2+1-1=2$). That would be divided by 3 (three questions), and then multiplied by 100 (to make the reporting easier). So that person would have a personal dimension score of 67.

The same procedure is used for the economic dimension. If the same respondent answered somewhat optimistic to the first question, neutral for the second question, somewhat pessimistic for the third question and somewhat pessimistic for the fourth question, that person's total score on the economic dimension would be -1 ($1+0-1-1=-1$). Divided by 4, because of the four questions, and multiplied by 100, the average economic dimension score would be -25.

The *Index of Investor Optimism* is based on the sum of the individual's personal and economic dimension scores. For the hypothetical investor described above, the final score would be 42 ($67-25=42$). Negative scores generally mean that there is net pessimism, while positive scores

indicate net optimism (giving greater weight to the "very" than to the "somewhat" responses, however).

This calculation differs in concept from the major measures of consumer confidence or sentiment. Those measures subtract the percentage of people who give a negative score from the percentage who give a positive score, so there is no score for each individual.

The advantage to the calculation used by the *Index of Investor Optimism* is that it allows for a multivariate examination of the individual factors associated with investors' feelings of optimism and pessimism, such as age, gender, type of investor, experience, amount of assets and income.

In his recent appraisal of its performance over its five-year history, Nobel Laureate economist Dr. Lawrence Klein compared the UBS *Index of Investor Optimism* to three major survey-based economic indicators—the Survey of Consumer Sentiment by the Institute for Social Research of the University of Michigan, the Survey of Consumer Confidence by the Conference Board, and the Na-

tional Association of Purchasing Management survey.

According to Klein and co-author Dr. Suleyman Ozmucur, the *Index* is "as least as good as and probably better, in terms of accuracy, than the competing indices, judging from its degree of correlation with key economic magnitudes such as consumer spending, personal income, industrial production, employment, and stock market averages."

A common problem with financial data is that the more accurate it is, the later it has arrived. The *Index*, according to Klein, "has excellent timeliness, in being available early each month for use in prediction of target variables with outstanding accuracy."

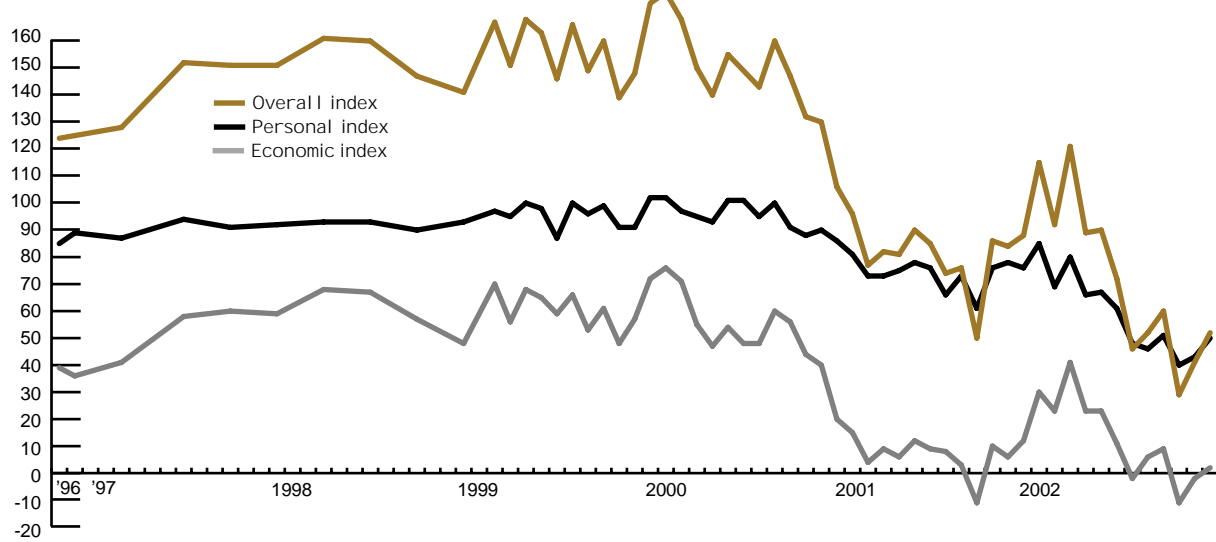
Klein found that, of all the surveys, the *Index* is reliable for "quantitative information from a strategic universe that has the potential for enlarging the information content of existing economic surveys." These are encouraging words for people who live and work in a "strategic universe." It's also financial music in a world of economic white noise.



Economic Signposts

The UBS/Gallup Index of Investor Optimism, October 1996 to December 2002

Figure 1
Investor Optimism in Steady Decline



Source: Surveys by UBS/Gallup, latest that of December 2002.

The baseline for the overall *Index of Investor Optimism* was established at 124 (the average individual score) in October 1996. Over the next several years, the *Index* established a generally upward trend, peaking in January 2000 (see Figure 1). With the exception of a 6-month rally after the low of 50 occasioned by the terrorist attacks of September 11, 2001, the *Index* has been in a generally steady decline ever since. It plunged to an all-time low of 29 in October 2002, before rising to 41 in November and 52 in December.

