

## Risk Management & Uncertainty

By: [Capital Spectator](#) | Jul 25, 2011 |

Predicting is hard—especially about the future, runs the old joke. But there's no escaping forecasting in finance and economics. Even a passive investor has an assumption—a forecast! If you own an S&P 500 index fund, you're assuming that you'll earn an equity risk premium. Where did you get that idea? There are a thousand possibilities for thinking positively, but the key point here is that you're anticipating a premium will come your way simply by holding risky assets.

Forecasting is unavoidable and hazardous, and so you can't spend too much time thinking about this challenge. Fortunately, there's no shortage of literature for helping us improve our efforts on this front. That includes a new series of essays on the topic at [Cato Unbound](#). The current issue asks: What's Wrong with Expert Predictions? Plenty, as it turns out. But all's not lost. For investors, Professor John Cochrane's piece—"[In Defense of Hedgehogs](#)"—is worth a read. He reminds that [risk management](#), as opposed to chasing return, is still the only game in town. "Once we recognize that uncertainty will always remain, risk management rather than forecasting is much wiser," he writes, advising:

Just the step of naming the events that could happen is useful. Then, ask yourself, "if this event happens, let's make sure we have a contingency plan so we're not really screwed." Suppose you're counting on diesel generators to keep cooling water flowing through a reactor. What if someone forgets to fill the tank?

The good use of "forecasting" is to get a better handle on probabilities, so we focus our [risk management](#) resources on the most important events. But we must still pay attention to events, and buy insurance against them, based as much on the painfulness of the event as on its probability. (Note to economics techies: what matters is the risk-neutral probability, probability weighted by marginal utility.)

So it's not really the forecast that's wrong, it's what people do with it. If we all understood the essential unpredictability of the world, especially of rare and very costly events, if we got rid of the habit of mind that asks for a forecast and then makes "plans" as if that were the only state of the world that could occur; if we instead focused on laying out all the bad things that could happen and made sure we had insurance or contingency plans, both personal and public policies might be a lot better.