CHAPTER 1

The Increasing Importance of "Risk-Wise" Investing

May you live in interesting times.

Ancient Chinese Curse

Our world, investment markets, and investing itself have changed dramatically in just the last decade. Investing has been irreversibly altered by a number of powerful, interrelated factors including:

- Enormous growth in the volume, availability, and instant dissemination of investment information.
- Unprecedented expansion of the number and types of investment vehicles.
- A dramatic increase in the sheer number of investors, domestically and worldwide.
- An explosion in the total size of investment holdings.
- Huge increase in investors' interest in, and knowledge of, investments and investing.
- The ongoing and remarkable lengthening of human life spans, raising the stakes and critical importance of investing successfully.
- The increased global interconnectedness of all investors, economies, markets, countries, and continents, and their growing interdependence on one another.
- The accelerating pace of worldwide change and all the uncertainties it generates.
- Enormously increased market volumes and at times gut-wrenching volatility.

These historic changes have created wonderful new investment opportunities and new challenges. They've increased the likelihood and impact of old familiar risks and totally new types of risks when the stakes for what's at risk are now even bigger. With those dramatic and continuing changes, understanding and managing risk is more important than ever before.

The Holy Grail?

Based on what we see, hear, and read virtually every moment of every waking hour, each and every day, achieving outstanding investment performance is the Holy Grail of investing. It's held up as the foundation of investment success. Enormous time, energy, and resources are devoted to identifying and urging us to take advantage of the newest, hottest investment ideas, best performers, and the next big investment winners all over the world.

For instance, the media overloads and overwhelms us 24/7 with analysts, pundits, seers, and prognosticators (often contradicting one another). They urgently forecast economic and market moves for the next year, quarter, month, week, hour, day, and unbelievably, even minutes, so that we can rush to take advantage of their insights. Simultaneously, we're experiencing an enormous explosion in the number of new investment vehicles, trading tools, and information sources. We're also seeing a deluge of new active and indexed investments strategies, all designed to "help us" make more money on both the positive and negative price movements of almost everything. We now live in an investment world offering more distinct types of investments to choose from, and more and different ways to make or lose money investing, than ever before in history. As more sophisticated active and index investment alternatives attract more assets and compete more intensively with one another, the range between strong and weak investment performance is also shrinking.

The same phenomenon is occurring with private equity, alternative investments, and hedge funds as well as many other investment types. As more managers with more assets under management chase similar opportunities, the range of performance narrows and gradually reverts to a tighter range, more closely grouped around the mean.

The Game Has Shifted

There is another change that's occurred in the investment world over the last 20 years, which has been overlooked by many investors. The nature of this subtle, but very important change was first pointed out by renowned institutional investment consultant Charles Ellis in his thought-leading book, *Winning the Losers Game*.[1] In his book, Ellis reviews why and how investing has shifted from a "Winner's Game" to a "Loser's Game." He describes how the nature of the investment world has changed to now favor those investors who make the fewest mistakes rather than the investors focused on gaining the highest returns. He observes that the key driver of investing success has become similar to the success drivers in activities like golf and amateur tennis. In all these pursuits the winners win not by outplaying their opponents but by making the fewest mistakes. If you have ever played golf or tennis, you are undoubtedly familiar with this phenomenon, because the harder you try to win, the more mistakes you tend to make.

Investing changed to a loser's game when large numbers of very bright people, with lots of resources, access to timely information, and lots of money to invest began competing with one another to achieve the best performance. The advantage now goes to investors who understand the benefit (using a baseball analogy) of the more consistent winning strategy of hitting lots of singles and doubles, getting on base regularly, and avoiding errors and missteps rather than having everyone of the team swing for the fence, attempt to hit home runs, and then strike out.

Ellis strongly emphasizes that the primary objective of investment management is risk management. Managing risk has always been important, but now emphasizing risk management and "Risk-Wise" investing is *the most important* investment success factor in achieving your long-term investment goals. Of course, this concept isn't new or just limited to investing. It is also the fundamental core of the Hippocratic oath made by physicians for thousand of years: "First, do no harm." Even real estate mogul Donald Trump has stated, "Protect the downside and the upside takes care of itself."

That viewpoint is now also shared by the world's largest business enterprises. In fact, the advantages of proactive risk management have become so important that within the last 10 years more and more large companies have created and staffed a totally new C-Suite level function focused on risk management. Adding to the long established positions of CEO, COO, CFO, CIO, CMO is the totally new position, and firm-wide department of the Chief Risk Officer (CRO). The underlying question though, is why? Why have these very sophisticated global enterprises felt the need to create a new senior executive position to oversee risk and risk management?

These multinational firms are placing such a big emphasis on risk management because they see and understand its tremendous value and realize:

- In today's world almost anything is possible (both positive and negative).
- Today's stakes have never been higher, and risk management never more important.

- Offense wins games, and defense wins championships.
- If something can happen, it typically will happen (often at the worst possible time) unless action is taken on it in advance.
- It is critical to be ready and prepared for any contingency, no matter how extreme.

These huge enterprises understand how much more efficient and ultimately less costly it is to invest time and effort in being proactive, prepared, and ready for risks. It's much preferable to paying the enormous tangible and intangible costs of being caught off guard, being unprepared for negative surprises, and furiously scrambling around to recover from risks when some of them inevitably become reality.

If major worldwide corporations, with all their resources and capabilities, are now focusing on risk and risk management throughout their entire enterprises, isn't it even more important for individual investors to do the same? Individuals investing for their own and their family's future carry the full responsibility of their future quality of life and prosperity, and it is all riding on their understanding and effective management of the investment risks they face. So where do you go to gain that critical understanding of such a multifaceted, multidisciplinary, and important a subject as managing uncertainty and risk?

The New Way to Gain Mastery

The big challenge for most investors in improving their knowledge of risk and risk management is that the subjects can seem complex, confusing, and even intimidating. When the unpredictability of the future is also factored in, the entire process can seem overwhelming and almost fruitless. As a result, many investors either give up on the effort right away or lose interest over time when confronted with the challenge. They just don't have the extra time to dedicate to educating themselves on the complexities of the subject, with all the other demands on their attention. Even investors who are fully committed to improving their understanding of the subject are often disappointed, because most sources of information on risk management either oversimplify the subject or offer varying forms of technical overload. At one extreme are the sources that discuss the subject of risk and risk management simplistically and skim over it much too lightly. At the opposite extreme are sources that elaborate on highly technical, detailed, quantitative approaches (the details of Modern Portfolio Theory, the Efficient Frontier, quantitative analysis, variance, alpha, beta, and correlation coefficients, standard deviation) that don't resonate even with many sophisticated investors, unless they also happen to be engineers, mathematicians, or statisticians.

The single most important thing to remember is that for any risk management approach to work, you must not only understand how the method works, but also why it works, so that you can understand its strengths and weaknesses. It also helps if, through personal experience, you know that it works under a full range of environments and circumstances. Next you must have enough knowledge of and confidence in the method to believe it will work, and then fully commit to it.

The most critical point to keep in mind is this: *Any risk management system that any investor uses and does not understand, or does not have confidence in, will not work*. The reason it won't work is because investors who don't truly understand and have confidence in their risk management methodology will many times abandon it, at the worst possible time. As a result, there is an enormous need for a user-friendly, knowledge-based, easy-to-understand, and easy-to-implement risk management approach. A new middle way is needed between the extremes of oversimplification and technical overload. That new knowledge-based, user-friendly alternative is the "Risk-Wise" Investor method.

The "Risk-Wise" Investor approach is specifically designed to help you and investors everywhere build a strong, knowledge-based understanding of risk and risk management in a practical, user-friendly, nontechnical, and easy to understand way. It is designed to increase your knowledge and understanding of risk management, and your confidence in your risk management abilities. It will also help its users make better informed investment decisions, reduce the number and impact of negative surprises, and improve the likelihood of investors achieving their long-term investment objectives. What makes the "Risk-wise" Investor approach so easy to understand and use is that you have and are already using it, very effectively, in numerous aspects of your daily life.

Release Your Own Natural, Everyday Risk Management Power

You are a very successful Master of Risk Management. Although you may be surprised by that statement, and may not actually feel like an expert risk manager, you indeed are one. In fact, you are an accomplished and very successful Master of Life-Risk Management if you are a normal adult human being. You are a Risk Management Master because you successfully deal with all kinds of risks (big, small, and some life threatening) multiple times, every single day. Your risk management skills are so well developed that many times you use them unconsciously. Just think about the life-threatening risks you take just driving to and from work or going out for simple errands, every single day.

You started learning about risks and risk management when you were very young. You survived all the risks of early childhood. You learned some of your risk management skills from your parents and siblings. They taught you about a full range of risks you faced and how to manage them. Unfortunately, some risks you had to learn about the hard way, and even today you may still carry the physical and mental scars from those painful lessons. If you have been or are now a parent, you know how often and how quickly small children can unknowingly place themselves in highly risky situations.

You've survived and learned to successfully manage the many dangerous risks of adolescence and the challenging teen years, when your emotions and raging hormones overruled your logic and controlled your actions. You may even remember some former personal friends from those days who weren't as good at risk management or risk decision making as you and as a result didn't survive their teens. In fact, teenagers are such a documented high-risk age group that auto insurance rates for teenagers and young adults are significantly higher than any other age group, except for those people well into their later senior citizen years.

When you graduated into adulthood you faced many new risks and learned how to manage them as well. The key point is that as adult human beings, we are all Masters of Life-Risk Management and very skilled in dealing with life risks. Not perfect by any means, because risk management is never perfect and accidents and mis-steps do happen. Even then, because we are prepared, we have mechanisms in place to minimize the impact of those surprises and almost inevitable accidents.

In general, adult human beings have extremely well developed risk management skills that are very easy to take for granted. Have you ever driven home, pulled in your driveway or garage and realized you don't recall making any conscious decisions on your drive home? It's as if you were on automatic pilot the entire trip. What's really quite fascinating are the responses you get when you ask most people to describe what process they use so skillfully to manage the life risks they face every day. Most, even after thinking for a moment, can't describe their risk management process because they don't know it. They don't think about it. They just do it. Those individuals have internalized their risk management process so much and become so comfortable with it that they can't articulate what it is.

What would it be like if you could reconnect with the process you use so effectively to manage everyday risks and apply that same process and those same impressive risk management skills in the investment world? You would:

- Better understand and manage risk.
- Make better, more knowledge-based investment decisions.
- Have more confidence in your risk management skills.

- Make fewer investment mis-steps and experience fewer negative surprises.
- Reduce the impact of the unpleasant surprises that do occur.
- Improve the likelihood of achieving your long-term investment goals.
- Be a happier more successful, less anxious, ready for anything "Risk-Wise" Investor.

The core of the "Risk-Wise" Investor method, and what makes it so different, is how it refamiliarizes and reconnects you with the very same process you have used in learning and developing your own everyday, and natural, life-risk management skills. It then provides you with a nontechnical, and easy to implement, step-by-step process to use in creating your own personalized risk management plan, and ongoing risk managed decision-making process. Let's now review the steps in our everyday, natural life-risk management process and see how easily they transition into the "Risk-Wise" Investor method discussed in the next chapter.