Avoiding a Single Point of Financial Failure

In 1995, Pixar was on a rocket ship growth trajectory.

Toy Story came out in November of that year to rave reviews and made more money than almost anyone thought was imaginable. It was the first full-length animated film done entirely using CGI and ended up grossing over $360 million worldwide.

The team at Pixar was feeling pretty good about themselves, but Steve Jobs was already planning on the company's first failure. He convinced the company's co-founder Ed Catmull that eventually they would make a film that flopped at the box office. To prepare themselves for this eventuality, Jobs pushed the private company to go public to secure funding that could prepare Pixar for a dud at the box office.

Jobs made the case that increasing the capital base would allow the firm to fund their own projects to give them more of a say in how they moved forward creatively. But it would also prepare them financially for a future failure. He argued it made no sense to depend solely on the performance of each new release to keep the ship afloat.

Catmull described his feelings about this idea in his excellent book, *Creativity Inc.:*

The underlying logic of his reasoning shook me: We were going to screw up, it was inevitable. And we didn't know when or how. We had to prepare, then, for an unknown problem—a hidden problem. From that day on, I resolved to bring as many hidden problems as possible to light, a process that would require what might seem like an uncommon commitment to self-assessment. Having a financial cushion would help us recover from failure, and Steve was right to secure one. But the more important goal for me was to try to remain vigilant, to always be on the lookout for signs that we were screwing up—without knowing, of course, when that would occur or how it might come to light.

In business school, I took an operations management class that required us to perform case studies using real-life examples of the problems facing businesses. Invariably, the solution ended up being about how to locate and fix bottlenecks that were causing a slowdown in production, supply chain issues, disgruntled employees, unhappy customers or a combination of these factors. But they were fairly easy to locate once you ran through the information.

Most businesses are pretty good at managing risks they can see. It's often the blind spots that bring about the biggest problems. Catmull continues:

When I mention the mistakes that were made at companies such as Silicon Graphics or Toyota, some people cite hubris as the reason. "They started to believe their own B.S.," they say. "They got complacent." Others argue that companies go off the rails because of unreasonable growth or

profitability expectations, which force them into poor short-term decisions. But I believe the deeper issue is that the leaders of these companies were not attuned to the fact that there were problems they could not see. And because they weren't aware of these blind spots, they assumed that the problems didn't exist.

Which brings us to one of my core management beliefs: If you don't try to uncover what is unseen and understand its nature, you will be ill prepared to lead.

Businesses must worry about competitors, consumer preferences, regulation, economic cyclicality, and their own poor decisions. Investors expose themselves to these same risks but the human element of over- and underreaction adds further risks to the markets.

This is probably one of the hardest aspects of investing in the markets. You can map out historical risk factors with pinpoint accuracy but figuring out where the future risks lie is at best a guessing game.

One of the best ways to manage these risks is to avoid having a single point of financial failure be your downfall. Here are some examples:

Not being diversified enough. If you cannot predict the future (let's be honest -- no one can), diversification is your best form of risk management and it comes in many forms. To avoid financial ruin, you can diversify your assets, your investment strategies, your income streams, and your career opportunities.

Not controlling your debt. Charlie Munger once said there are 3 ways for a smart person to go broke: liquor, ladies, and leverage. Carrying too much debt limits your options when things inevitably go wrong financially.

Not saving enough. A healthy savings rate provides the ultimate margin of safety in your finances. The more you save, the less money you have to replace to be financially independent. A high savings rate also gives you wiggle room in the event of a true financial emergency.

Not having a financial backstop. Most financial "emergencies" are really just infrequent expenses you can reliably expect to see, you just don't know when. These are things like car repairs, housing maintenance, insurance premiums, medical bills, technology upgrades, etc.

A true financial emergency will likely be something you don't see coming. Some potential backstops for this moment include liquid savings accounts, credit cards, insurance and home equity loans. Avoiding a single point of financial failure also means avoiding the use of these fallbacks for things you can plan for.

Carl Richards once said, "Risk is what is left over after we have thought of everything else."

You'll never be able to foresee every risk that comes at you in the markets or your personal life but you can plan ahead for the eventuality that there will be unforeseen risks.

Source:
Creativity, Inc: Overcoming the Unseen Forces That Stand in the Way of True Inspirations

Further Reading:
When the Unexpected Leads to the Unexpected