

Attitudes to risk

In theory, it's clear how much to invest to reduce exposure. In practice it's a little more difficult, but the theory helps to get the investment there or thereabouts...

Life & Le Care

Settle down to a good John Le Carré novel. It's got pace, action, and quick-witted heroes who cope with bad luck and worse enemies. Tinker Tailor Soldier Spy may have more suspense and blind alleys than real life but life and Le Carré are both fascinatingly fluid. There is no room for complacency because there's always the chance that something will happen.

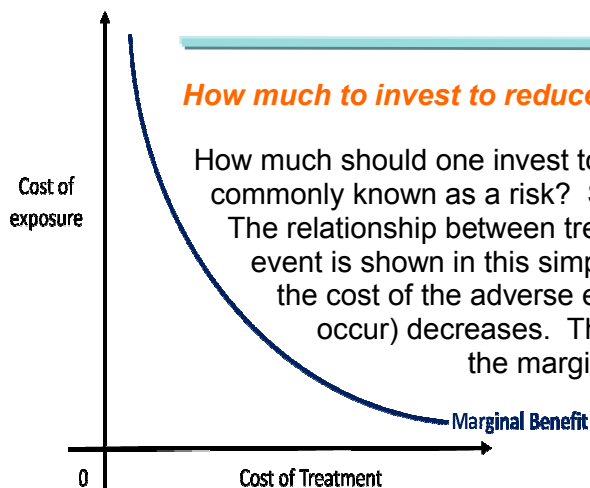
Making the character of George Smiley follow a pre-ordained course to detect a high-level mole in MI6 would make the plot boring, so Le Carré throws helpful and adverse events in his way. Smiley has a particular attitude to risk, and although he tries his best to manage his risks within the shimmering political and operational contexts in which he works, he was often forced to take calculated gambles.

For Smiley and anyone in the real world, any deviation from the expected can be positive or negative: when a person will make on average a loss this is said to be an "unfair gamble", a gain a "favourable gamble" and a zero return from an event a "fair gamble" (e.g. where there is a 50% chance of winning \$10 against a 50% chance of losing \$10).

Varying attitudes

Attitudes vary. A person who is averse to risk will take a gamble only when he or she thinks it is a favourable gamble. The more averse, the greater the likelihood of success before an opportunity is taken. Conversely, a risk-lover will pursue an opportunity even when the odds are less than favourable.

The situation is complicated by perception. A public servant may be averse to taking anything other than "fair gambles" but will in practice take extraordinarily unfair gambles because of a belief that he has more control over an event than is actually the case. Successful entrepreneurs on the other hand may seem to be taking unfair gambles, but in fact exert more control or are able to exercise much finer judgement so that they place themselves in positions to make very favourable gambles.



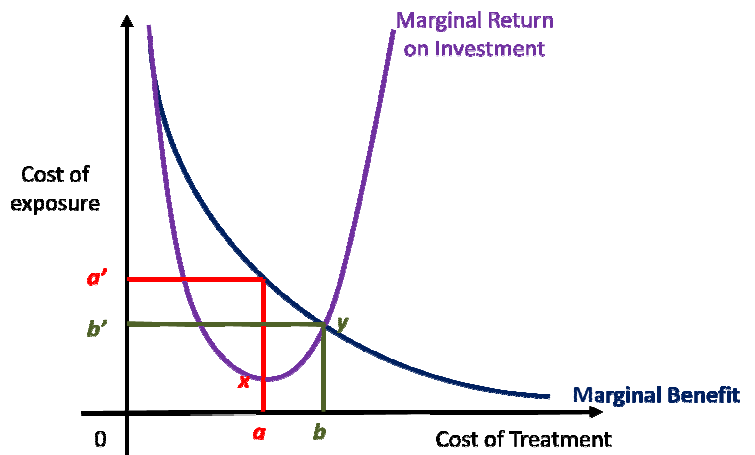
The marginal return on investment is drawn as a curve in this diagram.

The marginal return on investment curve represents the impact of the overall level of risk for each additional unit of investment.

The optimal point of investment x is reached at the bottom of the marginal return on investment, at which point the treatment is most efficient.

However, should investment continue after x , then the return on the additional investment is still positive until the point y , after which each additional sum spent on reducing exposure yields less than a similar amount of benefit should an adverse event occur.

So in theory, a rational person will take one of two logical choices when faced with a risk: be most efficient and spend a on treatment, accepting a level of a' exposure; or spend b to reduce exposure to the least it can be b' without the cost of treatment being inefficient in itself.



Summary

Economic theory is all very well, but the models either so accurately reflect reality that they are too complicated to help, or they are so simple that they only vaguely reflect reality.

What the charts and lines do show though, is that it's worthwhile trying to measure what you're doing, so that you can be like Goldilocks, and find something that's just right.



About the author



Adrian Sparrow has worked in senior management positions in a variety of industries. He was a consultant for Alexander Proudfoot, KPMG, and Deloitte. He has Masters degrees from Cranfield and Massey Universities. Adrian tries to bring insight and practical thinking to problems facing organisations.

