Buying Into Risk

Investors love risk, managers dislike it. Risk provides an alternative to making money by the sweat of your brow. Putting money into a risky situation is what makes profit. For those who doubt this, take a look at the insurance industry – a business wholly devoted to the assessment and conversion of risk to financial premium. In Singapore alone, about 35,000 people (almost 2% of the workforce) are either wholly or partly employed in this industry. The assets of the industry in Singapore grew by more than 50% in the two years of the Asian financial crisis to S$31 billion. Over the last five years the annual growth rate has averaged 16%, reaching revenues of almost S$8 billion in 1998. There is a lot of money in risk.

The whole story of business is the story of investors putting their money into unknown, uncertain, unexplored territories, in order to multiply it severalfold. Investors need managers, because managers are trained to minimise risk. Having created the risky context for their money, their concern is now to make sure it is as well-protected as possible in its search for added value. Managers put systems into place, streamline processes, create risk-avoidance procedures, and steer the investor's money into safe harbour.

Managers need risk much as doctors need sickness – without it, they had better find something else to do. They don't like it, but it defines everything they do. Accountancy is about minimising the risk of loss of assets; decision-making skills are about minimising the risk of error; meetings and teams are partly about spreading responsibility for risk of failure; management information systems are about minimising the risk of unexpected and dangerous environmental factors.

Business is a kind of guerrilla warfare between the creation of risky environments by entrepreneurs, innovators, investors and competitors, and the minimisation or taming of that risk by managers. And it needs to be that way: risk pursuance is pure folly unless it is accompanied by risk avoidance.

Let's go back to the insurance industry. The key tool of any industry player in the business of risk is knowledge. No player will agree to translate risk into money unless they have an actuarial analysis into which this policy fits. Knowledge is the single most important factor in the management of risk – whether it was the possession of accurate maps and local guides for the Portuguese explorers of the 15th and 16th centuries, experience and judgement in military and political affairs for the colonial powers in the three hundred years of the East Indies trade, or research into time and motion studies for massive productivity growth in mass production manufacturing at the beginning of this century.

"The manager minimises risk and enhances safety in three key areas. She puts into place systems that protect against losses from failure, folly and fraud. All three systems use knowledge to provide against the negative impact of risk."

LOSS FROM		COUNTER MEASURES	KNOWLEDGE MODEL
Failure	The predicted value-adding situation fails to materialise. Managers get their predictions wrong, investments suffer.	Use of competitive intelligence, market research, economic and demographic data, research and development.	Explicit to Tacit, Tacit to Tacit - experience and judgement formed by by data, information and knowledge to make predictions.
Folly	The predicted value-adding situation materialises but the execution of the company's positioning is flawed, through poor systems, communication or employee preparation/competency. The company is not poritioned to capture value from the new situation, even though it had been anticipated.	Skills and competency development in project management, leadership, communication, ITC infrastructure development, systems and workflow design.	Tacit to Tacit - involving judgements about adequacy of competencies and expertise, and transfer where necessary.

Fraud	The movement of money and assets is subject to criminal or malicious diversion.	Robust accounting and audit procedures, delegate financial responsibilities, separate ordering from payment responsibilities.	Explicit to Explicit - in implementing public, transparent systems. Transfer of best practice models.
	Using Knowledge to Counter Risk		Source: Patrick Lambe

Even a cursory examination of the knowledge models designed to minimise risk suggest immediately the differences between the mature organisation (which has most if not all of these models and structures) and the entrepreneur (who probably has few of them). It brings home immediately a key fact. The avoidance of risk itself invokes heavy costs. The mature organisation spends a great deal of money on infrastructure, checking, doubling up on procedures, documenting, security, and decision-making. It is, consequently, slow and unwieldy. Every decision that moves money has to go through several heads and processes, contrasted with the entrepreneurial small enterprise which is nimble, moves resources quickly and effectively, but has a higher risk exposure, and will fail more often in what it does.

This presents us with an apparent paradox: both the avoidance and the pursuance of risk impose costs – either through the systems and time invested in risk avoidance, or in the higher percentage of failures associated with riskier activity.

Why does the large mature enterprise spend to avoid risk, while the small entrepreneur spends to pursue risk? The answer probably lies in the association of success with brand strength. The possession of a strong brand reputation is more likely to warrant investment in risk avoidance. In relation to the value of the brand and the potential losses to that brand value should it be associated with repeated failure, such investment is probably justified. This issue is especially important in the case of publicly funded and government organisations, where the trust of the population in the integrity of the structures for transferring value is highly sensitive to loss and failure. Risk aversion is strongest in civil servants for good reasons – when brand value of publicly funded bodies is compromised by risky behaviour and loss, the implications become political as well as economic.

The small entrepreneur, on the other hand, usually has limited brand value to protect. Her loss is limited to the investment and to her personal reputation. Successful entrepreneurial businesses that undergo rapid growth generally begin to establish brand sensitivity and risk aversion in parallel – the poor performance of Dell computers in 1993, for example, resulted in Michael Dell hiring experienced veteran managers to build systems that were capable of delivering at a greater level of security and scale.

On the other side of the coin, in the new environment, large companies are beginning to perceive that they are too reliant on existing systems for minimising risk, and they are dangerously inexperienced in engaging with risk and devising new ways of dealing with it. In a business landscape that poses new and unforeseen risks this could be a fatal weakness. Procter & Gamble's new CEO Durk Jager told Fortune magazine in early 1999, "Everybody is always worried about taking risks because nobody likes to fail. But you have to celebrate failure." He didn't mean that, of course: he meant, as most "failure is good" rhetoric does, that you can learn from and celebrate intelligent failures, just so long as you succeed in the end. Procter & Gamble then went out and spent a year demonstrating to the business world just how inexperienced it was in playing with risk – its latest embarrassment a failed hostile takeover of Warner-Lambert and American Home. Pursuing risk is too easily associated with beating one's chest in public – it is good to remember the bespectacled actuary behind the vast profits of the insurance industry. Knowledge and experience do count.

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