

Unit IV

Risk in investment

Meaning of investment risk – risk return analysis – classification of risks – risk management - factors influencing the market prices of equity shares - The role of institutional investors – The behaviour of individuals investors – criteria for investment decisions.

Investment risk:

Investment risk can be defined as the probability or likelihood of occurrence of losses relative to the expected return on any particular investment.

Stating simply, it is a measure of the level of uncertainty of achieving the returns as per the expectations of the investor. It is the extent of unexpected results to be realized.

Risk is an important component in assessment of the prospects of an investment. Most investors while making an investment consider less risk as favorable. The lesser the investment risk, more lucrative is the investment. However, the thumb rule is the higher the risk, the better the return.

Risk returns analysis:

Risk and return analysis in Investment Management is related with the number of different uncorrelated investments in the form of portfolio. It is an overall risk and return of the portfolio.

The collection of multiple investments is referred to as portfolio. Mostly large size organizations maintains portfolio of their different investments and hence the risk and return is considered as the entire portfolio risk and return. Portfolio may be composed of 2 or more bonds, stocks, securities and investments or combination of all.

Risk is Relative:

The risk associated with the investments in stocks of Company XYZ generally decreases as more and more investment is made in different stocks of other uncorrelated companies. It is clear from an example in which a person is running a particular business that provides him return of \$200,000 per month. Another business is also run by the same person that gives him \$ 400,000 loss. Then that person will look onto both of his businesses in order to calculate overall rate of return for his investments. Similarly if different investments are made in stocks and bonds, then all of these are considered in calculating the overall portfolio risk & return. If a person has portfolio of different uncorrelated investments then risk of additional investment in particular Company XYZ will be changed. This means that when a person (organization) keeps portfolio having large number of different investments than further investing in particular share of Company XYZ will be different.

Diversification:

The risk of additional investment in certain share of Company XYZ will be different after maintaining portfolio of many uncorrelated different investments. In fact the risk is reduced by investing in different shares & bonds of different companies & in different countries. Diversified investments result in lowering of risk. With the increase in the size of portfolio, the level of risk generally reduces.

Portfolio Risk & Return

Portfolio of investments has overall Risk & Return which is considered. When additional investment in certain stock or bond is made, then the incremental effect of that additional investment on the entire portfolio is viewed.

Classification of risks:

Investment risk can be defined as the probability or likelihood of occurrence of losses relative to the expected return on any particular investment.

1. Interest Rate Risk

Interest rate risk is the possibility that a fixed-rate debt instrument will decline in value as a result of a rise in interest rates. Whenever investors buy securities that offer a fixed rate of return, they are exposing themselves to interest rate risk. This is true for bonds and also for preferred stocks.

2. Business Risk

Business risk is the measure of risk associated with a particular security. It is also known as unsystematic risk and refers to the risk associated with a specific issuer of a security. Generally speaking, all businesses in the same industry have similar types of business risk. But used more specifically, business risk refers to the possibility that the issuer of a stock or a bond may go bankrupt or be unable to pay the interest or principal in the case of bonds. A common way to avoid unsystematic risk is to diversify - that is, to buy mutual funds, which hold the securities of many different companies.

3. Credit Risk

This refers to the possibility that a particular bond issuer will not be able to make expected interest rate payments and/or principal repayment. Typically, the higher the credit risk, the higher the interest rate on the bond.

4. Taxability Risk

This applies to municipal bond offerings, and refers to the risk that a security that was issued with tax-exempt status could potentially lose that status prior to maturity. Since municipal bonds carry a lower interest rate than fully taxable bonds, the bond holders would end up with a lower after-tax yield than originally planned.

5. Call Risk

Call risk is specific to bond issues and refers to the possibility that a debt security will be called prior to maturity. Call risk usually goes hand in hand with reinvestment risk, discussed below, because the bondholder must find an investment that provides the same level of income for equal risk. Call risk is most prevalent when interest rates are falling, as companies trying to save money will usually redeem bond issues with higher coupons and replace them on the bond market with issues with lower interest rates. In a declining interest rate environment, the investor is usually forced to take on more risk in order to replace the same income stream.

