IN 1995, home prices in the United States rose by 1.7 percent. They kept climbing over the next 10 years at an accelerating rate. The climax was in 2005, when the increase was 15.7 percent, putting home prices at more than double their 1995 level. Except for the early years after World War II and during the great inflation of the 1970s, home prices in the United States had never doubled in the short space of 10 years.

This amazing development could not have occurred without one widely held assumption: that home prices could only go up. If more people had recognized that, as in the past, home prices could also go down, buying a home would have appeared much riskier. Few, if any, lenders would have issued mortgages with minuscule down payments, and there would have been no outbreak of liars’ loans or complex financial paper bought by institutions as a matter of faith in questionable triple-A ratings. The banking system would not be in such a mess and the world economy would be on sounder footing.

The greatest mystery in the following tumult was in two commonly used words whose value turned out to be hollow: risk management. Sophisticated investors claim that they spend a lot of time devising and executing risk management. But if they were managing risks, how could it be that leading financial institutions flirted with total ruin and that the usual flows of credit were frozen solid?

The debacle from which the system is now trying to emerge suggests that prevailing risk-management strategies were managing the wrong risks. Surely, a reversal in home prices was a risk to be reckoned with, but it appears to have played no role, or at least none that mattered.

These issues are not only for today’s financial turmoil. They go to the very root of what we mean by that four-letter word “risk.” Risk management is inherently impotent when it ignores the true definition.

Eloyn Dimson of the London Business School once defined risk as meaning that more things can happen than will happen. That is a fancy way of saying we don’t know what will happen, but it is a useful formulation when we take up the task of risk management. If more things can happen than will happen, we can devise probabilities of possible outcomes, but — and this is a big “but” — we will never know in advance the true range of outcomes we may face.

For example, the average annual inflation rate in the United States was only 1.4 percent from the end of 1954 to the end of 1965. But in 1965, who could have imagined that inflation would average nearly five times that rate over the next 15 years?

In short, our forecasts are wrong from time to time.

That observation sounds like a platitude, but consider the kinds of questions it provokes. How will we deal with surprises — outcomes different from what we expect? What are the consequences of being wrong in our expectations? This is the point when risk management begins to live up to its real meaning. Risk means the chance of being wrong — not always in an adverse direction, but

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always in a direction different from what we expected.

The key word is “consequences.” I learned this lesson many years ago from studying Blaise Pascal, a French mathematical genius in the 17th century who spelled out the laws of probability more clearly than anyone before him. This was a thunderclap of an insight that, for the first time, gave humanity a systematic way of thinking about the future.

Pascal was both a gambler and a religious zealot. One day he asked himself how he would handle a bet on whether “God is or God is not.” Reason could not answer. But, he said, we can choose between acting as though God is or acting as though God is not.

Suppose we bet that God is, and we lead a life of virtue and abstinence, and then the day of reckoning comes and we discover that there is no God. Well, life was still tolerable even if less fun than we might have liked. Here, the consequences of being wrong would be acceptable to most people.

Suppose, however, we bet that God is not, and lead a life of lust and sin, and then it turns out that God is. Now being wrong has put us into big trouble.

Risk management, then, should be a process of dealing with the consequences of being wrong. Sometimes, these consequences are minimal — encountering rain after leaving home without an umbrella, for example. But betting the ranch on the assumption that home prices can only go up should tell you the consequences would be much more than minimal if home prices started to fall.

In this assumption, the word “only” is ridiculous. There are no “onlys” in the future. More things can happen than will happen.

Under those conditions, risk management should concentrate either on limiting the size of the bet or on finding ways to hedge the bet so you are not wiped out if you take the wrong side — if home prices do start to go down, or even stop rising. Risk management is fundamentally different from managing volatility, which is how many investors view it. Volatility is often a symptom of risk but is not a risk in and of itself. Volatility obscures the future but does not necessarily determine the future.