A delicate balance between risk and reward

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Is risk bad for business? In the uncertain, complex and volatile environment of 2005, it no doubt seems to many executives to be so. Risk is something to be managed, reduced, hedged or sold to others. But it is worth recalling that the original concept of risk, derived from early European seafaring adventurism, contained a powerful sense of opportunity and reward as well as downside and danger.

We believe that, in the future, winning businesses will be those that are best able to balance coping strategies, which are defensive and focused on avoiding downside risks, with an increasing mix of exploitation and exploration strategies, which embrace risk and make the most of the opportunities it presents. This will require more than just continuous improvement in traditional risk management tools - it will also involve a shift in mindset and focus.

There are good reasons why executives tend to think of risk as something to be avoided. One is simply the hard-wired human psychology of loss aversion - for most people, it hurts more to be at risk of losing $10 than it feels good to have a chance to gain an equivalent amount.

Another is the leftover experience of the 1990s - in a highly permissive and opportunity-rich business environment, where it was remarkably hard to fail, a smart and simple risk strategy consisted simply of protecting against catastrophic downsides and then letting the engine run.

A third reason is the extraordinary innovation in risk management tools, which allow sophisticated hedging, repackaging and pricing of risk within increasingly liquid marketplaces. These tools are important - but they are unlikely to confer much in the way of sustainable advantage over the longer term. A business that gives in to loss-aversion psychology, sells off its risk to others and simply lets the engine run, will in the future most probably be described by one word: unprofitable.

The world has always been a complex and uncertain place from the perspective of anyone trying to create value over time. But without inappropriately flattening out the past and indulging in the fantasy that the “good old days” were simple and straightforward, we should acknowledge the obvious fact that business today is indeed faster-moving, more interconnected, increasingly global, and both bigger and broader than it has ever been. Moreover, competitive pressures frequently lead to radical changes in our business models and ultimately generate unanticipated problems - think of British Airways’ recent troubles arising from the outsourcing of its catering.
As the pace of change accelerates, many executives have the very understandable feeling that uncertainty and risk are increasing at a faster rate than is quantifiable and manageable. That

sounds like a scary proposition, but does it need to be so? In fact, a bigger menu of uncertainties provides daring innovators with new opportunities to create upside risk.

To see this more clearly, consider whether changes in the external business environment make the business ecosystem as a whole more fragile - or more robust. Is the larger system within which your business operates brittle and at the edge of chaos? Or is it “metastable” - a system that is not in equilibrium but is nonetheless enduring over the long term?

In July, a series of terrorist bombs hit the London underground train network. That experience seems to indicate one perspective: that a modern city is such a complex organism, with so many redundant pathways available to intelligent agents, that it is incredibly and surprisingly robust. When hit somewhere, it routes around the damage to self-heal in surprising ways. Then in August, a hurricane slams into New Orleans, and that experience seems to signal the opposite: that a modern city is such a tightly interconnected organism, with all its resources stretched in a relentless drive for efficiency, that it would not take much to bring the whole thing crashing down.

In fact, we do not know enough about the behaviour of complex systems to be certain how big a shock it would take to drive them to a new state, or towards chaos. The prevailing mood today is arguably to default to the pessimistic interpretation - that we occupy systems that are essentially fragile and vulnerable. Paradoxically, from the perspective of a generic actor in any system, that may be the more reassuring belief - after all, the more robust and metastable the system is as a whole, the less it needs any specific company, country or person to flourish or even survive. In a metastable system, nobody is too big or important to fail. But from the perspective of a strategic actor, both interpretations signal opportunity. Knowing more than others do about the nature of the system can be a critical source of advantage - and it requires us to think about the larger and more external context within which we operate.

But how much attention do executives pay to the external features of their business environment? In our work with major corporations, Global Business Network often draws a distinction between three critical environments for every business. The first is the internal environment - the organization itself and its people, systems, assets, processes, culture and so on. The second is the market environment - the world of customers and competitors, products and substitutes, suppliers and partners. The third is the external environment - the world of political dynamics, economic growth, technological development, social and demographic shifts and changes in the physical environment.

In our experience, most organizations pay far more attention to the first two than they do to the third. What beliefs could lie behind this allocation of executive bandwidth? One hypothesis is that the big, messy external world is so hard to understand that the returns to investing the next marginal bit of attention there are too small to matter. A second hypothesis is that the external space contains too much irrelevant risk. Over time, the risks that matter to the business will eventually filter down to be picked up and responded to accordingly.

These hypotheses are not entirely wrong. But they are also not completely satisfactory because they provide no real source of sustainable advantage. The observation that externally originated risk is hard to understand spells opportunity for someone who can separate, even partially, signal from noise. And if you wait until upside risk filters down to the transactional space also inhabited by your customers and competitors, it is already too late to seize the most attractive opportunities.

Yet most risk management today is based on coping strategies that manage downside risk. Such defensive measures are needed, of course - but they also have their limitations. Consider the most common coping strategies adopted today. Many companies cope with downside risk by using increasingly sophisticated econometric and other mathematical models. This is good, so far as it goes. But models have limitations, and it is often the case that the more finely tuned the model, the more catastrophically it tends to fail when the world moves outside the parameters for which it was designed (consider Long Term Capital Management, the hedge fund built around complex mathematical models that came close to collapse in 1998). Furthermore, those parameters are often much less transparent than they need to be because they become deeply buried within the assumptions of the model.

