BIAS, PERSONALITY AND RISK-TAKING DECISIONS

Matthew Leitch investigates how underlying and subconscious factors affect the level of risk people are prepared to take in corporate decision-making

Why do some people take crazy risks while others are too cautious? Why are we more cautious some days than others? When we make risk-taking decisions, which factors should we take into consideration and which are the irrelevant causes of bias? And what can financial managers do to improve risk-taking decisions?

Let's consider some factors that are clearly irrelevant biases and gradually move on to factors that are relevant factors that should be thought about carefully.

MACHO MANAGEMENT

A surprisingly large amount of scientific research has been done to study the links between testosterone (in men and women), power and risk-taking. For example, if an influential male executive, about to go into an important meeting, is reminded of a time when he was particularly powerful and successful, gets a nice smile from an attractive woman, and then sits down in the meeting on a wide, comfortable chair, the scene is set for some bold, perhaps reckless, perhaps unethical decisions.

All three of those cues - the reminder, the attractive smile, and the chair - have been shown to lead to measurable changes in testosterone, feelings of power, and risk-taking driven by optimism. Who knows what else could have a similar effect? What about an argument, an impressive office building, or a history of life experiences leading to a sense of personal invincibility? Is it any wonder that major banks occasionally gamble themselves into oblivion?

These factors can influence decision-making but they should not.

Unfortunately, there is less research on how to avoid these particular biases. A sense of the responsibility that comes with power seems to be helpful, and so is being aware of possible biases.

NARCISSISM

Personality features can cause bias too. Narcissism is a tendency to think ourselves better than we really are, and to do things to maintain that overly positive self-image. In tests of general knowledge most people are overconfident, but narcissists (so-called "normal narcissists", not people with Narcissistic Personality Disorder) proved the most overconfident and did worse on a task that involved gambling on their knowledge.

TEMPORARY DEBILITATION

While few of us would admit to narcissism (especially narcissists), most of us would admit to occasionally feeling tired, hungry, dehydrated, sleep deprived, and to drinking alcohol. All these affect our risk-taking decisions, usually causing us to be more cautious and to shy away from difficult, complicated decisions that involve a change from the status quo. You might imagine that alcohol would increase risk taking, but in fact it reduces it, at least for moderate doses we are aware of.

When things are going badly we are most at risk of carrying on with the actions that got us into a mess in the first place.

PERSONAL INTERESTS AND RISK TAKING

Suppose your chief executive is married to a billionaire and has no financial worries at all. However, she does want to be famous and so prefers bold, eye-catching strategies. She's not put off by the possibility of large losses for the company because she herself has no financial worries or stake. Clearly, if her personal interests are allowed to influence decision-making then this could lead to strategies that are too risky for most stakeholders.

Does it make any difference if she says that the strategies are within her "risk appetite"? No, because her job is to take into consideration the legitimate interests of all stakeholders, not just her own.

Conversely, suppose all your non-executive directors are established and successful, and so feel they have no need to improve their reputations, but don't want to ruin the last decade of their careers with a high-profile failure. Should their personal preference for low-risk

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strategies be allowed to influence decisions made on behalf of the company? Again the answer should be "no".

RISK ATTITUDE

If persistent individual differences between people in their attitude towards risk itself existed then these would also be unwanted individual biases. Fortunately, such individual differences may not exist at all and, if they do, they may be so weak that we have little to worry about.

Each year I teach on a masters course in risk management at the University of Southampton and one of my challenges is to help the students overcome misconceptions and confusions about the idea of risk attitude. I begin by teaching them to say "risk averse" not "risk adverse". After that things get more subtle.

The phrase "risk averse" is used in at least two completely different senses. Obviously, it can mean an aversion to the possibility of a bad outcome. If we are averse to an outcome then we are also averse to the possibility of that outcome. This is true even for people who love to gamble or take part in dangerous sports. They may enjoy the adrenaline rush but the gamblers would still prefer a system that guaranteed winning and the skydivers still take safety precautions. Their desire for the adrenaline rush outweighs their aversion to the potential bad outcomes.

Unfortunately, "risk averse" is also used to mean a tendency to see monetary losses as more important than gains of the same monetary amount. This is more of an aversion to a spread in results than to bad outcomes. Writers almost never distinguish between these two uses of the phrase so it is hardly surprising that people get confused.

Another crucial distinction not made often enough is between attitudes to risky behaviours and attitudes to risk itself. Almost all surveys described as measuring risk attitude actually just ask about risky behaviours and people do those behaviours for many reasons, including their perceptions of the potential consequences.

