

2.1 We All Take, and Manage Risks

Did you ever cross the street without checking the traffic? Maybe you were in a rush and didn't do it, but in general, this must be rare. When we are small children, we are taught to always check the traffic before crossing the street. This behavior becomes second nature to us and we do it instinctively for the rest of our lives.

Maybe you didn't think of it this way, but this is essentially a risk management tool. The risk here is to get hit by a moving vehicle. A pedestrian is largely defenseless against a moving 4000-pound force, so the best we can do is manage this risk by watching out. Risk management is essentially costless here; it takes a second to quickly check the traffic. The risk is not totally eliminated, but alleviated significantly.

In some other cases, you can actually eliminate the risk altogether. A plane crash is a very unique risk; very low in probability, but most likely fatal if it happens. Don't fly at all, and your risk is zero. Whether that is feasible or not is another question as this decision would mean no travelling (business and personal) or not seeing relatives who live far away unless they visit you. The following, in fact, is a very important lesson:

The fact you can eliminate the risk doesn't mean that you will do it. We are usually willing to tolerate small amount of risks. The goal is to manage the risk by bringing it to the desired level.

In other cases there are competing risks, and you have to choose one. During pregnancy, to-be parents may face a difficult choice. An amnio detects any chromosome problems with a 99% probability, but comes with a 0.5% risk of miscarriage. It is natural to respond differently to these risks depending on one's own preferences.

There are also many risks in the sports industry. The recent lockouts in the NFL and NBA created real risks not only for the athletes and owners, but also for the sports bar, the restaurant owner, TV channels, media and the garbage man who works at the stadium. In European soccer, performance of a sports team generally impacts cash flows because domestic revenue sharing may be tied to a team's standing.

How do we manage these risks? The examples above suggested a few possibilities. In some cases, we manage them instinctively, and without thinking. Sometimes, we just refuse to take them. In other cases, we manage them through detailed analyses and decision making.

We don't always ignore or assume the risk ourselves. When we can, we may choose to transfer it to someone else who is willing to take the risk that we don't want. Business contracts are an example. If you are a sponsor of a famous athlete for example, you may put into the contract certain clauses that protect you in the event of a personal issue, injury, or even performance issues. Insurance policies are another option to transfer unwanted risks. There is yet another tool which is utilized quite a bit: derivative markets. In the rest of this chapter we discuss these risk transfer tools in more detail and continue to build our framework.