Companies also cope with downside risk by elevating the risk function within the corporate hierarchy - for example, by establishing risk management committees at the board level. This is also good, because it ensures that risk receives greater resources and attention and that risk management and mitigation enjoy greater clout. But too much attention to risk at the board level can yield an overly defensive posture, because quantifiable (and often disaggregated) data becomes a fixation for decision-making and the tacit, tactile understanding that is present in other forms of knowledge within the organization is undervalued.

Companies increasingly cope with downside risk by throwing money at the problem. At a price, it is almost always possible to offload the risks you know about, through multiple layers of hedging and insurance. This is good, because it offers reallocation, specialization, economies of scale and scope, and all the other benefits that come with the disaggregation of business functions. But giving away risk (or, more precisely, paying someone to take it away) at some point means giving up control of significant pieces of the value chain and allowing others to control it to their advantage.

And finally, companies cope with risk by acting conservatively. Caution, discretion and prudence are sensible ways to view a complex world. But it is remarkably easy, particularly for large and successful organizations with a lot to protect, to become overly conservative. Conservatism at some point simply has to yield to growth strategies; the key is to know when to move. Cost-cutting can only go so far.

Loss-aversion is not a long-term way to win. In expanding markets, the smart hopeful will always beat the fearful.

This can be a deeper problem even than Clayton Christensen's "innovator's dilemma", although it certainly overlaps with and reinforces his important insight about the powerful forces that drive good companies following sound business practices to wait too long before developing and deploying disruptive technologies. Combine the organizational conservatism of so many incumbents with the loss aversion hard-wired into individual human brains, and you have a recipe for disruptive market change. That is just fine for the disruptive entrants and for the business ecosystem as a whole; indeed it is a big part of what makes some ecosystems metastable overall. But it is not so good for the companies that are eaten up along the way. They need a more aggressive and advantage-seeking way to think about risk and they need it now more than ever.

We believe that coping strategies, while remaining a necessary part of any corporate strategy, will in the future increasingly be seen, used and priced as utilities that everyone simply must have. But they will not be a source of significant and sustained advantage - that will come from seizing the upsides of risk.

There are two simple but important claims behind this argument. First, we believe that the information revolution has made "that which is known" more evenly distributed around the world and closer to real time. Put differently, facts (including fact-based statistical assessments of risk) will be available to everyone, all the time, at commoditized (and, thus, nearly equal) pricing. There will be precious little and diminishing differentiation available in access to "that which is known". This, of course, means that the "unknown" or at least "the uncertain" will become increasingly important as a source of competitive advantage.

Our second claim lies at the intersection of technology and ideology. In many aspects of economic, social and political life, information technologies combined with market-friendly ideologies have led to the increasing application of markets as a way of allocating resources and solving problems. It is axiomatic within simple microeconomic theory that externalities - situations where the full costs and benefits of a decision do not fall on the decision maker but on someone else - are a source of inefficiency in market settings. And so a critical piece of the re-engineering of marketplaces, enabled by information technology, has been the internalization of many externalities. For example, polluters increasingly have to pay the costs of their pollution.

This is good for the system as a whole of course. But it is not good for actors that have previously been able to capture the benefits of a product or an action and externalize the costs on to others. And there lies the second emerging challenge for corporate risk thinking. When companies could hold the return piece of the risk-return combination and impose the risk part on someone else, it was wonderful for the company that could get away with it, but socially inefficient. Nowadays, with technology enabling greater transparency and measurement of external costs, and ideology moving towards ensuring that they are internalized by those generating them, companies have less of this "risk externality inefficiency" to capitalize on. Therefore, they need to find something else to replace it.

And that means moving to re-embrace risk as a source of advantage. In the future, managing the standard downside risks will increasingly become a "hygiene factor" in business planning - simply part of the cost of playing. The notion that some companies are too big or important to fail, and, thus, can manage risk differently, will become less prevalent. In the 1960s, it really was true that "as goes General Motors, so goes America," but there really is no equivalent of that today, and it will become less likely over time that any company could achieve that threshold. Sustained advantage will come from the capacity to adapt faster and more effectively than the rest of the pack.

This notion is familiar as rhetoric, but still unfulfilled as practice in many respects. When advantage lies mostly in the unknown and the uncertain, the ability to sense and learn faster, to correct mistakes and drop losing bets, to tolerate ambiguity and live with, even embrace, ambivalence, becomes absolutely essential.

In the future, the discipline of business risk practice will need to help organizations navigate these challenges. This will require paying much greater attention to the external world beyond the immediate business environment, and the mapping of risks within more integrated frameworks that highlight their sensitivity to external uncertainty. It will require the systematic development of new competencies and capabilities that work from the "outside-in" - such as early warning and scanning systems, scenario planning, systems thinking and real options. It will require new approaches to experimentation and learning, and greater investment in the ongoing development of decision-making executives. It will require more emphasis on the nurturing and sustenance of internal and external human networks, and a strategic conversation that places risk as a source of discovery and opportunity.

Most importantly, however, it will require treating uncertainty as a powerful starting point for innovation and renewal, rather than simply as a threat to be minimized. The new discipline of risk will eradicate from our mental lexicon, once and for all, the mistaken 19th-century notion of "survival of the fittest". In a constantly changing environment, the organism that is optimally tuned for today's world is a dead organism in tomorrow's very different world. Forget survival of the fittest, and replace it with survival of the most adaptable. After all, as Darwin himself observed: "It is not the strongest of the species that survive, nor the most intelligent. Rather, it is those most responsive to change."