The Performance Relationship of Effective Risk Management: Exploring the Firm-Specific Investment Rationale

Torben Juul Andersen

Risk management has traditionally been occupied in eliminated downside exposures. This paper puts forward the idea of total risk management as the ability to respond to market factors beyond management control so as to stabilise corporate earnings. This in turn will lead to enhanced trust by investors and stakeholders and result in enhanced performance. The paper reports on an empirical study that examines the performance relationship of total risk management and finds a positive relationship, especially among firms investing in innovation and those operating in knowledge-intensive industries.

Introduction

Risk management is considered an increasingly important executive concern but there is limited empirical evidence regarding the implied performance effects as the associated practices continue to evolve. While risk management techniques often focus on the elimination of downside exposures, we conceive of total risk management as a general ability to respond to exogenous market factors beyond managerial control so as to damp the variability of corporate earnings. One argument in favour of this risk management outcome is that stable earnings reduce the likelihood of financial distress and make favourably-priced capital accessible for good business propositions. Another rationale suggests that stakeholder relationships are jeopardised if corporate survival is uncertain, so a lack of risk management will impose incremental costs on counter-party transactions. A more recent contribution adopts a resource-based view to suggest that effective risk management provides incentives for essential stakeholders to invest in assets and competencies that are specific to the firm, which holds the key to develop responsive business opportunities and gain sustainable competitive advantage. We analyse the latter reasoning in an empirical study examining the
performance relationship of total risk management and explore compliance with the underlying rationale among firms exemplar to observed outcomes. The study of a large cross-sectional sample provides general support for the firm-specific investment rationale. We find a positive relationship between total risk management and corporate performance and observe higher performance relationships among firms investing in innovation and firms operating in knowledge-intensive industries where firm-specific investments are particularly important. Incidentally, we fail to find evidence in support of the two alternative explanations for positive risk management effects.

A string of spectacular corporate failures and dramatic terrorism events over the past decade have increased the focus on risk management practices to deal with corporate exposures while arguing for the performance-enhancing effects of these approaches. Despite this surge in interest, few empirical studies have attempted to analyse whether the alleged advantages materialise. These attempts are partially hampered by the complexity of the risk management concept, which incorporates different practices to reduce downside losses as well as enhancing upside gains in a holistic and integrative manner. Some firms seem consistently to outperform in changing business environments but can this be ascribed to effective risk management capabilities? In the high-velocity computer products industries, commonly used to study strategic responsiveness under turbulent market conditions, names such as Cisco, Dell and Microsoft often appear as organisations that are successful at managing their market risks and stabilising earnings. However, is the seeming competitive advantage of such firms associated with effective risk management outcomes, and if so, what can explain these performance relationships? In this study we address these strategic issues.

Risk management is often perceived as the specific practices imposed to reduce the potential adverse effects of risk phenomena caused by price volatilities, accidents, political events, supply chain disruptions, economic developments, etc. These exposures may all have a substantial negative impact on corporate earnings but represent a wide spectrum of risks that often are dealt with by different specialists in the organisation. A more holistic perspective is concerned with the corporate handling of these market risks as well as the business opportunities they may induce. Hence, we define total risk management as the ability to respond effectively to all exogenous market factors beyond managerial control so the variability of corporate earnings is damped. This ability includes practices to reduce downside exposures, such as financial hedging, insurance contracting and management controls, as well as approaches to enhance upside gains through innovation, responsive decision-making, redeployment of resources etc.

The risk management focus is reflected in increasing corporate use of derivatives to hedge various market risks, engagement in insurance covers and adoption of formal enterprise risk management approaches. However, given the historical motivation for risk management and the emergence of regulatory requirements, there has been a tendency to emphasise downside risk. In fact, responsiveness also relates to an ability to exploit new opportunities that emerge from changing conditions. In other words, total risk management goes beyond a conventional risk perspective and incorporates response capabilities that allow the corporation to identify and exploit opportunities as market conditions change and thereby impose a more favourable risk profile. Where risk management often is conceived as procedures that identify and manage downside risk events, other responsive processes are equally important, such as the development of new business opportunities and the execution of them to counter and take advantage of evolving competitive scenarios.

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A number of rationales have emerged to substantiate the notion of positive risk management effects from a more stable earnings development. Effective risk management outcomes arguably reduce the likelihood of bankruptcy that should lower the average cost of capital and thereby enhance investment in economically viable projects. Conversely, it is argued that a lack of risk
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