Understanding / Mitigating Risk

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What is Risk?

Risk is uncertainty.

The definition of risk: "A situation involving exposure to danger." In the context of an entrepreneur, the "danger" is loss of capital, as well as the loss of time, effort, and personal reputation in a failed venture.

Risk is an inherent condition of human existence. There are always uncertainties, in every realm of your life. What teachers will you have next year? How well will you do on that exam? Will you have a good time this weekend? Will you get into a car accident next week?

Clearly there are different types of risks and different levels of risk. For example, there's "Academic Risk" (how well you'll do in school), "Social Risk" (how well you'll enjoy your personal life), "Safety Risk" (will you stay safe and healthy), and many, many others. Some risks are small and unimportant (the Social Risk of wearing shoes that don't match your outfit), while others are critical (the Academic Risk of not studying for an exam, or the Safety risk of texting and driving).

Finally, there are factors or risks that you control, and others that you can't. In terms of Academic Risk, you can't control which teachers you'll be assigned next year, but you *can* control how hard you study. You can treat other people well to manage your Social Risk. You can adopt safe behaviors - no texting, drugs or drinking when driving - to keep you safe.

The first task of an entrepreneur is to understand risk. Then the next step is to understand when / how you can mitigate risk without reducing potential reward.

Understanding Risk

Risk creates reward. If there is no risk there is no "doable" new venture - without risk there is no prospect for investors to earn a return on their capital. The old saying: "The greater the risk, the greater the return" is almost always correct.

The table below provides a snapshot of different types of risks that a new venture or small business might encounter.

Types of New Venture Risks		
Type of Risk	**Definition**	**Examples**
Business Risk	Risks associated with the success of a single venture.	• Operational risk (the company's ability to operate efficiently) • Personnel risk (ability to hire / retain essential talent)
Market Risk	Risks in a market sector that impact all competitors in that sector	• Technology risk (new technologies displace entire market sectors) • Regulatory risk (new regulations have a dramatic business impact)
Reputational Risk	Risks associated with the reputation and good standing of a venture	• Legal risk (the impact of a civil or criminal complaint) • Reputation risk (the impact of actions that could alienate customers)
Financial Risk	Risks associated with the financial standing / performance of a venture	• Credit risk (a company's ability to find debt funding) • Interest Rate risk (impact of rising or falling interest rates) • Foreign Currency risk (the impact of changing currency exchange rates)
Political Risk	Risks associated with the geography in which a venture operates	• Policy risk (new policy changes an industry's competitive balance) • Governmental risk (actions by a government that could impact a company's ability to operate in that jurisdiction)

Mitigating Risk

The goal for entrepreneurs: reducing risk without reducing potential reward. If there is no risk there is no "doable" new venture - without risk there is no prospect for investors. But reducing risk without reducing the prospect for reward increases the probability that the entrepreneur / small business leader will succeed.

Examples of New Venture Risks - and ways that an entrepreneur might mitigate these risks - are outlined in this table.

Business Risk	Cajun Coastal Restoration depends on its proprietary social media capabilities to deliver high-value services to industry and government client. Their ***Personnel risk***: they might not be able to hire and then retain talented young programmers who create, update and enhance these capabilities.
	Mitigation Strategies: a) offer signing bonuses to promising new programmers; b) provide programming team members with generous compensation and stock options that vest over several years; c) sign programmers to contracts with strong non-compete clauses *(ask your teacher what a non-compete clause is).*
Market Risk	Cajun Coastal Restoration completes their hands-on restoration work to comply with all state and federal standards. Their ***Regulatory risk***: new environmental standards may cause them to invest hundreds of thousands of dollars in new equipment and personnel training.
	Mitigation Strategies: a) work with clients and government agency contacts to track potential new environmental standards; b) develop upgrades to their equipment and mitigation services so CCR can promise clients they are prepared to meet any future standards (this will be costly in the short-term, but an effective positioning long-term); c) serve on industry advisory boards that provide input to government agencies that set regulatory policy.
Reputational Risk	United Airlines is known as "The Friendly Skies." Passengers just released videos on social media showing a passenger being violently taken off a flight, even though the passenger had a confirmed reservation. Their ***Reputational risk***: they might lose customers who don't believe the airline was being friendly or fair.
	Mitigation Strategies: a) apologizing and paying settlements to the passenger involved; b) changing policies to avoid future occurrences of this type; c) provide a new "If you're seated, you're 'good to go'" policy and advertising campaign.
Financial Risk	Cajun Coastal Restoration offers services in Mexico to Mexican clients, payable in Mexican pesos (which uses the symbol \$ MXN). While some of CCR's expenses are paid in \$ MXN (such as local contractors and travel expenses), other expenses are in American dollars (symbol \$ USD). Their ***Foreign Currency risk***: new federal policy has caused the peso (\$ MXN) to lose value - instead of \$20 MXN to \$1 USD, there are now \$30 MXN to \$1 USD. That means a \$1,500,000 MXN contract that used to be worth \$75,000 USD (1,500,000 ÷ 20) is now worth \$50,000 USD (1,500,000 ÷ 30). This means that all CCR contracts with Mexican clients are now money losers.
	Mitigation Strategies: a) require Mexican clients to sign contracts denominated in U.S. dollars (although this doesn't protect CCR when the U.S. dollar loses value!); b) increase prices to Mexican clients to anticipate the possibility that the peso may fall in value (although this might make CCR uncompetitive in the Mexican market); c) buy currency hedging contracts (although these hedges may cost more than the loss in value of the peso). ***With so many uncertainties and costs involved, it isn't easy to cost-effectively mitigate financial risks!***
Political Risk	Cajun Coastal Restoration does business with a large Venezuelan company. Given their own political crisis and their negative attitude towards the United States, the Venezuelan government just passed a law preventing American companies from receiving payment for their services.
	Mitigation Strategies: a) find a Venezuelan partner favored by the government that has permission to complete their contracts and receive payment; b) close their business in Venezuela to limit their losses.