Knowing and dealing with risks in financial assets – Part 1

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With the markets moving up and down like a roller coaster, one needs to carefully consider the various risks that are associated with each investment you make.

The fact is, many people either have no desire or no knowledge about how to protect themselves from unwanted risk. Whether it is investing, driving, or just walking down the street, everyone exposes themselves to risk. Your personality and lifestyle play a big role in how much risk you are comfortably able to take on. If you invest in stocks and have trouble sleeping at night, you are probably taking on too much risk.

Risk is defined as the chance that an investment's actual return will be different than expected. This includes the possibility of losing some or all of the original investment.

Those of us who work hard for every penny we earn have a harder time parting with money. Therefore, people with less disposable income tend to be, by necessity, more risk averse. On the other end of the spectrum, day traders feel if they aren't making dozens of trades a day there is a problem. These people are risk lovers.

When investing in stocks, bonds, or any investment instrument, there is a lot more risk than you'd think.

Broadly there are two basic types of risk:

- **Systematic Risk** - Systematic risk influences a large number of assets. A significant political event, for example, could affect several of the assets in your portfolio. It is virtually impossible to protect yourself against this type of risk.

- **Unsystematic Risk** - Unsystematic risk is sometimes referred to as "specific risk". This kind of risk affects a very small number of assets. An example is news that affects a specific stock such as a sudden strike by employees. Diversification is the only way to protect yourself from unsystematic risk.

Apart from the fundamental types of risk, let's look at more specific types of risk, particularly when we talk about stocks and bonds.

- **Country Risk** - Country risk refers to the risk that a country won't be able to honor its financial commitments. When a country defaults on its obligations, this can harm the performance of all other financial instruments in that country as well as other countries it has relations with. Country risk applies to stocks, bonds, mutual funds, options and futures that are issued within a particular country. This type of risk is most often seen in emerging markets or countries that have a severe deficit.

- **Credit or Default Risk** - Credit risk is the risk that a company or individual will be unable to pay the contractual interest or principal on its debt obligations. This type of risk is of particular concern to investors who hold bonds in their portfolios. Government bonds, especially those issued by the federal government, have the least amount of default risk and the lowest returns, while corporate bonds tend to have the highest amount of default risk but also higher interest rates.

- **Interest Rate Risk** - Interest rate risk is the risk that an investment's value will change as a result of a change in interest rates. This risk affects the value of bonds more directly than stocks.

- **Foreign-Exchange Risk** - When investing in foreign countries you must consider the fact that currency exchange rates can change the price of the asset as well. Foreign-exchange risk applies to all financial instruments that are in a currency other than your domestic currency.

- **Political Risk** - Political risk represents the financial risk that a country's government will suddenly change its policies. This is a major reason why developing countries lack foreign investment.

- **Market Risk** - This is the most familiar of all risks. Also referred to as volatility, market risk is the day-to-day fluctuations in a stock's price. Market risk applies mainly to stocks and options. As a whole, stocks tend to perform well during a bull market and poorly during a bear market - volatility is not so much a cause but an effect of certain market forces. Volatility is a measure of risk because it refers to the behavior, or "temperament", of your investment rather than the reason for this behavior.

The risk-return tradeoff is the balance an investor must decide on between the desires for the lowest possible risk for the highest possible returns. Remember to keep in mind that low levels of uncertainty (low risk) are associated with low potential returns and high levels of uncertainty (high risk) are associated with high potential returns.

The risk-free rate of return is usually signified by the quoted yield of Government Securities because the government very rarely defaults on loans. Let's suppose that the risk-free rate is currently 7%. Therefore, for virtually no risk, an investor can earn 7% per year

on his or her money. But who wants 7% when index funds could yield 10-12% per year? Remember that index funds don't return 12% every year, instead they return -5% one year and 25% the next and so on. In other words, in order to receive this higher return, investors much also take on considerably more risk.

Can risk be reduced by any means? One can attempt to reduce the risk in the portfolio with diversification.

While diversification does not guarantee against a loss, it is the most important component to helping you reach your long-range financial goals while minimizing your risk. Keep in mind, however that no matter how much diversification you do, it can never reduce risk down to zero. There are three main things you should do to ensure that you are adequately diversified:

Your portfolio should be spread among many different investment vehicles such as cash, stocks, bonds, mutual funds, and perhaps even some real estate.

Your securities should vary in risk. You're not restricted to picking only blue chip stocks. In fact, the opposite is true. Picking different investments with different rates of return will ensure that large gains offset losses in other areas. Keep in mind that this doesn't mean that you need to jump into high-risk investments such as penny stocks!

Your securities should vary by industry, minimizing unsystematic risk to small groups of companies.

Another question people always ask is how many stocks they should buy to reduce the risk of their portfolio. The portfolio theory tells us that after 10-12 diversified stocks, you are very close to optimal diversification. This doesn't mean buying 12 bank or cement stocks will give you optimal diversification. Instead, you need to buy stocks of different sizes and from various industries.

To achieve superior diversification, you would want to diversify across not only different types of companies but also different types of industries. The more uncorrelated your stocks are, the better.

It's also important that you diversify among different asset classes. Because different assets - such as bonds and stocks - will not react in the same way to adverse events, a combination of asset classes will reduce your portfolio's sensitivity to market swings. Generally, the bond and equity markets move in opposite directions, so, if your portfolio is diversified across both areas, unpleasant movements in one will be offset by positive results in another.

Diversification can help an investor manage risk and reduce the volatility of an asset's price movements. Remember though, that no matter how diversified your portfolio is, risk can never be eliminated completely. You can reduce risk associated with individual stocks, but general market risks affect nearly every stock, so it is important to diversify also among different asset classes. The key is to find a medium between risk and return; this ensures that you achieve your financial goals while still getting a good night's rest.

Different individuals will have different tolerances for risk. Tolerance is not static; it will change as your life does. As you grow older tolerance will usually shrink as more and more obligations come up, including retirement. On the other hand with growing investible surplus, some people display higher risk tolerance with advancing age.

In the next issue, we will discuss risk reward concept, determining risk preference and Investment risk pyramid.

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