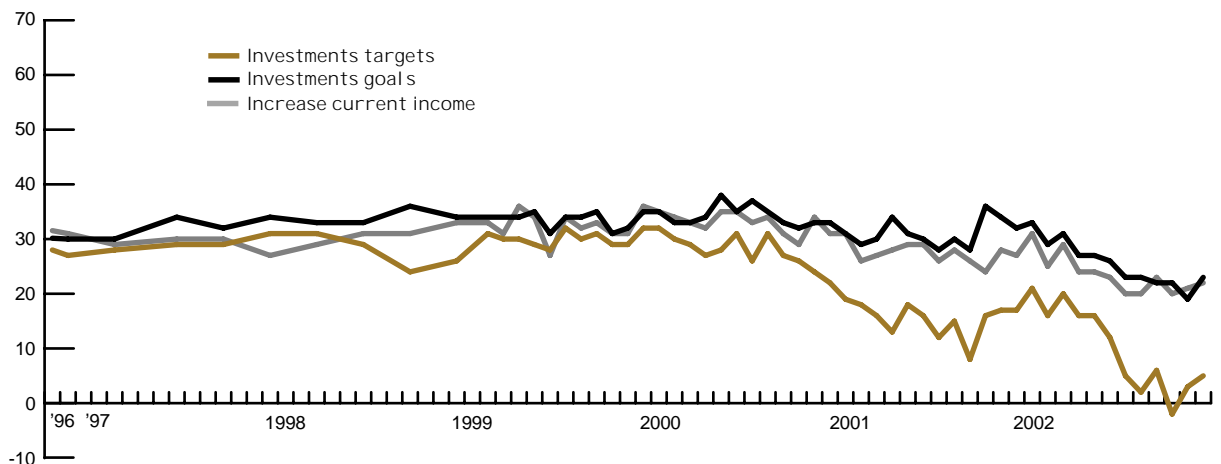
The increase in the *Index* in December was the result of increases along both its personal and economic dimensions, which had been in significant decline since March 2002. The personal dimension increased 7 points to 50 in December, placing it 10 points above its October low of 40.

By looking at the impact of each question on its dimension we can determine what drives the change in each month's personal dimension score (see Figure 2). For example, the December increase in the personal dimension was due mostly to an increase in investor optimism about their ability to make their long-term investment goals—up four points for the month.

Figure 2
Charting the Personal Dimension

Questions:

Overall, how optimistic or pessimistic are you that you will be able to achieve your investment targets over the next twelve months?
...your investment goals? How would you rate your ability to maintain or increase your current income over the next twelve months?



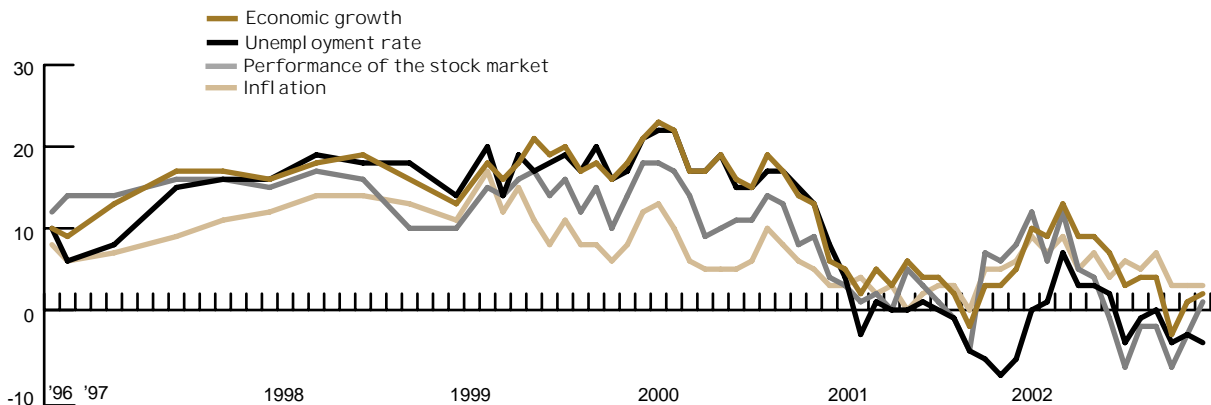
Source: Surveys by UBS/Gallup, latest that of December 2002.

The economic dimension increased 4 points to +2—slightly better than in November, but still suggesting that investors as a group remain essentially neutral about the prospects for the economy over the next 12 months (see Figure 3). The increase in the economic dimension was due mostly to an increase in optimism about the stock market, which was up four points.

Figure 3
Charting the Economic Dimension

Questions:

Now, I would like to ask you to think about the factors that could affect the overall investment environment over the next twelve months. ...[A]s far as the general condition of the economy is concerned, how would you rate... over the next twelve months?



Source: Surveys by UBS/Gallup, latest that of December 2002.

Each month, the UBS/Gallup *Index of Investor Optimism* survey includes additional questions concerning the investment environment. In December 2002, two out of three investors told Gallup that the issue of questionable accounting practices in business was still hurting the US investment climate a lot. This was down only 4 percentage points from September, when 70% of investors said questionable accounting was hurting the investment climate a lot. In fact, more investors said they were worried about accounting issues in December 2002 than did so in July when 60% of investors said this problem was hurting a lot.

The poll also found that 89% of investors thought these issues were hurting the investment climate a lot or a little—virtually the same as September’s 90% and July’s 91%. This combined measure was also higher than the 84% of May and the 81% of March.

One out of three investors said that the issue of conflicts of interest between Wall Street firms’ research departments and investment banks was hurting the current investment climate a lot. This was down a little from September’s 36% and July’s 42%, but essentially the same as the percentage of investors who were worried about corporate earnings (34%) and general economic conditions (31%). It was higher than the percentage of investors worried about such conflicts of interest in May (28%).

Other issues cited by more than one out of three investors as hurting the US investment climate a lot included corporate earnings (34%), talk about a possible US attack on Iraq (37%), and the threat of more terrorist attacks (47%).

The UBS web site can be reached at www.ubs.com/e/index/about/research/indexofinvestoroptimism.html

The Roper Center data information can be reached at www.ropercenter.uconn.edu/ubs.html