Volume 7, Issue 12 December 2019

RightRisk™

RightRisk News

Evaluating Risk Management Strategies

Dates to Remember

Spring-planted crops sales deadline:
- March 15, 2020

Noninsured Crop Disaster Assistance Program (NAP)
Deadline for springseeded forage and all other crops
- April 1, 2020

For more information see:
http://www.rma.usda.gov
http://www.fsa.usda.gov

How Much Risk is Right for You?

Strategy is often used to describe the means by which a person/business plans to use resources to reach the desired ends. A strategy is usually designed to achieve long-term or overall goals. One of the keys to successfully implementing a strategy is a clear understanding of what you are trying to accomplish with decisions made and actions taken over the course of time.

Risk management strategies are generally designed to do one of four things: 1. avoid the risk; 2. transfer the risk outside the business; 3. control the risk within the business or 4. accept the risk as a part of doing business. Let's take a brief look at each of these in the context of evaluating risk strategies starting with some definitions reminding us about the importance of measurement.

Avoid the Risk

Attributes are things you value and measure like profit, debt, etc. Objectives establish directions of improvement for one or more attributes. Examples would include an objective to increase profit or to decrease debt. Goals combine one or more attributes with an acceptable target level of achievement. For example, an objective to decrease debt may result in a goal to reduce debt to less than $400,000 within the next five years.

Transfer the Risk

One of the main benefits of a strategy is that it forces you to identify what you are trying to accomplish, to think about how you will measure progress, and how you will evaluate how well the strategy is working overall.

Evaluating risk management strategies can be tricky at best and may be almost impossible without a commitment to consistently measure progress. Remember, a risk management strategy is designed to achieve one or more long-term management goals. It may be obvious, but a strategy is not accomplished through a single decision; rather, it requires a series of decisions aligned to keep things moving toward the desired goal.

Control the Risk

It is tempting to evaluate risk management decisions only when the outcomes become known. For example, a farmer may view the decision to purchase insurance as good, based on whether the insurance paid an indemnity. Otherwise, the premium paid to purchase the insurance is viewed as an expense that wasn't needed. This is not a healthy way to evaluate the decision. We don't purchase insurance hoping to collect indemnity payments. We purchase insurance for the protection it provides. The purchase decision should be evaluated based on the best information available at the time the decision is made and with consideration about how well it helps management accomplish its risk management goals.

Accept the Risk

Consider the situation where a farmer is looking to address the risk of growing a particular crop on land owned by the operation. For simplicity, assume the crop decision has already been made (due to crop rotations, equipment needs, etc.) and the decision boils down to determining how to increase the probability of covering all

fixed and variable expenses, while maximizing profits. The farmer could adopt the strategy of avoiding risk if their tolerance for risk is very low.

In this case, the farmer can avoid the risk of growing a particular crop by simply not growing the crop and renting the land to someone else for a guaranteed cash income. Is this a good tradeoff for the operation? The answer depends upon the potential range of net incomes associated with growing the crop, compared to the cash rent income from leasing the land, as well as taking into account the fixed expenses.

How well does this strategy accomplish the overall business and risk management goals? There can be a great number of factors that go into making this assessment, including the probabilities attached to the uncertainty of growing a crop and the possibility that renting out the property may introduce new risks to business.

Alternatively, the farmer could adopt a strategy of transferring some of the risk outside the operation. Transferring risk is commonly accomplished through insurance or marketing contracts. For example, in exchange for a premium expense, a crop insurance contract transfers some potentially bad outcomes to an insurance company that will cover a portion of the cost when a bad event occurs. This strategy can effectively control the *impact* of unfavorable risky outcomes. However, it does not control the *probability* of the unfavorable outcome occurring. Before purchasing coverage, a farmer should ask, "Does the insurance policy provide the financial protection needed at an acceptable cost?"

Another strategy is to control risk within the operation. This strategy may involve taking action to control the *probability* of various outcomes occurring or it may involve taking action to control the *impacts* of potential outcomes. For example, increasing the probability of a good crop production outcome can be accomplished by adopting good production practices. A strategy to decrease the impact of dry weather can be implemented by a decision to plant a drought-tolerant variety.

Finally, accepting risk as a part of doing business may be justified where the tools to address a particular risk are unavailable, too expensive or are ineffective, but the potential reward is judged to be worth moving forward with the activity anyway. Evaluation of such a strategy involves evaluating the risk-reward tradeoff and actively monitoring that relationship as the future unfolds.

Results are important, but even good risk management strategies don't come with guarantees. Strategies can fail for a number of reasons. Sadly, one of the most common reasons strategies fail is the lack of commitment to the strategy across time.

Remember, a strategy is carried out by a series of decisions taken over time and designed to achieve a desired goal. Multiple decision points require management to remain committed in the face of changing conditions. However, changing conditions also warrant periodic review that ensure that goals and objectives remain relevant and properly prioritized. Review may also bring about changes in strategy that keep the business moving in the desired direction.

The ***Evaluating Risk Strategies*** course by John P. Hewlett, Jay Parsons, Jeffrey Tranel and William Taylor, 2018 is available free of charge at **RightRisk.org** > Courses.

RightRisk helps decision-makers discover innovative and effective risk management solutions.

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RightRisk News is brought to you by the RightRisk Team

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How much risk is right for you and your operation?