

# Risk Is What You Don't See

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Harry Houdini was more than an escape artist. Anything that made people gasp interested him and was something he would try.

One of his famous tricks was letting big men punch him in the gut as hard as they could. Houdini – an amateur boxer before becoming a magician – said he could flex his muscles in a way that could absorb any blow. The stunt matched what people loved about his escapes: the idea that his body could conquer physics.

One day in 1926 Houdini was resting in his dressing room after a performance when a group of students from McGill came in to visit.

One of the students, Jocelyn Gordon Whitehead, asked, “Is it true, Mr. Houdini, that you can resist the hardest blows struck to the abdomen?”

Without warning he then began slamming his fist into Houdini.

Arthur Conan Doyle's book *The Edge of Unknown* writes:

Houdini stopped him suddenly in the midst of a punch, with a gesture that he had had enough.

Houdini immediately after stated that he had had no opportunity to prepare himself against the blows, as he did not think that Whitehead would strike him as suddenly as he did and with such force, and that he would have been in a better position to prepare for the blows if he had arisen from the couch for this purpose.

A day later Houdini was doubled over with abdominal pain. His appendix was ruptured, almost certainly from Whitehead's blows.

And then Harry Houdini died.

The riskiest stuff is always what you don't see coming.

Risk is complicated, which is why we're not great at dealing with it. It's more than just something bad happening. How risky something is depends on whether its target is prepared for it. A big event people have time to prepare for can be handled without much fuss. A smaller one out of the blue can be deadly.

Houdini – who buried himself under six feet of dirt in a straight jacket and dug himself out weeks before he was killed by a student's jab – learned this the hard way.

It's also something we should remember when thinking about the economy and our investments.

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The biggest economic risk is what no one's talking about, because if no one's talking about no one's prepared for it, and if no one's prepared for it its damage will be amplified when it arrives.

But look at forecasts of the biggest economic risks for the year ahead, which are published in force this time of year.

With few exceptions people cite the trade war and the election. Last year it was impeachment and the trade war. In 2018 it was interest rate hikes and the trade war.

The same risks, repeated over and over, sometimes several years in a row.

Google News cites 8.4 million mentions of "trade war" in recent years. People might be worried, but no one is surprised. Businesses might be frustrated, but many have prepared as much as they can.

Compare that to what in hindsight have actually been the biggest risks.

To name a few: 9/11, Lehman Brothers' inability to find a buyer, Iraq invading Kuwait, the 1973 OPEC embargo, Pearl Harbor, and a small Austrian bank called Creditanstalt whose 1931 bankruptcy set off a chain reaction of global bank failures that ignited the Great Depression.

These were big events. What turned them into disasters was that few discussed them even moments before they occurred. They were surprises. So the people affected by them did not prepare, either mentally or with actions. They could only react, often amid panic.

Which is where things get ugly.

Two things happen when you're caught off guard. One is that you're vulnerable, with no protection against what you hadn't considered. The other is that surprise shakes your beliefs in a way that leaves you paranoid and pessimistic. Driving by car surged after 9/11 as people avoided air travel, leading more excess car deaths than casualties from the actual terrorist attacks. After Pearl Harbor it was a foregone conclusion, doubted by few, that Japan would soon attack California. After a lifetime of accepting injuries as part of his job Houdini's last words after being surprised by the student were, "I'm tired of fighting." The mental toll of surprise can be crushing.

Paying attention to known risks is smart. But we should acknowledge that what can't see, aren't talking about, and aren't prepared for will likely be more consequential than all the known risks combined.

That's how history has worked.

We are bad at forecasting the economy. But that's not because we can't analyze how an event will impact the economy. We just can't analyze events we haven't considered to begin with. Risk is what you don't see.

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By definition there's not much you can do about this. It's one of those things that just *is*.

It's impossible to plan for what you can't imagine, and the more you think you've imagined everything the more shocked you'll be when something happens that you hadn't considered.

But two things can push you in a more helpful direction.

**Think of risk the way California thinks of earthquakes.** California knows a major earthquake will happen. But it has no idea when, where, or of what magnitude. Emergency crews are prepared despite no specific forecast. Buildings are designed to withstand earthquakes that may not occur for a century or more.

Risk gets ugly when you think it requires a specific forecast before you start preparing for it. It's better to have expectations that risk will arrive but you don't know when or where than to rely exclusively on forecasts – almost all of which are either nonsense or about things that are well known.

**Give yourself a wide berth.** If the heaviest truck to cross a bridge is 5 tons you design it to be able to withstand 10 tons or more. In the same way, if you think recessions will reduce your wealth by 20%, design your allocation to be able to withstand a decline of, say, 40% or more, realizing the powerful recession you aren't thinking about will be more impactful than the one you envision. Putting extra padding around the risks you can see is one of the only ways to prepare for the risks you don't see.

More on this topic: