

Risk: What Could Go Wrong?



Planning with confidence in
an uncertain world.

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About Ann

My Beginnings

Born and raised in New York City, I started my professional career planning to be an astrophysicist. After an undergraduate degree in Physics from Princeton University and a Masters in Astrophysics from Caltech, I realized that being a pure research scientist was not a good match for my problem solving and planning oriented personality. So I shifted gears into a 30-year career in the defense industry, using my analytical skills and facility with numbers first designing and building software systems and then managing multi-million dollar programs for large and small defense contractor.



(L): Photo of Ann J. Shubert, CFP®, MBA

The Path to Financial Advisor

In 2014, while enrolled in the University of New Mexico's Executive MBA program, I made another major career transition. Becoming a Financial Advisor has given me the opportunity to combine my long-term interest in investing with my extensive experience in planning and risk management to help people improve their financial lives.

I love to share knowledge with others and am passionate about helping people reach clarity and confidence around their finances, no matter where they are in their life's journey. I particularly enjoy working with women professionals and small business owners, and members of the LGBTQ+ community.

What is Risk?

The future is full of unknown outcomes.

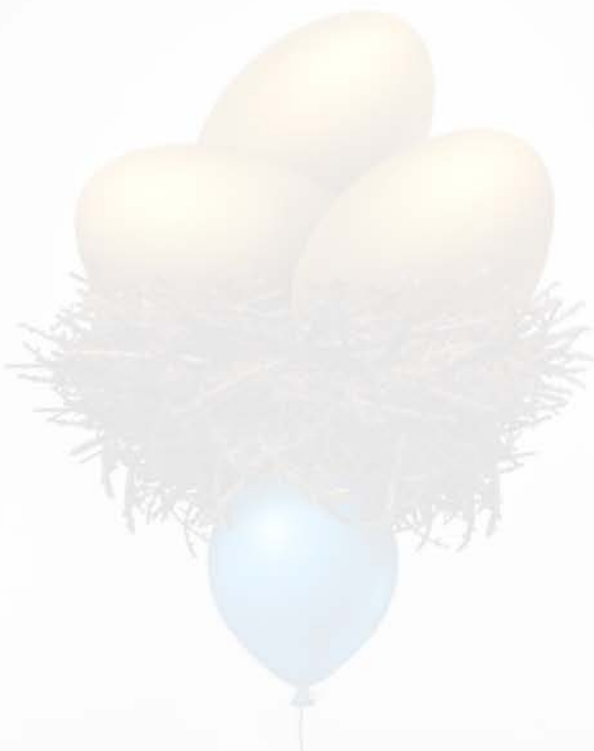
I might get sick next week and feel lousy, or I might not. The stock market might go down next week and my retirement account balance drop, or it might go up and my account be worth more.

In systems engineering or project management a risk is generally defined as a potential future event or condition that will have a negative effect should it occur. Potential future events or conditions that would have a positive effect are referred to as opportunities. (1)

