The illusion of control: dancing with chance

Looking back, it may seem obvious that there was insufficient risk management in the financial industry. In a new book called 'Dance with chance, making luck work for you' authors Spyros Makridakis, Robin Hogarth and Anil Gaba suggest that while there are events that you can't anticipate, there are better ways of dealing with risk.

One of the key steps, they write, is accepting that there are things that you can't control.

That's much more difficult that in sounds. They warn that people assume they can control much more than they actually do and that they underestimate the role of chance.

"One should pay special attention to what we can predict and what we can't predict," says Gaba, the Orpar Chaired Professor of Risk Management and Professor of Decision Sciences at INSEAD. "Underestimating uncertainty has very serious implications for risk management."

The authors completed their work on the book before the crisis began in September 2008 and Gaba says watching the downturn reaffirms his belief that there are strategies that can help people perform better. He says it's just chance that the book has been published at a time when risk management is in the headlines.

The authors pinpoint two kinds of risks: subways and coconuts. You can do research and be relatively sure that the subway will be predictable most of the time. On the other hand, you know that coconuts fall from trees, but you can't predict when they will fall or where they will land. So, you can plan for the subways, but it is difficult to plan for the coconuts.

Makridakis, Hogarth and Gaba argue that we have to accept that there are some things that we can't predict so the idea that we can control risk is an illusion. "Just accepting that is a huge step. It doesn't come easily for most people, but it is absolutely the first critical step," Gaba says.

Acceptance is the first part of what the authors call the 'Triple A' strategy of accept, assess and augment.

First you accept that there are things you can't control. Then you try to assess the uncertainty and finally augment your plan to make sure you manage risk more effectively.

That means using models, independent opinions, internal and external advice and any other means to assess the unknown risks and to make your business nimble and open to change when the unexpected happens.

"You are better off focusing your energy on planning for the range of possibilities that could actually happen," Gaba says.

For example, he says it's very difficult to tell which start-up businesses will be successful in the early stages. If you accept that, a better strategy is to try to diversify over a number of projects just as venture capitalists do. Not all the projects will pay off but you diversify your risk so that you have a better chance of nurturing one that will succeed.

The book examines four domains which the authors say are critical to most people: heath, wealth, success and happiness. "Very often people assume much more control than they actually have," Gaba says.

Chance and randomness play a significant role in business and in our lives. "The point is not that the world is hopeless and you shouldn't do anything, it's just that we should do a more careful assessment of what we can predict and what we can't predict. And where we can't predict then the effort and the resources are better spent on planning," Gaba told INSEAD Knowledge.

When he looks at the current crisis, Gaba says risk management was ineffective because there was unwarranted respect given to sophisticated models and an overconfidence in human judgment.

"It's a very good example of how things can go wrong."

Given the uncertainties facing most businesses now, he says it's very difficult to focus and very difficult to predict when the current downturn will end.

"Could things get much worse? Would things start to get better in the first quarter of 2010 or would it take another three years or would it become more like what happened in Japan? These things are very, very hard to predict," Gaba says. "So instead of trying to predict this, which you actually cannot, you are better off spending your resources and effort on planning for various contingencies."

And when it comes to managing risk in investing, the authors have pillars of wisdom: "Be average. Be patient. Be risk aware. Be balanced."

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