Investment Risk Management

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Abstract
Investment Risk Management is the process of identifying possible risks in the investment and analysing them well in advance and to take necessary steps to prevent them. In the case of businesses, when they make financial investments, they undertake risk management so efficiently that they can identify the potential economic risks, their impacts and ways to overcome them. Risk management takes place when an investor or fund manager quantifies of the potential losses and takes necessary actions to tackle the risk involved in the investment. The purpose of this paper is (i) To study the various steps involved in the process of investment risk management. (ii) To understand the importance of investment risk management. (iii) To identify the principles that guide investment risk management and (iv) To know the different ways and strategies to manage the risk.Financial Risk Management controls the entire investment game. Thispaper provides a starting point for investors or fund managers to establish their risk management strategies. Investment Risk Management teaches how to make more by risking less. Investment risk management is the secret behind safe and consistent profits making in any market condition.
Keywords: Risk Management, Fund Managers, Financial Investments, Investment Risk Management.

Introduction

In financial term, risk is defined as the potential for variability in returns. Risk means 'Chance of Loss'. An investment is said to be risk – free if the actual return and the expected are the same. On the other hand, investment is considered a risky one when its returns show wide variations. The expected returns vary according to the type of securities in which investments are made. Higher the variations between the expected and actual returns, riskier the investment is. While making investment decisions, it is essential to measure the correct level of risk associated with the different types of securities available for investment. A better understanding of risk in its different forms will help investors to know the various opportunities, trade-off, and costs involved with different investment. Risk Management is inevitable in everyone's life. So one must have the ability to face the risk and overcome it. The main advantage of investment risk management is it minimises risk of loss. In case one investment performs poorly, other investments may perform better, thereby reducing the investment loses. The main disadvantage of risk management is, the difficulty in its implementation as it takes a long time to collect information relating to strategic plans. A risk management program will help to foresee the risk, to build a better defence and thereby reduce liability.

Objectives of the Study

As it is a concept paper the purpose of the study is to:

- To understand the importance of investment risk management.
- To study the various steps involved in the process of investment risk management.

- To identify the principles that guide the investment risk management.
- To know the different ways & strategies to manage the risk.

Research Methodology

To prepare this paper only secondary data was used. Journal, Published Articles and Websites were used for collecting the secondary data.

Limitations of the Study

As it is a concept paper based on the secondary data. It has all the limitations of secondary data.

Investment Risk

It is the probability of losing some or all of the original investment, or that investment does not perform as estimated. Generally higher the chance of occurring loss, the greater will be the investment risk, and will be the expected returns. In the popular sense, investment risk is defined as, "a deviation from an expected outcome". The deviations can be either positive or negative. The volatility depends upon the risk tolerance capacity of the investor, taking into account his psychological comfort with the uncertainty and the possibility of incurring losses.

Types of Investment Risk

Market Risk

It is the risk that affects the entire market because of economic developments other events, resulting decline in the value of investments. The various types of market risks are equity risk, interest rate risk and currency risk.

- **Equity Risk:** It applies to investments made in equity shares. The market price of shares always varies depending on demand and supply forces. Equity risk arises as a result of a drop in the market prices.
- **Interest Rate Risk:** It is the risk which applies to investments made in debt instruments such as bonds, debentures etc. Because of changes in the interest rate, there is a risk of losing money.
- **Currency Risk:** It is applicable in the case of foreign investments. Here there is a risk of losing money due to variations in the exchange rate.

When investments are made, they are exposed to various kinds of risks, and different risks can affect investment returns differently.

Liquidity Risk

It is the risk in which investors find it difficult to sell the investment at a fair price. When money is needed, he has to accept at a lower price for selling the investments.

Concentration Risk

It is the risk that arises due to the concentration of money in one investment or one type of investment. The concentration risk can be reduced by diversifying the investments, spread the risk over different types of investments, industries and geographical location.

Credit Risk

It is the risk faced by the government entity or company which faces a financial crisis and find it difficult to pay interest or repay the principal amount on the bonds issued by them.

Reinvestment Risk

Re-investment arises due to the risk of loss from re-investing the principal amount and regular interest payments at lower interest rates. Re-investment risk affects when the interest rate drops. It can be avoided, if the investor intends to spend the interest payments or the principal amount at the time of maturity.

Inflation Risk

It is the risk that occurs because of inflation. It reduces the purchasing power of money over time. The risk of loss in purchasing power arises because the value of investments does not align with inflation. Shares and Real Estates are the investment alternatives, as their prices also rise in line with inflation.