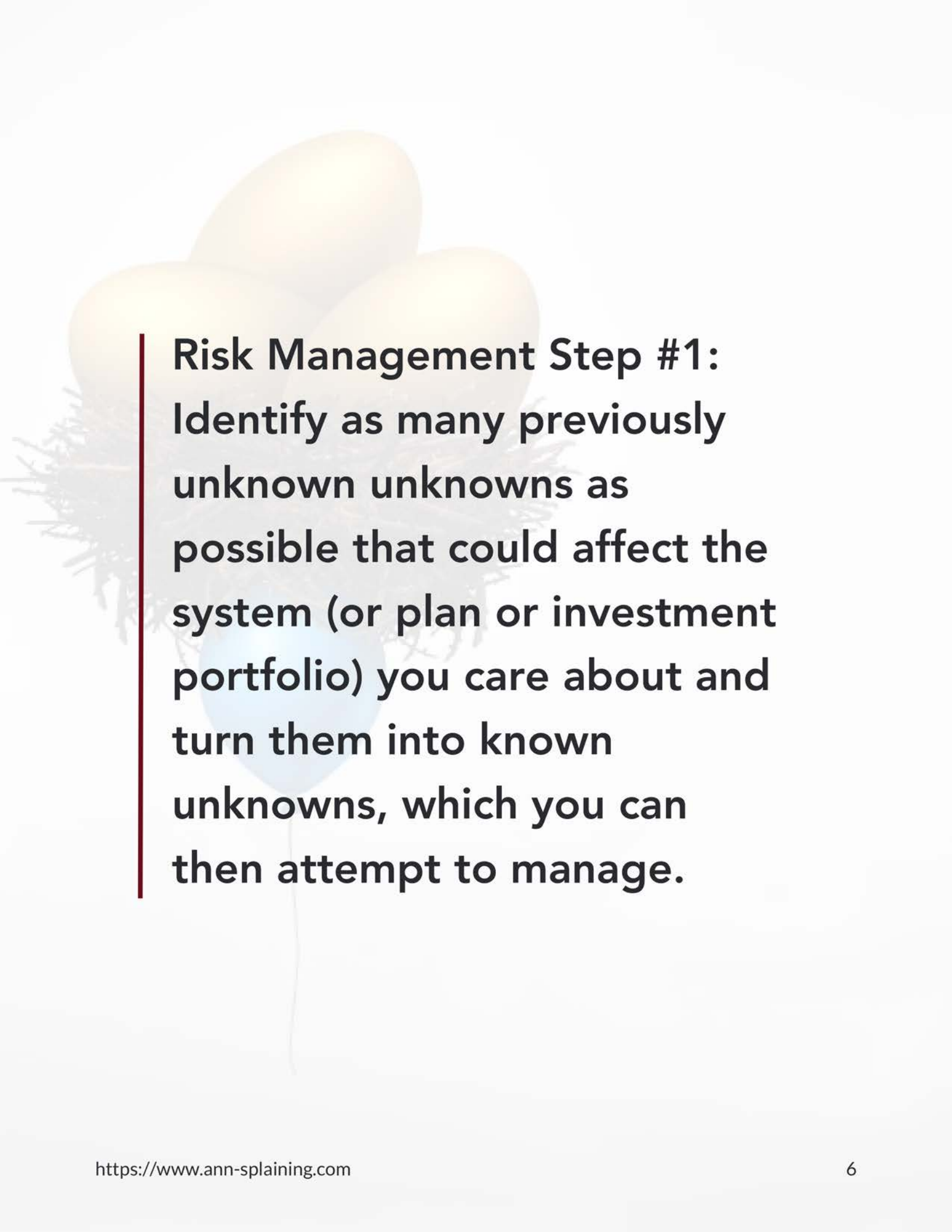
These definitions work equally well in the financial world, whether we are talking about investments or financial planning.

These unknown outcomes can also be divided in another way: as known unknowns or unknown unknowns (yes that really is a thing!). A known unknown involves something where the outcome itself is understood, at least in general,

the uncertainty is whether it will occur, or when, or how bad (or good) the outcome might be. We know that we don't know how it will come out. In comparison, an unknown unknown is an outcome that has not even been considered, something we don't know we don't know. This often results in surprises, and if it's a risk, the surprise can be unpleasant. (2) As humans we tend to come up with a plan and then forge ahead. Spending time to ask questions, or imagine unintended consequences or undesirable outcomes, can help reduce the potential for unexpected shocks in the future.



**Risk Management Step #1:
Identify as many previously
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The Two Characteristics of Risk

