The Risk-Wise Investor
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The Increasing Importance of "Risk-Wise" Investing

p.3 Major premise: risk management is the most important factor in successful investing
Why so much attention to risk management? High stakes, potential for anything to happen

p.5 "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."
Risk-Wise Investor approach to risk management builds on habits we already have

p.6 Most of us have very well developed risk management skills that allow us to deal with everyday risks

Introduction to the "Risk-Wise" Risk Management Process

p.11 Everyday risk management process
1. Identify risks
2. Understand risks
3. Review risk reduction/risk management strategies available
4. Evaluate risk/reward tradeoff
5. Make your decision to act or not act
6. Implement
7. Learn and adapt

p.13 Risks can be managed, but never eliminated

The Evolving History of Risk and Risk Management

p.17 "Of course risk and risk management are nothing new to human experience. They are as much a part of being human as living and breathing."
We become more comfortable with old forms of risk, but new forms are constantly showing up as society and the world changes

p.22 Timeline of risk management key dates in the modern age (1620-present)

p.36 Stability is an exception and instability the norm throughout history
Instability is the price of growth

"Risk"--What Is It, And How Does It Work?

p.42 Definition of risk from Apple CFO Peter Oppenheimer: "The degree to which an outcome varies from expectation"
Empowers us to determine our own expectations of potential outcomes, which we control
Encourages thinking through the full range of possibilities

p.43 Mandebrot's three stages of uncertainty
1. Mild uncertainty: bell curve distribution, well defined, low variability, routine
2. Wild uncertainty: opposite of mild, non-structured, highly unpredictable, extreme fluctuations
3. Slow uncertainty: between wild and mild

Which "School" of Risk Management Is Best?

p.47 Good risk management is compatible with the following six statements
1. Risk is about the future (not the past or present)

2. The future offers no certainty
3. Risk measures possibility and potential impact
4. Risk can lead to good and bad outcomes
5. Outcomes can be wild or mild, including possibilities not considered (black swans)
6. Risk is a relative phenomenon, what's risky to one may not be risky to another

p.48 Risk management definition from Australia/New Zealand Standards 4360:2004: "Risk management is the culture, processes and structures that are directed toward realizing potential opportunities while managing adverse effects."

p.50 Two schools of risk management

1. Quantitative
2. Qualitative

Quantitative School

-Developed over hundreds of years starting late in the Renaissance (Pascal, Fermat, et al)
-Tools include modern portfolio theory, Sharpe ratio, CAPM, Black-Scholes, Efficient Frontier
-Works well when markets are stable and uncertainty is mild
-Relies on extrapolating past data into the future
-Efficient frontier varies greatly decade-to-decade (p.54)
-Prices and return distributions do not follow a bell curve (p.55)
-Price movements are not always independent of one another
-Markets are not always efficient
-Investors are not always rational

p.57 Argument against the quantitative school

p.58 Qualitative School

-World is always changing and each situation is different
-Similar to how we manage everyday risks
-Forward looking, while referencing the past
-Knowledge and experience based
-Personal and subjective process
-Does not rely on potential use of flawed assumptions
-Works with both wild and mild situations

p.62 "Another way to benefit from both schools of risk management is to use quantitative techniques for periodic portfolio rebalancing, while using the qualitative approach to manage big picture risks and for making the occasional tactical decisions to defensively raise cash, hedge, or become more aggressive when appropriate."

Understanding the Risk/Perception Reality Gap

p.79 Some risks we perceive to be greater than they are, while others we perceive to be smaller than they are

p.81 Examples of common perceptions and misperceptions

p.83 Risk perception fluctuates constantly

p.84 Perceived risk can become enormous in four situations

1. Where there are large scale consequences
2. Where the risk is new or unfamiliar
3. Where the risk is beyond our control

4. Where the risk occurs suddenly or unexpectedly
p.86 Perceive risk vs. stock price
p.87 Risk=Hazard+Outrage
Hazard is the factual characteristics of risk
Outrage is the emotions associated with risk

Avoiding Common Pitfalls of Decision Making Under Uncertainty
p.89 The ultimate all-important skill of decision making
p.92 Cognitive reflection/self-learning
Tested for acceptance of fast instinctive answer or our ability to reflect on the answer (system 1 vs. system 2)
p.91 Prof. Shane Frederick test for decision making patterns
p.94 Hot hand in basketball falls within normal expected range of events (The Hot Hand in Basketball: On the Misperception of Random Sequences)
p.97 Randomness is more prevalent than we realize
Taleb: hypothetical 10,000 fund managers
p.100 Humans would rather fit in with the crowd and be wrong than be different and right (need to belong)
p.101 "When investing, it's not just your own assessment of the future that matters, but also the combined sentiment and assessment of all market participants
p.102 Sir John Templeton: "The time of maximum pessimism is the time to buy. The time of maximum optimism is the time to sell."

The Advantages of Managing Risk Categories
p.109 Common risks to investing in stocks
p.110 Common risks of fixed income
p.116 Crisis events impacting investments that we cannot control
1. Natural disasters
2. Manmade crisis events
3. Financial crises

Understanding and Prioritizing Risks
p.120 Three elements of understanding risk
1. Likelihood or probability of occurrence (high/moderate/low)
2. Personal impact (high/moderate/low)
3. Learn about the characteristics

The "Risk-Wise" Risk Management Planning Process
p.134 Discounting function of equity markets
Markets tend to decline several months prior to the start of an actual recession
THOUGHT: problem is that when a recession starts is only known ex-post, also markets can decline and a recession may not occur

Models of Outstanding Risk Management

p.167 Commercial aviation: comprehensive, exhausting and on-going focus on eliminating any potential threats or risks

p.166 Only 10 to 15 percent of commercial pilot applicants are accepted into training programs

p.172 Common thread is acknowledging the risks that happen and facing them directly, taking a more proactive approach by seeking solutions

Navigating Crisis Events and Bear Markets

p.194 "The best way to deal with crisis events is to expect them and prepare a plan of action for how you will deal with them, well in advance."