Stanford eCorner

Managing the Risk / Reward Tradeoff

William A. Sahlman, *Harvard Business School*

May 01, 2007

Video URL: http://ecorner.stanford.edu/videos/1809/Managing-the-Risk-Reward-Tradeoff

William Sahlman, professor at Harvard Business School, maintains that entrepreneurs must manage the relationship between risk and reward, illustrating his point with the example of John Osher, creator of the very successful spin toothbrush. Specifically, Sahlman argues that entrepreneurship is fundamentally about decreasing risks and increasing the chances of success?an issue that is fundamentally related to the people in the venture.

Transcript

So what you really have to do is to think about: how do I understand the relationship between risk and reward? Not, "How do I deal with a certain amount of risk or a certain amount of rewards?" I'll give some examples. One thing that clearly could go wrong in a venture is that the founder dies. And if the founder's the critical cog in the wheel, that's bad. What could you do? Well, you could buy the key person life insurance. Now, I want you to think, there are only some circumstances in which there's a minor conflict of interest. If the company's not doing well. So you also need to think through the incentive effects of whatever you do. But that's an example of managing risk and reward. In John's case, you could sit at the beginning and say, "What can go wrong?" and write a list of things. You can sit and say, "What can go right?" and I can promise, most of us are great at coming up with a list of what can go wrong.

We are terrible at "what can go right." And entrepreneurship is about "what do I do? How do I respond if I have this mix of potential good news and bad news?" John, I think, said it very well. He's not a big risk taker. There are people who succeed, having taken very big risk. But the fact is, they're the exceptions. And we don't see the stories about the people who took those same very large risks. So I think John's a perfect example of someone, at each step, trying to manage the relationship between risk and reward. Now, this is an obscure graph that on the left hand side, shows the probability of some payoff in year 5. So what's your company going to be worth in 5 years? And my experience with ventures is that there's some likelihood the venture will fail. Maybe it's 30 % maybe it's 50 % I will tell you, every entrepreneur I've ever met says zero is the right assessment. But my experience suggests some higher number is appropriate.

Typically, it's hard to create a small company. So the most interesting thing about the world is, what's the right hand tail look like? What's the upside, and how do I balance the risk? But the more important issues is: how do I change the odds? Because your goal, as entrepreneurs, is to lower the likelihood of failure and to move the entire curve to right, increasing the upside, increasing the likelihood that you'll have a positive outcome. There are lots of ways you do that, although people will turn out to be critical. So in my experience, and this is a theme that has come up a couple of times: all successes are attributed to people, and all failures are attributed to people. And sure, we've seen bad ideas but frankly no bad idea is unfixable. So it's a bad idea that wasn't fixed, and that's a people problem, not an idea problem, typically.