Risk, leadership and management

I've had a lot of discussions recently about businesses taking risks. As we (hopefully) emerge from this recession, how will people's mindsets have changed based on what they have been through, and how does risk – and our perception of it – alter as situations change?

I want to look at a few examples at the extremes to illustrate and illuminate the variety of possibilities.

High risk / high reward

In this category, I want to split the exploration into a further two parts:

Low chance of big win

The classic example of this type of risk/reward behaviour is the National Lottery. Everyone knows that the chances of winning (meaning winning into the millions) are extremely low, and yet many, many people take part regularly. What is it about this risk behaviour that causes even those people who really understand their probability of success to take part at all?

One explanation is that the downside is (or can be) so negligible in comparison to the upside – a pound or two per week versus a potential payout of (lets say) £50 million appears to be manageable. The loss is essentially written off as soon as the ticket is bought, and so the mental payout range is from zero to £X million – all upside

Low chance of big loss

An intriguing report on the radio recently looked at the likelihood of a significantly-sized asteroid striking the earth – an event that happens, on average, every 100 million years. The interviewee was arguing that more should be spent on prediction and prevention because it will happen, even though the chance of it happening in any specific year is minute.

The challenges to this view include:

- We can't do anything even if we know
- The chances of it happening in our lifetime is minuscule
- The expense to predict and research prevention is hugely expensive

The comparison between this example and the lottery example is illuminating. A critical difference is that for Earth, an asteroid strike will happen, whereas for an individual, a lottery win won't happen.

Big business / small business

The difference between big and small businesses taking risks also highlights some of the perhaps subconscious thinking we do and instinctive reactions we have.

What is small to one is big to the other

Spending "a few thousand pounds" for a big business may be so insignificant as to qualify as an accounting or rounding error at the end of the month. The same amount of money could be a huge percentage of the costs of a small business over that same time frame. So who is taking the bigger risk?

On a one-off basis, certainly the smaller company. But, if that decision is made by every other member of staff in the organisation every month, and the small company has two employees versus 10,000 in the larger one, how does the risk profile change?

One has more to lose than the other

Whilst in many ways big companies can seem more immune to, or protected from, risk, the potential downside can be much greater. When Gerald Ratner made his off-the-cuff comment about the quality of one of his company's products, the business was destroyed. If the owner of a similar business with a single store made the same comment, would it have the same effect?

Looked at in a less extreme way, a 10% drop in sales might be awful for a company the size of Tesco, but it might mean complete failure for a sole-trader, as a drop of that amount might lead to a loss that (s)he simply cannot afford.

One has more to win than the other

On the upside, who has more to gain? The likelihood of an IT consultant doubling his or her income must be greater in a fixed period than the chances of Marks & Spencer doing the same. Therefore, superficially, it would seem to be a better risk/reward profile for the smaller organisation.

Again, however, there are different ways of looking at this. The IT consultant might work like crazy to double their sales, and still deliver less additional value than a quick decision by M&S to adjust their pricing on bras.

Boom / bust

Different economic circumstances also bring different assumptions and presumptions into play. Try these for size:

- Times are tough – we need to be careful
- Now is the best time to invest – no-one else is
- Make hay while the sun shines
- Everyone else is driving forward – we need a piece of that action

Risks are very different at different points in the economic cycle, but there is no single answer to the spend/don't spend question that applies to all organisations simultaneously.

--

Risk, leadership and management are fundamentally intertwined, and yet a **real** understanding of risk is seen as rather a dark art. However, there are plenty of things that can be done at a simple level to understand and mitigate risk, and a later article is going to delve into that area – and perhaps the dark arts too!