Risk Management

To expect success is a model for failure.

"If you can't predict the future,
then you need a system that can handle breakdown"
– John Maynard Keynes.

Harvard Business Review had published a very well written article on the need to change the way we think about risk. Here are a few recommendations:

1. It's more effective to focus on the consequences – that is, to evaluate the possible impact of extreme events. Try to gauge how your company will be affected, compared with competitors, by dramatic changes in the environment.
2. Risk managers mistakenly use hindsight as foresight. Today's world doesn't resemble the past; both interdependencies and nonlinearities have increased. It causes winner-take-all effects that have severe consequences. Less than 0.25% of all the companies listed in the world represent around half the market capitalization.
3. Recommendations of the "don't" kind are usually more robust than "dos". A dollar not lost is a dollar earned - risk managers don't treat them equally. They place a greater emphasis on earning profits that they do on avoiding losses. In chess, grand masters focus on avoiding errors; rookies try to win.
4. Standard deviation – used extensively in finance as a measure of investment risk – shouldn't be used in risk management. Risk managers should avoid using methods and measures connected to standard deviation, such as regression models, R-squares, and betas. Anyone looking for a single number to represent risk is inviting disaster.
5. If you tell investors that, on average, they will lose all their money only every 30 years, they are more likely to invest than if you tell them they have a 3.3% chance of losing a certain amount each year. Providing a best-case scenario usually increases the appetite for risk. Always look for the different ways in which risk can be presented to ensure that you aren't being taken in by the framing or the math.
6. Most executives don't realize that optimization makes companies vulnerable to changes in the environment. Evolution has given us spare parts – we have two lungs two kidneys, for instance – that allow us to survive. In companies, redundancy consists of apparent inefficiency: idle capacities, unused parts, and money that isn't put to work.

Remember that the biggest risk lies within us: we overestimate our abilities and underestimate what can go wrong. Any corporation that doesn't recognized its Achilles' heel is fated to die because of it.

Source: *Harvard Business Review*, "The six mistakes executives make in Risk Management",by N. Taleb, New York University; D. Goldstein, London Business School; M. Spitznagel, Universa Investments.

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