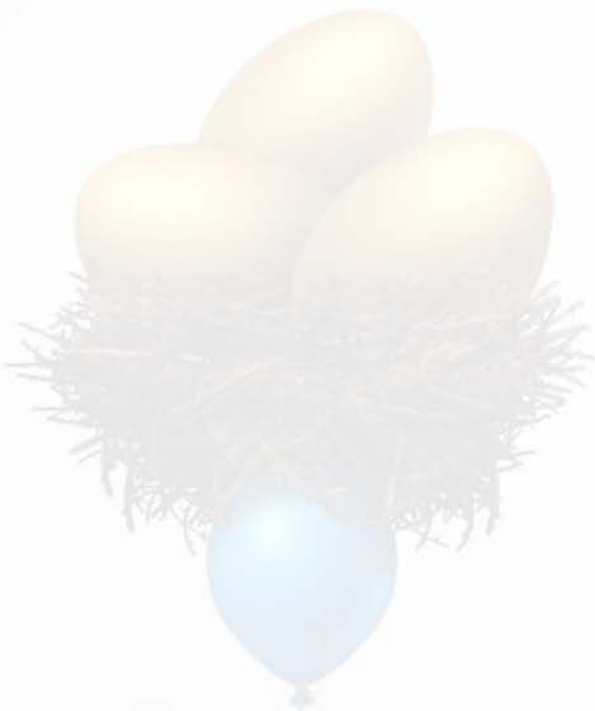
While risks are by definition unknowns, we often have some idea of the likelihood (or probability) that the risk will occur as well as the magnitude of the impact it would have if it did. This can be represented in a standard risk management tool called a Risk Matrix:

LIKELIHOOD	5	Yellow	Yellow	Red	Red	Red		Red	HIGH RISK
	4	Green	Yellow	Yellow	Red	Red		Yellow	MEDIUM RISK
	3	Green	Yellow	Yellow	Yellow	Red		Green	LOW RISK
	2	Green	Green	Yellow	Yellow	Red			
	1	Green	Green	Green	Yellow	Yellow			
		1	2	3	4	5			
		IMPACT							

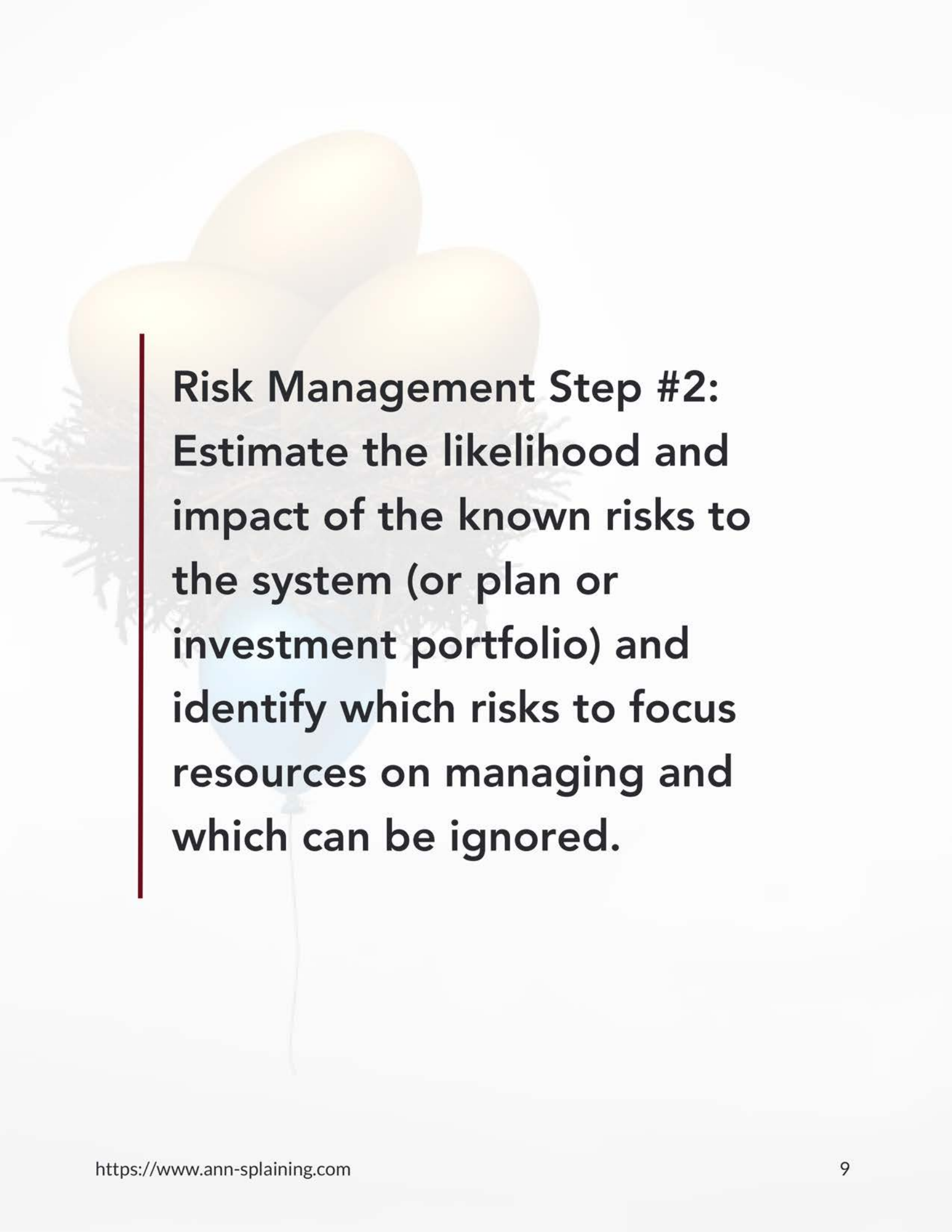
The matrix helps us combine these two characteristics so we can organize the known risks to our system (or our plan) onto a scale from Low to High, helping us to prioritize which risks need the most attention. This is important, since managing a risk often consumes some type of resource, perhaps money, perhaps time and attention.

