E Q U I T I E S

Do Financial Markets Reward Buying or Selling Insurance and Lottery Tickets?

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Investors, like almost everyone else, dislike catastrophic negative surprises and love unexpected windfalls. That is why so many of them employ insurance-like investment strategies or embrace lottery-like gambles.

It is a tale of two tails: the left tail of negative surprises and the right tail of positive surprises. Some investors seek to protect themselves from the left tail by employing insurance-like strategies like put sales or currency carry trades. Others gravitate toward lottery-like gambles, such as buying IPOs or overweighting small-cap growth stocks.

As logical as this may appear to some investors, a review of financial-research literature suggests that both of these strategies tend to lose money in the long run unless managers are exceptionally skilled in active timing and selection. At the same time, there is evidence that the contrary — selling financial-catastrophe insurance or assets with lottery-like payoffs — has tended to be profitable over the long run.

In short, selling financial investments with insurance or lottery characteristics should earn positive long-run premiums if investors like positive skewness enough to overpay for these characteristics. The empirical evidence is unambiguous: Selling insurance and selling lottery tickets have delivered positive long-run rewards in a wide range of investment contexts. Conversely, buying financial catastrophe insurance and holding speculative lottery-like investments have delivered poor long-run rewards. Thus, bearing small risks is often well rewarded, bearing large risks is not.

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