How can a pre-mortem help to manage risk?

Performing postmortem analysis is essential. If we treat every mistake as a learning experience, we will eventually work toward a more and more robust process, and hold ourselves accountable.

However, postmortems are most useful for tasks that are repeated under more or less the same conditions. When a problem changes dynamically—for example, portfolio risk management—a different approach is in order.

What does failure look like?

One possible solution is a "pre-mortem," a thought experiment where decision-makers assume an outcome and then work backwards to arrive at possible causes.

For example, assume that you will struggle to afford retirement expenses. What could have caused the shortfall? Perhaps you underestimated your current spending, or you may have forgotten to account for a new expense that you will face in retirement. Maybe there was a bear market that has temporarily impaired your retirement assets.

This process is called "prospective hindsight," and it can help investors better prepare for risks because it asks "What does failure look like?" This reframes the usual risk-management question, "What could go wrong?" and opens the mind to a new set of possibilities.

This inversion is similar to the way that a chess player learns from playing both sides of the board. We often learn as much when we play against ourselves—probing our own weaknesses of their own strategies—as when we challenge another opponent. That's particularly true in investing, because while a chess player can learn from playing hundreds of different opponents—and will be satisfied if his or her odds of victory improve—an investor doesn't get thousands of trials to achieve their financial goals. We only live once, so robustness is key to investment success.

What does success look like?

But while "prospective hindsight" can be a useful exercise for finding the weaknesses in our portfolios and financial plans, it's also helpful when you begin with a positive scenario.
For example, you end up with far more retirement savings than you need. How did this happen, and what are some solutions? Perhaps you worked too many years or spent too frugally. Or maybe your family has discovered philanthropic goals that are a higher priority than you thought when you built your financial plan.

Ironically, having too much saved might be viewed as another type of failure because it means that success could have been achieved with less work. Thinking through the consequences of having a little extra is also useful for planning purposes. In fact, this process might help you clarify some "stretch goals" that you and your family can strive toward.

Forewarned is forearmed

This concept of "prospective hindsight" is essential for testing financial plans and investment strategies for weaknesses and opportunities. Risks that remain "unknown unknowns" (to borrow a phrase from Donald Rumsfeld) are probably not being managed, and at least some of these could be a "black swan" (low probability, high impact) event for your financial plan. Only by keeping an open mind can we hope to identify these ahead of time.

Adding a pre-mortem to existing risk-management analyses is particularly useful in a group setting, where studies have shown that it can help teams to provide greater insight into risks, develop a range of flexible strategies, and identify issues that may not have been considered before.¹ Prospective hindsight can disrupt "groupthink," helping to facilitate a more open-minded and productive risk-management conversation—especially when compared to a post-mortem analysis, where there is blame to assign.

Proactively assessing risks and calibrating expectations is key to investor success, because they can help us avoid making reactive risk decisions, which tend to be more emotional and costlier.


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Appendix

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