Horizon Risk

Horizon risk is the one which may shortened investment horizon because of an unforeseen event. For example, that event may be loss of a job, which may compel the investor to sell the investments, which were expecting to be held for a long time.

Longevity Risk

The risk of outliving savings is known as Longevity Risk. This risk affects those people who are retired or are nearing retirement.

Foreign Investment Risk

It is applicable in the case of buying foreign investments. The risk of loss arises when making investments in foreign countries.

The different kinds of risk should be considered at stages of investment for achieving different investment goals.

Risk and Psychology

An important aspect has been contributed by the field of behavioural finance to the risk equation, i.e. how people differently view between gains and losses. In the language of prospect theory, an area of behavioural finance introduced byAmos Tversky and Daniel Kahneman in 1979, investors exhibit Loss Aversion, they put more weight on the pain associated with a loss than the good feeling associated with a gain.

Investment Risk Management

It is the process of identifying, analysing and acceptance or minimise the uncertainties in investmentdecisions. It is the attempt by an investor or fund manager to examine the potential for losses in an investment and then take appropriate action. It is the secrets to be safe and to get consistent profits under any market conditions. Investment without risk management is like being a quarterback without a frontline to protect.

Risk Management is a process of estimating the risk exists in an investment and then dealing those risks. It is because it can reduce or increase the risk depending upon the financial goals of investors.

Accounting and Risk Management

Although the risk is forward-looking, accounting is backward looking and relies on historical costs from events occurred in the past. Accounting information can inform investors about stock market conditions, bankruptcy, corporate funds, volatility etc. In addition to that, the financial statements contain many useful disclosures about risk, uncertainties and discount rates.

All investments carry some degree of risk. By better understanding the nature of risk and taking necessary steps to manage those risks; one can be in a better position.

Importance or Uses of Investment Risk Management

- It saves time, cost and effort.
- It helps to discover new investment opportunities.
- It helps in making better decisions by forecasting possible threats and opportunities.

It is clear that a good risk management plan is the base for the success of any investment.

The Principles of Investment Risk Management

Basically, there are three principles for Investment Risk Management, which is applicable almost everywhere.

Principle 1: Prediction about the Future

Making correct predictions is a task,mainly when it's about the future. Asset Management Firms make these predictions, and they are paid for this, and every prediction is subject to a level of errors. Investment risk management tries to understand these levels and to use these understandings in the decision- making process, keeping in mind the uncertainty.

Principle 2: Investing not a Game

Investing in financial markets is not a game. Financial Markets always face a massive break from normal behaviour; here the rules are well-defined and known in advance. Investment risk management must consider the chances of big regime change.

Principle 3: Clarity is Imperative

The third principle gives more importance to the clarity of duties between investment managers and their clients. The clients must have a clear idea about the decisions which he has to make and the decisions which he can leave to the investment managers. All parties dealing with the client's capital must have knowledge about their responsibilities so that they can move quickly and precisely.

Risk Management Process

There are five steps involved in the risk management process.

Step 1: Identify the Risk

It provides the foundation of risk management. Risk identification requires knowledge of the company, the market in which it operates, the legal, social and economic, the political environment in which it does business etc. For each risk identified make clear its sources or causes and documented well.

Step 2: Risk Analysis

Once the risk has been identified, the next step is to assess the possible impact of each risk and its probability of occurrence. In the risk analysis, it is crucial to make the best educated guesses or opinions to properly implement the risk management process. The main problem in risk analysis is determining the rate of occurrence since it is difficult to obtain statistical information on all kinds of past events.

Step 3: Risk Evaluation

Risk evaluation determines the tolerability of each risk, i.e. which risk needs treatment and which requires more priority. This could be achieved by comparing the risk according to their severity and consequence basis.

Step 4: Risk Treatment

It is a continuous process in which individual risk treatments are assessed to determine whether the residual risk levels are up to a tolerable level. The most appropriate treatment is selected on the cost and benefit basis. In cases, further treatment may not be possible or affordable. Hence the residual risk may be accepted and communicated.

Step 5: Monitoring and Review

Risk management is a continuous process in which risks are continuously monitored and reviewed for the success of the business strategy adopted. This step is essential for better risk management in future.

Communication and Consultation

Communication and consultation are essential qualities of risk management. Risk Management cannot be done without communicating and consulting. It is inevitable and in practice at each stage of the risk management process.

