Why do we take risks?

To determine the psychological underpinnings of risk-taking, we first have to agree on a definition of risk. I will use it to mean «the probability and magnitude of loss, disaster or other undesirable event». Thus, it should come as no surprise that most people are risk averse (and not risk neutral), since most individuals do not want to endanger their life, their health or their money. Humans accept the risk that something bad can happen (such as losing money) if they believe that the probability that it will happen is low enough so that the expected outcome is worth the gamble.

Sensation seeking and impulsivity

Scientists have found empirical evidence that those who are high on sensation seeking or high on impulsivity generally take more risk than those who score low on these personality traits. Individuals high in sensation seeking like to experience strong emotions, and high risk can create strong emotions. In many cases, however, the risk-taking behaviour is not a general phenomena, but limited to specific domains (e. g. individuals may enjoy the thrill of physical risks and participate in increasingly dangerous sports, while remaining conservative in how they invest their money). Individuals high in impulsivity will act before they think or may have problems controlling their urges. They generally take higher risks because they focus on the reward and fail to consider the consequences. So far, research examining the influence of impulsivity on financial decision-making has consistently found it to be a liability. For example, in collaboration with the Toulouse School of Economics, we recently found that impulsive financial experts were less able to adapt their risk-taking behaviour to account for changing market conditions, thereby losing more money than non-impulsive experts.

Learning, experience and rewards

Most people will take risks in those areas in which they feel most comfortable and in domains in which they receive the greatest rewards. However, more risk should not be confused with better decisions. Research has repeatedly shown that experts can make both better and worse decisions than novices. On the positive side, experience leads to better choices concerning which factors to include in the risk analysis, a realistic estimate of the possible consequences, and therefore an appropriate level of risk – neither too conservative nor too risky. On the negative side, experience leads to overconfidence and a failure to consider new information in an ever-changing environment. This can lead to a false sense of security. Not surprisingly perhaps, experts often take higher risks because they do not perceive their behaviour or decision as risky.

Beware of the consequences

Finally, research has shown that people will take higher risks if they do not have to fear the consequences. For instance if they are insured, if the consequences of failure are less than the consequences of success, or if they are investing money that does not personally belong to them. In other words, if risk taking is rewarded with positive outcomes (such as higher salary, promotion, bigger office, prestige) and there are little or no consequences when the risk leads to failure, then managers, companies and even cultures will encourage more and more risk-taking at the expense of planning, analysis or stop loss. Enron is a useful case study to examine these phenomena in the real world.

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