Most students begin the course thinking there is evidence that people differ in their inherent attitude towards risk and that these differences are large and account for differences in behaviour. In fact, separating out the effect of true risk attitude, if it exists, from all the other factors that drive our behaviour is probably impossible. Alternative measures of risk attitude do sometimes correlate

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but not very well. Apparent risk attitude in different situations sometimes correlates but, again, not very well. It is usually much easier to explain differences in behaviour by differences in perceived consequences.

EXPLORING OBJECTIVE CIRCUMSTANCES

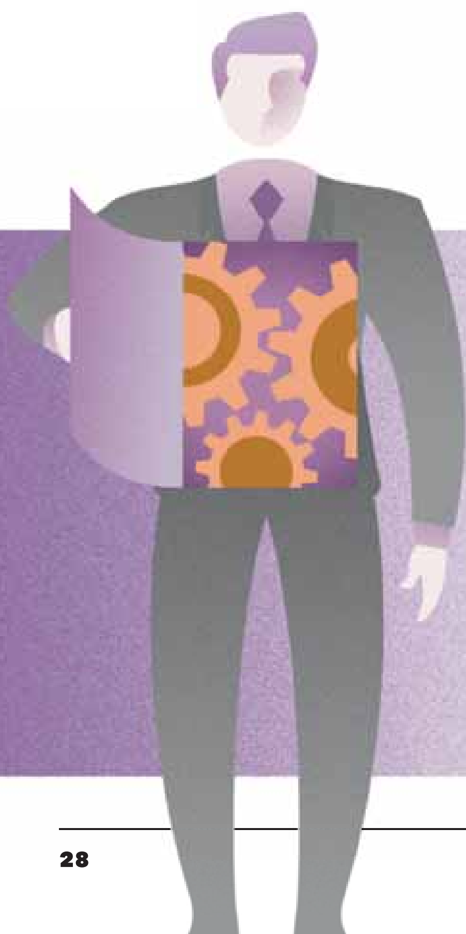
Having surveyed some factors that should not influence our risk-taking decisions for an organisation (though of course they often do) it is time to survey the legitimate considerations.

What might be the consequences of each alternative course of action in the decision? For a large, risky decision this is much more than just making a best estimate of the direct financial consequences reduced to a net present value.

What alternative outcomes are possible and how would we stand financially at different points in time bearing in mind our financial reserves and the possible results of other activities? What if the predicted results occurred, but not at the predicted times? Could we face insolvency or breach limits on borrowing? What might be the implications for other investments we need to make?

We need to consider factors such as the predictability of cash from other activities, the amount of information, flexibility, and control we have, and how quickly problems could emerge - even if they are too complicated to model quantitatively.

A financial manager helping colleagues with risky decisions can provide valuable reminders of these key factors in a decision, can explore and quantify the direct and indirect consequences of alternatives, and can provide helpful information about the future context of predicted results.



DIFFERENT STAKEHOLDERS

In many decisions the various stakeholders will experience different consequences so it may be helpful to consider the future from their various perspectives. Even if you believe that, for example, a company's only legitimate stakeholders are its shareholders, it may still be helpful to understand the implications for employees, customers, and suppliers because their reactions will indirectly affect shareholders.

It may also be important to consider how consequences will be distributed. Making decisions using only averages is dangerous. For example, if employees are to be paid more on average but a quarter of them are to be paid less, that quarter may create strong resistance.

RELEVANT PERSONAL FACTORS

Personal factors are not always irrelevant. Imagine that your chief executive has risen through the ranks of a large company that somehow avoided major trauma. He struggles to cope with incomplete information, shocking news, and stress. He likes plans that are complicated, rigid, and based on far too many assumptions. Should these facts influence risk-taking decisions?

Well, if he is set to remain your chief executive then they should. Personal performance under pressure affects how he is likely to perform and makes a risky plan that much riskier.

Conversely, a top team with directly relevant specialist knowledge is better equipped to take on a risky plan that others should reject.

CONCLUSION

Some personal factors are relevant considerations in a good decision, but many are just sources of bias that should be managed as best we can. With multiple stakeholders involved, decision-makers in organisations cannot just do what suits them personally.

The secret of good risk-taking decisions is not to look inwards and explore your feelings; it is to look outward and forwards to understand what the future might bring and how outcomes of decisions will look in circumstances we might face in future. ●