6. Inflationary Risk

Also known as purchasing power risk, inflationary risk is the chance that the value of an asset or income will be eroded as inflation shrinks the value of a country's currency. Put another way, it is the risk that future inflation will cause the purchasing power of cash flow from an investment to decline. The best way to fight this type of risk is through appreciable investments, such as stocks or convertible bonds, which have a growth component that stays ahead of inflation over the long term.

7.Liquidity Risk

Liquidity risk refers to the possibility that an investor may not be able to buy or sell an investment as and when desired or in sufficient quantities because opportunities are limited. A good example of liquidity risk is selling real estate. In most cases, it will be difficult to sell a property at any given moment should the need arise, unlike government securities or blue chip stocks.

8.Market Risk

Market risk, also called systematic risk, is a risk that will affect all securities in the same manner. In other words, it is caused by some factor that cannot be controlled by diversification. This is an important point to consider when you are recommending mutual funds, which are appealing to investors in large part because they are a quick way to diversify. You must always ask investorsself what kind of diversification investors client needs.

9.Reinvestment Risk

In a declining interest rate environment, bondholders who have bonds coming due or being called face the difficult task of investing the proceeds in bond issues with equal or greater interest rates than the redeemed bonds. As a result, they are often forced to purchase securities that do not provide the same level of income, unless they take on more credit or market risk and buy bonds with lower credit ratings. This situation is known as reinvestment risk: it is the risk that falling interest rates will lead to a decline in cash flow from an investment when its principal and interest payments are reinvested at lower rates.

10.Social/Political Risk

Risk associated with the possibility of nationalization, unfavourable government action or social changes resulting in a loss of value is called social or political risk. Because the U.S. Congress has the power to change laws affecting securities, any ruling that results in adverse consequences is also known as legislative risk.

11.Currency/Exchange Rate Risk

Currency or exchange rate risk is a form of risk that arises from the change in price of one currency against another. The constant fluctuations in the foreign currency in which an investment is denominated vis-à-vis one's home currency may add risk to the value of a security.

Risk Management:

Risk management is the process of identification, analysis and acceptance or mitigation of uncertainty in investment decisions. Essentially, risk management occurs any time an investor or fund manager analyzes and attempts to quantify the potential for losses in an investment and then takes the appropriate action (or inaction) given his investment objectives and risk tolerance.

1. Follow the Trend

The trend is investors friend until it ends. One way to manage investment risk is to commit to only buying stocks or Exchange Traded Funds (ETFs) that are in an uptrend and to sell them once they violate their trend line support. You can draw investors own trend lines by connecting a series of higher lows on a chart, or you can use a moving average like the 50-day or 200-day to act as support. If the price breaks that support level by a predetermined amount, you sell.

2. Rebalancing

Longer term investors may try to manage risk by periodically selling stock investments or asset classes that have come to take up too much of their portfolios. They will sell off those assets and buy more of the stocks or ETFs that have underperformed. This can be a forced means of buying low and selling high.

3. Position Sizing

Another way to play defense is to simply limit investors exposure. If a given investment is riskier than others, you can choose not to invest in it or to invest only a small amount of investors capital. Many investors use this type of approach to gain exposure to riskier sectors like biotechnology or small cap stocks. A 50% loss on a \$2,000 investment hurts a lot less than it would on a \$20,000 investment. The easiest way to lower investors stock market risk is to shift some of investors capital to cash.

4. Stop Loss Orders

You can place a stop loss order with investors broker that will automatically sell out all or part of investors position in a given stock or ETF if it falls below a preset price point. Of course, the trick is to set the price low enough that you won't get stopped out on a routine pullback, but high enough that you will limit investors capital loss. Placing a stop loss order is one way to limit the damage to investors portfolio and force investorself to follow a strict defensive discipline. Moving or ignoring stop loss levels almost always results in greater losses in the end. The first exit is the best exit.

