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Help Investors Make Better Risk/Reward Decisions

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Worldwide, we humans share a curious, common, and overlooked propensity to automatically perceive many risks as greater or less than they actually are. These deep-rooted risk misperceptions make it easy to unknowingly set ourselves up for misjudgments, lost opportunities, and unpleasant surprises, particularly when investing.

Without realizing it, these and other ingrained perception errors can cause us to undermine our own best interests. The results of many of these investor misperceptions of risk are already familiar, as well as frustrating, to financial planning professionals. However, their root cause is so deeply imbedded in our behavior, they can be hard to identify.

Here are just a few examples of risk misperceptions financial planners and their clients routinely deal with (sometimes experiencing all four within a single 24-hour period) and where psychologists have proven that we humans perceive the risks as much greater than they actually are— situations that are: large scale in their consequences; beyond our perceived control or influence; new, unfamiliar, or not understood; and/or not expected or occur suddenly.

Behavioral scientists have documented that these and other universal misperceptions of risk occur all over the world, throughout all cultures, age levels, and among both men and women. The study of this phenomenon has developed into the behavioral science field of risk perception.

Because perceiving risk accurately is the foundation of risk assessment, effective risk/reward decision making, and successfully managing risk, every planner should hone his or her skills for understanding this misperception phenomenon and addressing it effectively with clients.

A deeper understanding of risk misperceptions will help all of us make more informed and more sound risk/reward decisions.

Key Factors Affecting Our Risk Perceptions

The following key factors affecting our perception of risk[1] provide the foundation for understanding, addressing, correcting, and then neutralizing the impact of many common misperceptions of risk.

Trust: The more we trust, the less afraid we'll be. The less we trust, the greater our fears.

Four potential sources of trust are: the communications informing us about risks; the process for deciding if we'll be exposed to a risk and how to deal with it if we are; our confidence in the institution, company, or person exposing us to the risks; and our familiarity, understanding, and advance preparation for the risks.

Keys to building trust include:

- Openness, transparency, and disclosure of risks
- Competence and experience
- Sincere dialogue, starting with respect for and validation of investors' emotions (exhibit caring and empathy)
- Not just talking, but demonstrating actions that are in clients' best interests (for example, review with clients the benefits, risks, and appropriate risk management initiatives of investment recommendations, allowing them to make fully informed risk/reward decisions)
- Reducing negative surprises by helping investors identify, understand, prioritize, and prepare for possible risks in advance

Risk versus benefit: The more we perceive a benefit from any choice, the less fearful we are of the risks that choice may involve. Millions of people live in the southeastern United States, directly in the paths of devastating hurricanes because they like the climate more than they fear hurricanes.

Control: If you feel you can control the outcome of a hazard, you are less likely to be afraid. This can either be actual physical control as when you're driving and controlling the vehicle, or a feeling of control of a process that addresses risks, as when you feel you are able to participate in risk management policy-making and/or implementation.

Choice: This is different from the risk when we directly face a threat. The point here is whether we choose to take the risk in the first place, or if the risk is imposed on us involuntarily. We are much more afraid of a risk when it is imposed on us than when we choose to expose ourselves to that risk. We interpret the risks of skydiving, scuba diving, or rock climbing very differently from learning we have cancer.

Natural versus man-made: We are less afraid of natural risks and usually more afraid of man-made risks. Like being more fearful of radiation from microwave ovens and high-voltage electrical lines than the documented risk of sun exposure causing melanoma.

Horror: The worse the outcome (horror) from a risk, the more afraid we are of it. Like being crushed to death, pulled into a wood chipper, or decapitated, and less afraid of the leading cause of death in the United States—heart disease.

Catastrophic versus chronic: We tend to be more afraid of things that can harm or kill a lot of us, in one place at a time, than chronic risks that may cause as much or more damage but are spread out over space and/or time. Like 9/11, the Japanese tsunami of 2011, the BP oil spill, or devastating earthquakes versus pollution; also temporary, gut-wrenching drops in the investment markets versus monetary inflation.

Uncertainty: The greater the uncertainty about a risk, the greater our fear is likely to be. Uncertainty can exist because we don't have all the facts, or we have them but don't understand them. Things that can't be seen are uncertain by their very nature and generate greater risk perception and fear. Examples include being more afraid during and just after a major stock market drop or economic contraction when the risks actually have been squeezed out of the system, and being less afraid when we think we know more, like following a long series of stock market advances and strong economic news when the risk of a reversal is often higher and overlooked.

Me versus them: A risk seems bigger, the facts notwithstanding, if we think it can happen to us. It doesn't matter if a risk is one in a million if we think we may be that one.

New versus familiar: When we first encounter a risk and don't know much about it, we are much more afraid. After we've lived with a risk for a while, familiarity, experience, and time reduce our fear, even though the risk is still there. Consider the 1950s bomb shelter mania in reaction to the (then) new risk of nuclear war. Even though today's worldwide nuclear bomb destructive capacity dwarfs that of the 1950s, we are much less anxious about the threat, because we've lived with it so long.

Children: We fear risks to children more than we fear risks to adults.

Personalization: A risk made personally real by a person or victim we know is more frightening and perceived as greater than one that is statistically real, but only hypothetical in our mind.

Fairness/morality: We are more upset by risks to the poor, the weak, or the vulnerable, than we are about the same risks to workers, the wealthy, or the powerful. We're more upset by risks when those who suffer the peril get none of the benefits.

Awareness: The more aware of a risk we are, the more concern it raises. Awareness is often generated by the media, but it also can arise through personal, social, or other interpersonal contact. Like being less afraid of terrorist risk before 9/11 and more afraid after 9/11.

Addressing Client Misperceptions of Risk

By reading this you've already taken the first step in correcting these common risk misperceptions by identifying, understanding, and becoming familiar with them.

Next, take every opportunity to educate your prospective and existing clients regarding the importance of learning about and addressing these common risk perception pitfalls, implementing initiatives to do so in your practice. You may want to consider using a risk perception pitfall checklist with clients to help them identify and avoid these traps in their ongoing financial decision making.

Over time, your efforts to familiarize yourself and your clients with these risk perception traps will make it easier for you to remind clients of those traps if they fall victim to them. Your efforts will pay off even more when clients quickly recognize and neutralize the pitfalls you prepared them for, placing increased trust and confidence in you, and improving the likelihood of achieving their financial objectives.

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Endnote

1. The list of key risk perception factors is from the work of Paul Slovic of Decision Research and the University of Oregon, the work of author and risk consultant David Ropeik, and from the book *The Risk-Wise Investor: How to Better Understand and Manage Risk*, by Michael T. Carpenter, published by John Wiley & Sons Inc.