

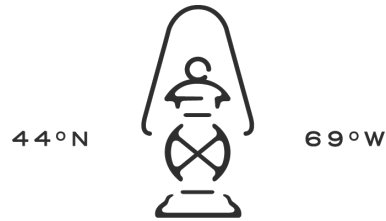
KEVIN CALLAHAN

LEADERSHIP WAYFINDING

# A Brief Overview of Real Options

REDUCING DECISION RISK

[WAYFINDER@KEVIN-CALLAHAN.COM](mailto:WAYFINDER@KEVIN-CALLAHAN.COM)



## To Predict, or Not to Predict, and So What?

---

Leaders and organizations are constantly making a steady stream of decisions. Achieving desired outcomes is often heavily dependent on a specific future coming true. The more stable and known something is, the more predictable it is. It is to decide to invest time, effort, and money in predictable things. As humans, we crave and seek this certainty, even going so far as to imagine it. For better or worse, the world doesn't always cooperate!

When we can predict the future of a process, we can make definitive decisions about what to do next. For example, when operating a production line, we can manage parts inventory based on current and known future demand.

When we cannot predict the future of a process, we still must make decisions. However rather than make definitive decisions on a single unlikely future, to safely proceed we must make multiple small efforts to gain feedback and knowledge. For example, when we are deciding what features prospective customers want in a new product.

We run into real problems when people and organizations make decisions as if the future was predictable when it is quite unpredictable! This article borrows heavily from Maasen et al.'s excellent graphic novel *Commitment*, Duke's stunning book *Thinking in Bets*, Taleb's groundbreaking book *The Black Swan*, and Snowden's work on complexity. Refer to them for more detail and background information.

## Options as Bets

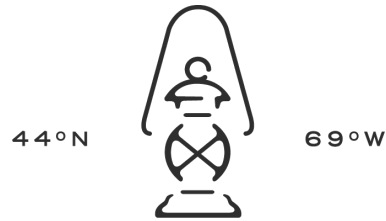
---

All options are a type of bet with probabilities, variability, and risks. As we shift our thinking from seeking to immediately have definitive answers to generating options, many things start moving. One of them is that we likely create far more possible ways forward than we will ever decide or can afford to take. This is, perhaps counterintuitively, a good dynamic as long as we don't get stuck here.

There are several classes of *options*; the kind I'm referring to is called *real options*. There are other options, such as the financial instruments used to set the value of things like the future price of corn. Another type seeks to balance contractual risks between multiple parties, such as buying future shipping capacity in a tanker based on the future market price of oil. Unlike those hard things, we tend to focus on much simpler things.

Creating real options tends to be cheap and fast. Something as simple as ideas in a meeting or writing an email can create options. Once created, such options can be *exercised* (fancy word for holding on to it). All of these have varying degrees of cost and risk. Additionally, options, by their nature, have an expiration date, after which they automatically discard. Finally, an option should not be exercised early unless we have a very clear understanding of why. The moment an option is exercised, it ceases to be optional and becomes a commitment. Commitments tend to cost a lot more than options!

If an option is exercised, the cost/downside to doing so is known and limited (i.e., a company's cost of a 5-minute call center conversation with a customer). Interestingly the benefit/upside can be unknowable and possibly infinite (i.e., the value over time of a delighted, loyal customer through that 5-minute conversation). In short, just like in poker,



you bet you can achieve a much greater benefit by spending a small known amount. Since it's a bet, you might lose for several reasons. As a general rule of thumb, options should be *inexpensive*. If you're making bets (we all are, all the time), it might be wise to afford to lose from time to time!

Paradoxically, deciding what *not* to do through discarding options is sometimes the most effective way to arrive at what to do! And discard we must! Otherwise, we get swamped with more than we can ever get done. Many software product backlogs are so overloaded with requests that even if no more were added, it would take YEARS to deliver all of them. I'm pretty sure that's not a very responsive way to operate a product development function.

## Conclusion

---

High uncertainty brings a set of risks that many leaders and organizations are unsure of how to deal with. They know there is a limited time and money and that simply saying "we don't know" isn't enough. Options are a middle path of sorts, where we gain the strength of plans and structure while harnessing the unlimited potential of high-volatility situations.

For more information, please visit [www.kevin-callahan.com](http://www.kevin-callahan.com) for more resources, including downloads, blog posts, upcoming events, and more!