5. Diversification

The idea behind investment diversification is to buy asset classes or sectors that are not correlated. That means that if one goes up, the other is probably going down. Diversification has been a lot more difficult to achieve over the past few years as many asset classes have become highly correlated. Even stocks and bonds have been moving in the same direction much more often than in the past. Diversification is a good strategy to limit investors risk, but *it only works if the assets you buy are truly uncorrelated.*

Factors influencing the market prices of equity shares:

The following are the factors that influence share prices

1. **Demand and supply**: Demand and supply of securities influence price of securities. If the demand of securities is more than the supply (buyers are more than the sellers), prices of securities increase. On the other hand if the demand of securities is less than the supply (buyers are less than the sellers), prices of securities decrease.
2. **Bank rate**: In case of lower bank rate (lower interest rate), the demand for funds would be higher and the demand for securities would be high. Whereas in case of higher bank rate (high interest rate), the demand for funds would be lower and therefore the demand for securities would be lower.
3. **Market players**: Security prices are influenced by the market players. If the number of bulls are more than the bears, then the prices of securities would increase. On the other hand, if the bears are more than the bulls, the prices of securities would decline.
4. **Dividend announcements**: Dividends act as a signalling device for share price movement. Dividend announcements influence share prices. If companies announce dividends, generally share

prices of those companies tend to increase. An important point to note is, if the rate of dividend announced is less than what was expected by investors, share prices would decline, whereas if they are up to or more than expectations, share prices would increase.

5. **Management profile**: Management profile significantly influences success of companies and therefore they have an important influence on share prices. If the management comprises of educated, experienced professionals with a successful track record then share prices would be higher. In case the company is taken over by a management having a poor reputation then the share prices would fall.

6. **Trade cycle**: Trade cycles refer to cyclical fluctuations in economic activity. During boom conditions the share prices would be at their peak and during depression they would be at their lowest point. Share prices would gradually increase during recovery conditions and would fall during conditions of recession.

7. **Speculation**: In case speculation in the market is high or in case speculation in a stock is high, then the price of that share would be showing high fluctuations. In case speculation is at a low level then the fluctuations in share price would be lower.

8. **Political factors**: Political factors such as ideology of the party in power, policies of the government, relations with other countries influence share prices. For e.g. when the UPA government won elections, share prices fell to a great extent because it was felt that the government policies would be influenced by the communist parties.

9. **Industrial relations**: In case there is good relationship between the workers and the management of a company, the productivity would be high leading to better profits. Therefore share prices would be higher. In case of companies where industrial relations are poor and strikes and lockouts occur regularly, performance of the company would be poor. Therefore share prices would fall.

10. **Stability of government**: When there is a stable government, businessmen feel confident to invest in new businesses and expand existing businesses. Production, sales and profits are higher and consequently share prices would increase. In case of instability in the government, new investments do not take place. Demand, production and profits are lower and share prices fall.

11. **General market sentiments**: It is generally said that sentiments move the markets. If there is optimism among market players, more buying would take place leading to increase in share prices. In case market players are pessimistic, then more selling would take place pushing down share prices.

12. **Actions of institutional investors**: Share prices are influenced by Institutional investors such as mutual funds, investment trusts, pension funds etc. They have large amount of funds at their disposal. When they start buying, share prices would increase and when they sell, share prices decline

13. **Level of foreign investment**: In recent times, the level of foreign institutional investors (FII's) have played a significant role in influencing share prices. If the level of foreign investment in the market increases (more buying of shares), then the share prices increase. If the level of foreign investment decreases or if FII's sell their investments, then the markets fall.

14. **Returns offered by other markets**: If the Indian markets offer high returns, institutional investors (especially FII's) would invest in Indian markets. Demand for shares would increase and prices rise. In case returns offered by markets in other countries are attractive, then institutional investors would sell their securities in order to invest in those markets. In such cases, shares would be sold in large quantities lowering prices.

