The Feeling of Risk

By Paul Doggett

We know that people often say that they have a gut feeling about things. It might be a gut feeling about another person, about flying and of course about stocks, companies and investing. People ‘feel’ their way through life just as much as they ‘think’ and ‘act’ their way through it. Our feelings, our emotions, our psychology is always turned on and always interacting with the world around us.

This is important for traders and investors to know because as psychologists Paul Slovic tells us:

“….people base their judgments of an activity or a technology not only on what they think about it but also on how they feel about it. If their feelings toward an activity are favourable, they are moved toward judging the risks as low and the benefits as high, if their feelings toward it are unfavorable, they tend to judge the opposite- high risk and low benefit.”

- Paul Slovic, The Feeling of Risk 2010, page 26

So in our case, if we have favourable feelings about a company, we will judge the corresponding risk of putting money into that company as being low and the benefits of doing so as being high. Take a bellwether stock such as Woolworths (WOW). It was in a clear downtrend between May 2014 (where it peaked at $38.92) until the start of August 2016 when the downtrend was technically broken and the stock began moving sideways. At its low, WOW hit $20.30. That’s a 47.8% loss in value from the 2014 peak. How can we explain why some investors bought the stock at $35 or $30, or $28 or $25 during the downtrend?

We can explain it by using well documented psychological research.

Investors bought WOW between May 2014 and August 2016 as it lost value because they had a good feeling about the company. If we extrapolate Paul Slovic’s quote from above, we know that if an investor has a good feeling about the company, they will see the risk of investing in it as being low and the benefit (or payoff) as being high.

Woolworths (WOW) Weekly Chart

Woolworths is a well-known brand and it competes in a near duopoly in Australia, so maybe that is why investors feel good about it. You get the argument put forward all the time that people have to eat and seeing Woolworths sells food, it won’t go out of business. Ergo – good feeling for the stock abounds in investment circles and the inherent risks are perceived as low even though technically the risk associated with the downtrend during the period shown in the diagram above was high.

The flipside to this scenario occurs when our feelings towards a company are unfavourable. When this happens, we tend to judge the company as high risk with limited benefits. Take a company such as Whitehaven Coal (WHC). I would suggest that for some time prior to February 2016, WHC was widely regarded as unfavourable due to it being a coal company and perhaps also, because it is a smaller listed company. Yet between February 2016 and February 2017, the stock has run up from a low of 35 cents to an intra-day high of $3.35 – a nine-fold increase in value.

Whitehaven Coal (WHC) Weekly Chart

This is the sort of return we dream about in the market. But due to our unfavourable feelings towards the stock, we may shy away from investigating in it simply because our feelings, rather than any analysis, persuades us that the company is unfavourable and therefore, it also carries high risk.

By no fault of their own, most investors are ignorant of the range and extent that psychological quirks influence their investment decisions. Hopefully now you've read this article, there is at least one psychological factor that you will be more mindful of in the future.