The Lower the Risk, the Greater the Reward

By **Dan Huckabay**, President, Commercial Surety Bond Agency

Now, be honest, did you read that headline and think, "That's not the way that saying goes"? Most of us are trained to think just the opposite – if we want great rewards, we have to take big, bold risks. However, if you ever hear Warren Buffett speak about his investment strategy, he talks about minimizing his downside risk while reaping the largest possible upside.

Here are three of Buffett's rules on investing that I think apply to any business – particularly construction.

"Rule No. 1: Never lose money. Rule No. 2: Never forget rule No.1"

In business it's sometimes easy to think losing money is just part of the game. With all of the unknowns that are faced in construction, it can be even easier to justify losing money on certain tough projects and having those jobs create losses for the company as a whole.

No one is perfect or has a flawless track record. After all, we are human and will make mistakes, and sometimes things will happen that are outside of our control.

But rather than expecting perfection, I think Buffett is talking about having an attitude that losing money is not acceptable.

I have personally seen the difference this attitude can make among contractors. Those that believe profitability is the Holy Grail tend to be much more profitable over the long term, and some, in fact, rarely, if ever, lose money. They set up systems and their decision framework to protect against the downside, and give themselves the greatest chance for the upside.

"Risk comes from not knowing what you are doing."

Buffett talks a lot about the theory of having a "circle of competence."

Basically, each person or organization is going to have things they are well equipped to understand and perform at a high level. The key is to know what those are, write them down, and most importantly, stick to them.

On the surface, this sounds easy, but in construction, every job is unique and has a variety of risk factors. This is where consistently evaluating and sticking to your circle of competence can be challenging.

Construction expert, Dr. Thomas Schleifer, did a study in the last few years of the risk factors like job type, size, location, etc. inherent in construction projects that cause losses and contractor failure.

He then statistically weighted them based on their likelihood to affect the successful outcome of a project, and he came up with a tool that contractors can use to evaluate potential projects.

You can download the project selection tool for free at https://www.simplar.com/projectselectionprogram/

Having a system like this that takes out the human guesswork and emotion of evaluating each potential job can significantly enhance profitability. Even if it eliminates just one bad job a year, imagine the money you can save and how dramatically it would lower your risk.

"You don't have to swing at every pitch."

There is a great YouTube video entitled, Warren Buffett: Circle of Competence, where he relates picking investments to a book that the baseball player Ted Williams wrote called *The Science of Hitting.*

In it there is a picture of Ted Williams with the strike zone broken down into 77 squares, and he points out if he waits for the pitch that is in his sweet spot, he will bat .400, and if he has to swing at those balls in the lower corner, his average would drop down to something like .235.

Buffett goes on to say that the beauty of investing is there is no three-strike rule, so he is never forced to swing for anything outside of his prime target. Construction is somewhat similar although there is the pressure to cover overhead. The point is not whether to swing at all – the point is to be more discriminating when you do swing.

Buffett uses another analogy to encourage discipline in which he refers to a punch card with 20 spots on it, and he says to imagine that each time you make an investment, you have to punch out a hole, and when you are done with all 20 holes, you can't make any more investments.

Imagine the same was true with bidding work, and I would venture to say contractors would be a lot more selective.

Construction work is getting more plentiful both in the private and public markets.

On average, our clients have experienced increases in revenue for the last three years, but margins have remained stagnant. For most contractors, this ultimately equates to greater risk for no more reward.

As the market continues to improve, every contractor will have to decide for themselves whether to be selective in the jobs they undertake and stick to their circle of competence in order to lower risk and maximize profits, or continue the old mantra of taking on great risks by getting lots of work in hopes of great rewards.

Historically, more contractors fail during a booming market than during a depressed one, so if history serves as a guide this time around, following Buffett's guidance could pay handsomely. ■