The Two Characteristics of Risk continued

Knowing what can be ignored (i.e. Low Risk items) and which must be addressed to as great an extent as possible (i.e. High Risk items), helps allocate those resources most effectively. There is no one approach to how to set up a risk matrix, how many levels to use, etc..., this is just an example. But in general, something with a very high impact (5) and very high likelihood (5) is a risk that should be addressed somehow. As either of these characteristics drop, the risk can receive less and less attention.



**Risk Management Step #2:
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How People View Risk

An individual's response to risk, the potential danger they might face in a given situation, is generally thought to be part of their core personality and as a result, fairly stable throughout their lives.(3) This is often called their **Risk Preference** or **Risk Tolerance**; the higher it is, the more comfortable they are in accepting uncertainty about future events as well as potentially greater negative impacts.

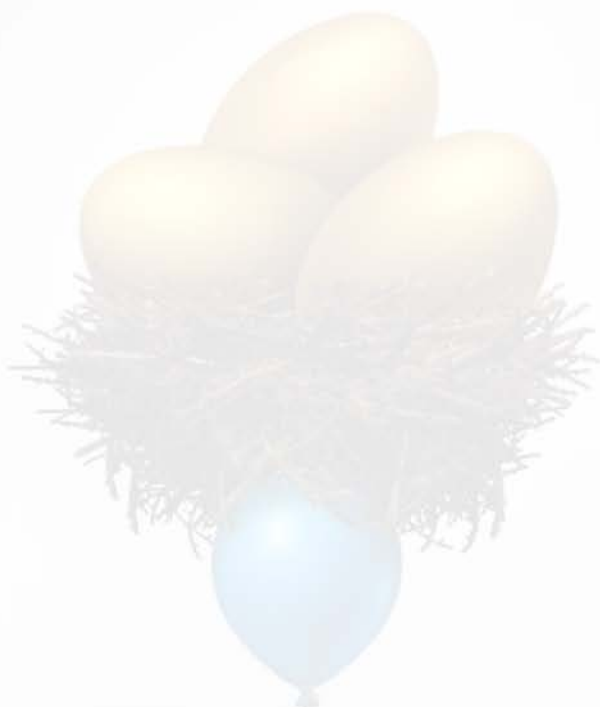
However, rational people will not generally choose to take on the possibility of something bad happening without some kind of potential reward. So how an individual's risk tolerance affects their behavior will be dependent on the particular situation and how they assess the value to be gained from taking on that risk.

In addition, while Risk Tolerance is fairly stable as a general trait, an individual's perception of the risk involved in a particular situation is more variable, and more dependent on their beliefs and experiences with that situation.

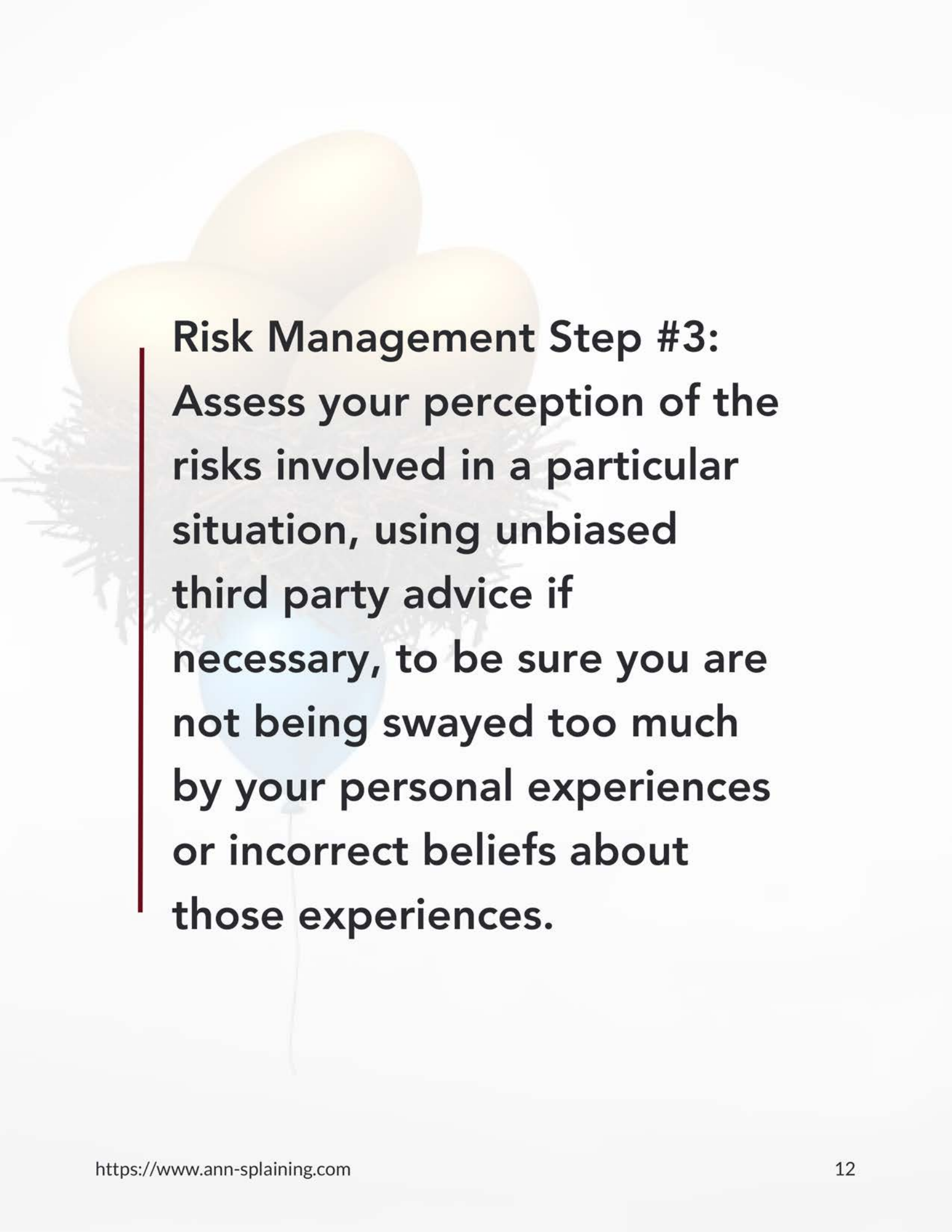
Someone who lost a lot of money in the 2008 financial crisis may view investing in the stock market as much riskier in 2009 than they did in 2007, even if the market is operating the same way it did before.

