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Cash Flow | June 18, 2012 | CFO.com | US

The Unhealthy Fear of Risk

Some executives seem to be more concerned with making sure bad things do not happen than they are eager to make good things happen.

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In last month's *Capital Ideas* column, "Why Isn't the Stock Market Higher?" I illustrated how the stock market has lost a third of its price to earnings valuation multiples since 2007 despite consensus estimates of 40% higher net income in 2012.

One important reason the valuation multiples are so low is that companies are reinvesting a lower percentage of their cash earnings back into the business. So why is management holding back? Many companies are waiting for the "certainty" that the economy is "back on track," but they will likely be too late. While any one company cannot change the macro environment, it can ensure it removes all self-imposed obstacles limiting its ability to succeed.

For the majority of companies that underinvest, the problem is an unhealthy fear of risk. The increasing emphasis on governance and risk management has led a number of executives to become overly risk-averse. This is most readily observable in their business investment decisions. Many are forgoing investments that would create value for shareholders if they sense even the slightest risk of failure. These companies need a better balance of risk and return.

In other companies, the problem is misguided performance measures. There is so much focus on efficiency that percent measures such as profit margins and rates of return carry much more weight in decision making than growth and investment. Some even view investment as being broadly bad: something to be avoided so returns can climb even higher. These companies need a better balance of growth and return.

Investment hurdle rates can also be too high. Some executives are hesitant to recognize the lower cost of capital that exists today and often add unnecessary padding to raise the hurdle rate and be more “conservative.” To be sure, being conservative can be a desirable trait — but being too conservative simply leads to underinvestment. These companies need a better balance of being aggressive and conservative when appropriate.

This hesitancy to invest can be exacerbated when a company is highly leveraged or very committed to a high dividend or share-repurchase policy. Interest and shareholder distributions reduce the flexibility of management and reduce the margin of error when things go wrong. This can lead management to take even fewer chances, which is why our research shows that more highly leveraged companies deliver lower shareholder returns on average.

Consider an example investment of $10 million being considered by a company worth $500 million. It’s big enough to be very important to management and the board of directors, while not large enough to dramatically affect the company if it goes awry — it is only 2% of market capitalization.

For simplicity, let’s assume there are only two potential outcomes: 1) There is a 40% chance the investment will fail and the entire investment will be lost, and 2) There is a 60% chance the investment will be successful with a 100% profit of $10 million. If successful, there is a 75% chance the company can invest an additional $20 million with the same 100% profit and no risk.

To determine the expected value of this investment, we value each outcome and weight them based on the expected probabilities.

The total probability-weighted expected gain is $11 million, which is 110% of the investment. Most of us would be happy to make an investment that would be expected to go up in value by over 100%.

Despite this positive math, many management teams aren’t making such risk-versus-return investments today. It is 40% likely that the project fails, and even though it only represents 2% of the value of the company, executives might logically fear they will attract negative press. They could potentially have their positions called into question, as is happening to management at JP Morgan.

And what if several such investments go wrong in a row? We know flipped coins can land on heads many times in a row just based on randomness. Might this randomness be mistaken for poor management, leading the company’s share price to plummet — an outcome that might potentially attract acquirers or activist investors?

Trends in executive compensation don’t help either. Where stock options once provided a big carrot on the upside, there is now more often a tempered motivation supplied via restricted stock and performance shares. Less risk and less reward in executive pay gets in the way of encouraging executives to take worthwhile risks by making investments that maximize value. In the quest to make sure executives don’t earn money they don’t deserve, compensation committees and governance experts might have inadvertently created too weak of an incentive to truly succeed for some management teams.

What does this potential underinvestment problem mean to management? First, recognize the value of investment and assess whether the company is adequately investing in its future. Consider all investments, including capital expenditures, acquisitions, research and development, marketing, and technology.

If there is an opportunity to invest at a higher rate, consider whether there are self-imposed constraints embedded in risk-management techniques, performance measures, and investment analytics that are causing the company to underinvest. Make sure the company isn’t overly leveraged with debt, and ensure the upside/downside sensitivity of rewards encourages the right balance of risk and reward.

Most importantly, make sure the culture of the organization you are looking to invest in reflects balance between growth and return, quality and quantity, and aggressive and conservative mind sets.

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