Formal Risk Reporting is one of the ways of risk communication. A risk communication possesses the following merits:

- It encourages stakeholder involvement and accountability.
- It helps to obtain maximum information to reduce uncertainty.
- To meet the reporting needs of stakeholders.
- To ensure that all the necessary expertise is used to inform each step of the process.
- It helps to meet different communication needs and requirements of stakeholders.

How to Minimize Investment Risk?

Diversification

Diversification of investment means invest in a variety of securities across and within asset classes, industry sectors and even geographic areas. A well-diversified investment portfolio will help to offset a fall in the value of one asset by an increase inanother.

Focus on the Investment Goals

Usually, growth investment assets have some short term volatility. So no need to get panic where the market fallsconsider whether there are still chances to achieve long term goals.

Monitor the Investments

The balance of assets may vary based on gains or loss value. It may also reduce the diversity of the portfolio. In case any assets strays too far from its target, the rebalance the portfolio by selling some of one asset type and buying more of another.

Consider Financial Advice

For developing a plan or selecting the appropriate financial products seek financial advice may be essential for risk appetite.

Beware of Scams

The scammers try to take advantage of the investors when the markets are volatile. So beware of such scams.

How to Manage Risk?

Once the value of risk in investment has been identified, then start the different ways of managing them.

Cost-Effective Approach

In this it says that it wouldn’t be cost-effective to spend more on eliminating a risk than to meet the event if it occurs. It is advisable to accept the risk than to spend more resources to eliminate it.

Avoid the Risk

Here, it emphasizes avoiding the risk. It is a good option, but have to remember about one thing that by avoiding the risk, one is missing out an opportunity.

Share the Risk

Another way to manage risk is to share the risk as well as the potential gain with other people, organisation or even with some third parties.

Accept the Risk

This option is the best when it is not possible to prevent or minimise risk. Sometimes it is better to acceptsome risk when the potential loss is less or when the potential gain is worthy.

Control the Risk

Risk can be controlled to some extent by using preventive and detective actions. Preventive actions aim to prevent a high-risk situation from happening, whereas detective actions involved double-checking the financial reports and conducting safety testing before investing on a large scale.

Investment Risk Management Strategies

Investment Offence

In the case of investing, there are different ways to an offence. Firstly, invest in the stocks of successful companies on the hope that they will continue to outperform. Secondly, waiting to hit their target investment a specific value or price based on technical and fundamental analysis. Whatever method is adopted, the ultimate goal is to generate capital appreciation.

Investment Defence

Investment defence is as important as a successful offence. Warren Buffet one of the most successful investors ever has given two most important rules of investing.

Rule 1: Don't lose money.

Rule 2: Never forget Rule 1.

Following are the best strategies to protect money in the game of investing or 5 ways to play defence:

1. **Follow the Trend**: One way to manage investment is to follow the trend, i.e. buy those stocks only that are in an upward trend and to sell them once they violate their trend line. Trend lines can be drawn by connecting a series of highs-lows on a chart or using a moving average like 50-day or 200-day to act as support.
2. **Rebalancing**: It is the method adopted by long term investors to manage risk, i.e. by periodically selling stock investments that have underperformed. It is based on the principle of buying low and selling high.
3. **Position Sizing:** This is another way to play defence. Many investors use this type of approach where they choose not to invest in an investment which is riskier than others or to invest only a small portion of capital to riskier sectors. The easiest way to reduce stock market risk is to transfer some capital to cash.
4. **Stop Loss Order**: This is another defensive discipline to limit the damage to the investments by placing a stop-loss order with the broker which will automatically sell out all or part of given stocks if it falls below a predetermined price level. By using this method can limit the capital loss to a great extent.
5. **Diversification**: It is also a strategy to limit investment risk and it works only if the asset classes or sectors that are not correlated. That means an increase in one does not lead to a decrease in another while making diversified investment make sure to look at the recent performance rather than relying on past performance.

Conclusion

Risk is inevitable for the success of every investment, but understanding how to manage risk and earn a profit is something difficult. The peculiarity of risk is that it changes from time to time and hence, risk management will be appropriate where it is dynamic and evolving. Monitoring and reviewing are inevitable for the success of risk management. Risk Management is a continuous process. And so continuous risk monitoring and review is an integral part for better risk management in future. This paper provides a starting point for investors or investment managers to establish their risk management strategies. Investment Risk Management teaches how to make more by risking less. It is the secret behind safe and consistent profits making in any market condition. If financial security is the main goal, then investment risk management should be primarily focused. The truth is that investment skills and knowledge will known from the investment results. Always to remember this quote "Invest with your head, never with your heart".

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