How People View Risk

Behavior in risky situations will often be driven more by an individual's **Risk Perception** than by their core Risk Tolerance.



Risk Management Step #3:
Assess your perception of the risks involved in a particular situation, using unbiased third party advice if necessary, to be sure you are not being swayed too much by your personal experiences or incorrect beliefs about those experiences.

The background features a soft-focus image of several balloons in shades of yellow, orange, and blue, with some greenery. A thin red vertical line is positioned to the left of the text.

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What Can You Do About Risks?

Once you have identified and assessed a risk, how do you respond?



There are four choices:

Choice 1: Avoid the risk – change your plans or approach so that the risk is no longer applicable. For example, if you are concerned about the risks of air travel, you can take a train instead.

- Be careful that you don't introduce other risks you haven't considered or unexpected costs. Perhaps the train is actually more dangerous or the train fare is higher than the airfare would have been.

What Can You Do About Risks? continued

Choice 2: Transfer the risk – enter into an arrangement or contract that makes someone else responsible for the impact of the risk. This is most often seen in the purchase of insurance; homeowners or auto insurance are common examples of transferring risk. There is usually a cost associated with transferring risk, which should be significantly less than the risk being transferred for this approach to be beneficial.

- Be sure you understand how much of the impact you have actually transferred and how much you will still incur. Property insurance on a rental house may pay for it to be rebuilt after a fire, but not replace rental income lost during that time.

Choice 3: Mitigate the risk – take additional steps or modify your approach to make a risk either less likely, less impactful, or both. As one example, vaccinations generally reduce the chance of getting a particular illness, or how sick you will get if you do.

- Taking actions to mitigate a risk may introduce new risks. A vaccination itself may have undesirable side effects which are hopefully not as bad as the effects of the disease it is supposed to protect against.