15. **Availability of credit:** In case credit is available without much restriction, then investors would borrow to invest in the markets. Demand for shares would be more and therefore prices rise. In case credit is restricted, then the level of borrowing would be less and demand for shares would also be lower.

16. **Effective regulation:** If the stock market is run in a transparent manner with effective regulation then the investors would feel confident to invest. Therefore more buying would take place and share prices increase. But when regulation is ineffective and if scams occur (Harshad Mehta scam, MS Shoes scam, CRB scam, Ketan Parekh scam and the recent IPO scam) investors would lose confidence. They would panic and sell their shares. So prices would fall.

Role of institutional investors:

The roles of **institutional investors** differ between businesses, dependent on the rules and responsibilities laid out at the founding of investors company or as investors business evolved over the years. The most common definition of a stakeholder, however, is a large investor that has the clout to hold viable institutional investors.

Decision Making

The most common gathering of institutional investors in a publicly traded company is the board of directors, comprised of high-ranking executives and occasional outsiders who hold large amounts of equity in the company. Any one of these institutional investors has the power to disrupt decisions or introduce new ideas to the company.

Direct Management

While the board of directors is a more "hands off" approach to controlling a company, some institutional investors prefer the "hands on" approach by directly assuming management positions. Institutional investors can take over certain departments - such as human resources or research and development - to micromanage the business and insure success. In privately owned and publicly traded companies, large investors often directly participate in business decisions on the management level.

Investors

Institutional investors are regarded as large investors, who will either increase or decrease their stakes in investors company according to investors financial performance. Ideally, they act as guardian angels for everyday investors, poring over financial reports and pressuring management to change tactics if necessary. Certain institutional investors, known as activist investors, will make wildly unpredictable investments and divestitures in order to move the share price and attract media attention to a certain issue. Carl Icahn is well known for this high pressure tactic, which is used to mold companies more to his liking

Corporate Conscience

Large institutional investors are generally high profile investors, and would like to steer clear of companies that trample human rights and environmental laws. They monitor investors company's outsourcing activities and globalization initiatives, and may vote against investors business decisions if they are deemed harmful to the company's long-term goals.

Other Responsibilities

Institutional investors who care about these four issues, but more often than not, short-term profits take precedence over long-term sustainability. While institutional investors may own investors company, it's easier to control investors investors when investors company is privately held than publicly traded. Often times, the large influx of cash from a successful IPO turns out to be a deal with the devil when investors company is suddenly taken over by a board of directors that ousts.

Behaviour of individual's investors:

Physical appearance

The physical appearance and the personality of the individual's investors have great contribution in his success in the business. If he has good appearance and commanding personality, it impresses the employees and makes him a successful individual's investors.

Education

Today business is a complex activity and demands the services of educated and skilled persons who especially know the tact's of business. So the education is compulsory for a good individual's investors to understand the complication and has communication with others.

Technical Skills

Today every business demands some sort of technical skill. So a good individual's investors must know all those technical skills required for that particular business which he has stated. For example investors wants to manufacture Air craft's, then you must be a engineer and investors want to open an audit firm then you must be a chartered accounted.

Honest

It is true that honesty is a best policy, so, for the success of the business, it is necessary that the business must be an honest person. He should not receive any one. He should not mix up inferior quality in his own. He should work honestly. People will trust him and his business will develop.

Hard working

An individual's investors must be a hardworking man. He should be habitual to work for a longer time to develop and look after his business. If he is not hard working and is a lazy person he cannot complete the other and he will have to suffer losses.

Courteous

An individual's investors must be a cool minded person and should talk with his subordinates, colleagues and customer politely. He should not leave courtesy in any case, in this way can win the hearts if his customers and can develop the business relations.

Discipline

It is the quality of a good individual's investors that he must have a disciplined personality. He must be regular, punctual and dutiful. He must not leave today's work on tomorrow. He should present himself as a role model for other employees.

Decision power

Many business decisions are made by an individual's investors. It is necessary for a good individual's investors that he must have quick decision power. He should not make delay in important decision and it is only possible when he has quick decision power to settle the matters.

