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Worth the Risk?

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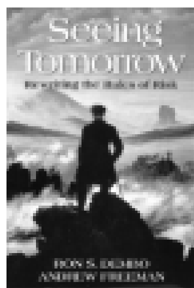


Seeing Tomorrow—Rewriting the Rules of Risk

By Ron S. Dembo and Andrew Freeman

John Wiley & Sons, 1998, 260 pages

www.risk-seeingtomorrow.com

Seeing Tomorrow—Rewriting the Rules of Risk is a book on "new ideas about the way we all make decisions involving risk." The authors want to rewrite the rules on risk because many people consistently make poor decisions and so might benefit from some established rules to guide them in their decision making. Rewriting the rules is an admirable goal. Who doesn't want to make better decisions? Who doesn't want to get control of their risk? To show how to make improvements in decision-making, the book examines numerous situations in which people have made decisions—decisions covering everything from buying a house to investing. Reading between the lines, it is strongly implied that if the decision makers had followed the authors' advice and the authors' risk management framework, many of their poor decisions could have been avoided. Of course, it remains an empirical issue as to whether such advice would have actually resulted in better decisions.

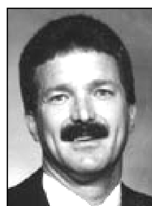
Decisions Are Getting More Complex

To show how to make better decisions and how to manage risk, Dembo and Freeman begin by illustrating the complexity of issues related to decision making, a complexity that continues to increase. The sheer number of choices that confront each individual today is greater than ever before. Who could use the authors' advice? Everyone, according to Dembo and Freeman, from individuals to businesses and governments. It is, however, this attempt by the authors to help everyone that is a little confusing early in the book. The reader may wonder whether the book is really written for individuals or for governments and businesses, or perhaps only for financial theorists? This happens, in part, because the examples of decisions used in the book include everything from buying groceries to making financial decisions on derivatives.

The authors offer several insights to managing risk. They assert that we have probably relied too much on governments to manage risks for us. They emphasize, moreover, the importance of the individual in dealing with risk. They argue that we are all individual risk managers and that we should do what we can to manage risk in our own decisions. It's important to recognize that we are each risk managers, bringing our own unique view of risk to bear on our decisions. The authors also point out that there is risk in inaction (when we don't make a decision), and that an acceptable risk one day may appear foolish the next day.

Okay, so they have focused our attention on the importance of risk in decision making. But wait, haven't all those derivative disasters and other headline stories, such as Barings, Orange County, and long-term capital management, just shown us that risk management is really next to impossible? No, reply the authors. Instead, they suggest that risk management has never been more discussed and more acceptable than it is today. Further, the current emphasis on risk management is leading to improvements in the field (and, of course, the authors hope to contribute to its improvement). What is the improvement they offer? It starts with the insights mentioned previously and then leads into a risk framework.

At this point in the book, it isn't clear what type of risk the authors are reviewing.



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The implication is that it is financial risk. Readers who have studied financial risk will agree with the importance of the topic. Other readers, who take a broader view of risk, will recognize that there are many types of risk faced by companies in today's business world. They will be somewhat disappointed about the lack of discussion of strategic risk, technology risk, risk in the marketing processes of a company (e.g., customer satisfaction risk), and the many other types of risk that are being addressed by today's businesses. They will be left wondering whether the risk framework can be applied to these areas. However, the risk insights offered by the authors can be applied to many areas and do provide useful information to risk managers of all kinds.

Risk Management Framework—The Key to Better Decisions

The framework has four major sections: time horizon, scenarios, risk measurement, and benchmarking. Dembo and Freeman admit that their approach may have too many formulas, but they ask the reader to be patient and understand the logic of their risk management framework. The authors use excellent examples to point out the importance of each section of the framework. Readers are likely to enjoy, for example, the discussion of "scenarios." The authors recount how so-called "experts" predicted the demand for ship-building and the demand for oil and go on to show why such predictions were seriously wrong. For example, the failure to consider alternative "scenarios" in their predictions had serious negative consequences for many companies. For "risk measurement," the authors point out the importance of tailoring risk metrics to the decision versus applying risk measures too broadly. For "time horizon," the authors remind us of the importance of understanding the exact time horizon over which we are trying to manage risk. They note that our time horizons on decisions will change based on our circumstances. For example, a person about to retire may have more concern over losing an investment than a person just starting out. The authors note that "benchmarking" provides opportunities to make comparisons, but point out that the incorrect use of benchmarking has resulted in many mistakes. Benchmarks are best used, the authors maintain, when they incorporate both the context of the user, and the context of the decision, and when they are not assumed to be static. That is, benchmarks should be changed and updated as circumstances change.

Other key insights Dembo and Freeman offer on risk management include those on the concepts of risk-adjusted evaluations and regret. Risk-adjusted performance, or RAP, as the authors call it, accounts for any risks taken or accepted in a project. That is, the authors suggest that we shouldn't just measure performance, but instead we should measure performance that accounts for any risks assumed in a project. For example, they point out that historical returns earned by mutual funds don't really tell us about the risks taken by the fund managers. The authors further illustrate RAP by discussing the popular concept of EVA or "economic value added." They point out that EVA tells us very little about the future risks a company faces.

Perhaps the authors' favorite insight on risk management is the concept of "regret." They suggest that regret affects many types of decisions but has, for the most part, been ignored by many decision makers. They spend considerable time reviewing concepts of probability theory and theories of modern finance. Throughout the book, they illustrate that many people consider only the upside of their decisions and fail to think about the downside and subsequent regret they might feel over their decisions. Further, many people seriously underestimate the "regret" they'd feel if a deal (or decision) failed altogether. For example, they argue that Swiss banks should have considered regret and the downside in their recent battles over paying out claims by World War II victims. According to Dembo and Freeman, the Swiss banks now seriously regret their initial stance because it brought considerable negative publicity and damaged many business relationships. In essence, they suggest that Swiss banks failed to adequately consider these downside costs. As another example, they discuss a contemplated stock offering by Goldman Sachs and suggest that many older partners failed to consider the downside risk and regret faced by the younger partners, causing them to vote differently than the older partners.

But can the Dembo and Freeman framework and risk insights be used by others? The authors suggest that their risk framework could be used in many situations, including governments' decisions about banking regulations or political decisions. They state that we can all do better if we'll control our risk. It's hard to counter such generalizations. While the authors provided some insights on risk management, they seem to stretch things a little in suggesting that so many decisions can be made using their framework. Furthermore, it isn't clear how easy it would be to apply their framework. However, in spite of this, the risk framework offers valuable insights into the process of making decisions. The authors themselves admit that they've provided a simple set of rules for risk management and that, at a minimum, they've laid out a beginning for better risk management. ■

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