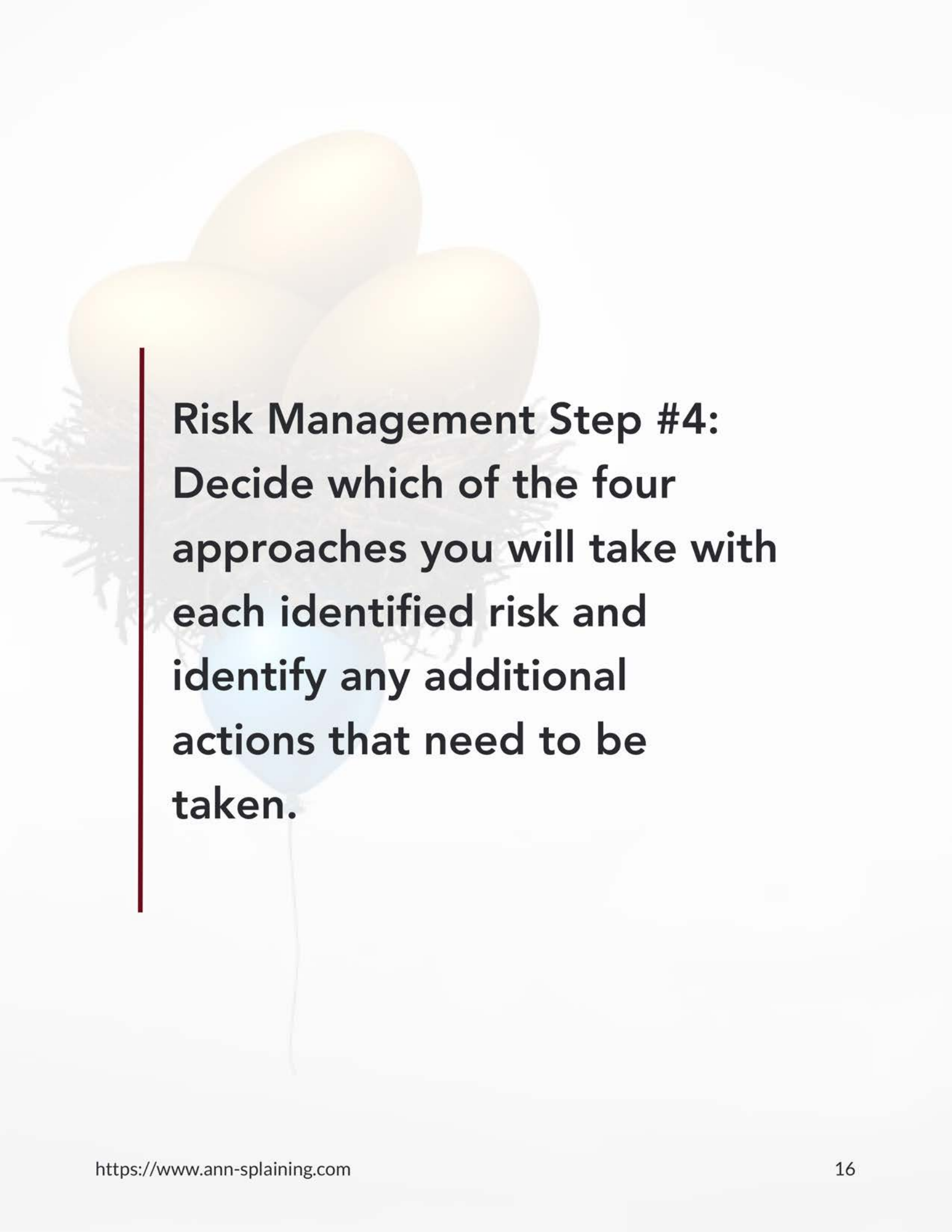
What Can You Do About Risks? continued

Choice 4: Accept the risk – in the case that either the impact of the risk or its probability, or both, are fairly low, the best choice may be to simply accept that it may occur and respond at that time. This saves the cost of managing the risk since the consequences are not that bad.

- It is also possible that the risk may be fairly high, but there is no way to Avoid, Transfer, or Mitigate it. In this case, at least awareness that it exists allows for planning should it occur.



Risk Management Step #4:
Decide which of the four approaches you will take with each identified risk and identify any additional actions that need to be taken.



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Risk and Financial Planning

My next posts will get more specific about risk in investments and financial planning, because managing risk is a very large part of what I do for clients.

Just recently a prospective client told me her first big money question is: **Will I have enough?** This is a very common concern, and of course we can create a plan for her to save a certain amount, invest a certain way, and make other financial decisions, so that the answer to that question is most likely yes.

But then she told me her other big money question: **What could go wrong?** This is exactly the question that must be asked, and answered with identified risks and appropriate responses, for her to have confidence that she will be ok. Her plan takes into account all the unknowns we can think of that might undermine her progress toward the life she wants to have.

Come back for my next installment on risk where I will talk about specific risks in investing, such as market volatility, concentration risk, opportunity risk, and human biases.

Risk and Financial Planning continued

If you want to jump ahead a little, here's an [online investing risk tolerance questionnaire](#) you can fill out to find your current "risk number," or investing speed limit. I will reach out to follow up, but I promise I won't start spamming you (don't you hate that?).

References

1 - DoD Risk, Issue, and Opportunity Management Guide for Defense Acquisition Programs, <https://acqnotes.com/wp-content/uploads/2017/07/DoD-Risk-Issue-and-Opportunity-Management-Guide-Jan-2017.pdf>, accessed 06/04/23

2 - Unknowns: 3 Kinds, Australian National University, <https://i2s.anu.edu.au/resources/three-kinds-of-unknowns#:~:text=Description%3A%20One%20useful%20way%20of,unknown%20knowns%20and%20unknown%20unknowns>, accessed 06/04/23

3 - Risk preference is a relatively stable personality trait, Max Planck Society, <https://www.mpg.de/11682204/risk-preference-personality-trait>, accessed 06/04/23

The content in this PDF is for information only, everyone's situation is different. If you have personal financial concerns, please schedule a 30 minute free, no obligation call with Ann [here](#).



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<https://www.ann-splaining.com>