Cooperative

It is necessary for a good individual's investors that he should have passion of co-operation for his colleagues and employees. He should trust on teamwork. When he cooperates with others in the best interest of business then he can also expect their cooperation, which is necessary for the success of the business.

Managerial Skills

An individual's investors have to manage all the business activities. So he should be an expert of managerial skills. It is often said that a good manager is good individual's investors, so management skill is necessary for successful individual's investors.

Innovative

New changes and development are taking place in business like every other field of life. It is all due to new inventions and scientific and technological developments. So a individual's investors should always be ready to develop and apply new rules for the advancement of the business.

Financial Soundness

The success of the business mostly depends upon the financial soundness of the individual's investors. Without sufficient funds no business can be run properly. As the business extends, it earns more and more profit and the extension of the business demands excessive finance, so the good individual's investors should not only be financially sound party but should also know the skills of financial management.

Experience

It is rightly said that an old is gold. So it is necessary for the smooth running of the business that a individual's investors should have vast experience of business. An experienced person can earn more profit as compared to a new one and can become a successful individual's investors.

Communication Power

A number of times a individual's investors has to address his employees attend important meeting and has to contact with customers and with other people. If he has effective communication power then he can impress and convince the others and it is very important for the business.

Leadership Qualities

An individual's investors are the leader of this concern and leader should lead from the front. When the leader is competent, every business activity is performed smoothly. So a good individual's investors are that who has all the qualities of leadership in order to extend the business and to earn more profit.

Criteria for investment decisions:

Embrace an Investing Strategy

Investors choose to be a value investor you are at the right place to learn more. I believe investment decisions should be valuation-based. Whichever investing strategies you choose, maintain a consistent approach. In other words, a value investor should not be participated in momentum investing.

Invest With a Margin of Safety

Investors buy an asset for less than its real value you have a margin of safety. One of my favorite sayings is: Price Matters! The best plan to lower risk is to buy investments at a price that is lower than the real or intrinsic value.

A low price means greater upside appreciation if conditions are favorable. At the same time, a low price provides a margin of safety if circumstances are not ideal. Always plan on less than ideal conditions, something usually goes wrong.

Asset Allocation

Investor's asset allocation, how you divide investors portfolio among different asset categories, will be the biggest determinant of investors investment returns. I find this is where many investors fail because they put little thought or effort into their asset allocation strategy.

Diversification is Vital

Investment diversification in small numbers provides enormous benefits. In other words, five investments is much better than two, ten investments is better than five. However, the marginal benefits of adding additional investments decreases as the numbers get larger until the costs become greater than the benefits.

Invest For the Long Term

Short term investing is one of the biggest downfalls of current investing strategies. The truly great investors realize investors buy an investment at a favorable price it may take time for the market to recognize its true value.

Use Compounding to Investors Advantage

Compounding or exponential growth (they mean the same thing) is a powerful financial concept. Understand how it works for you and why dividend growth compounding multiplies the value of compounding.

It's equally important to understand the devastation of reverse compounding. The more of investor's portfolio you lose the harder it is to make it back because you lose investors principal. A 10% loss only requires an 11% gain to get back to break-even. However, a 50% loss requires a 100% gain to get back to break-even.

Employ Risk Control Strategies

Because it is so important to not lose investors principal you must employ risk control strategies. Portfolio volatility is an investment return killer. Investors don't control risk you will suffer greatly in bear markets. Avoiding large portfolio drawdowns should be one of investor's preeminent investing principles.

Anticipate Market Volatility and Make it Investors Friend

Despise portfolio volatility but embrace market volatility. You can control portfolio volatility but you cannot control the inevitable volatility of investment markets.

Therefore, you should be prepared to take advantage of investment opportunities. At the same time, you need to be cognizant of overvalued assets and be willing to move to cash when conditions are unfavorable.

Control Investors Own Destiny

No one cares about investor's money more than you do. Wall Street fraud, conflicts of interest, and outrageous fees make self-directed investing an attractive alternative.