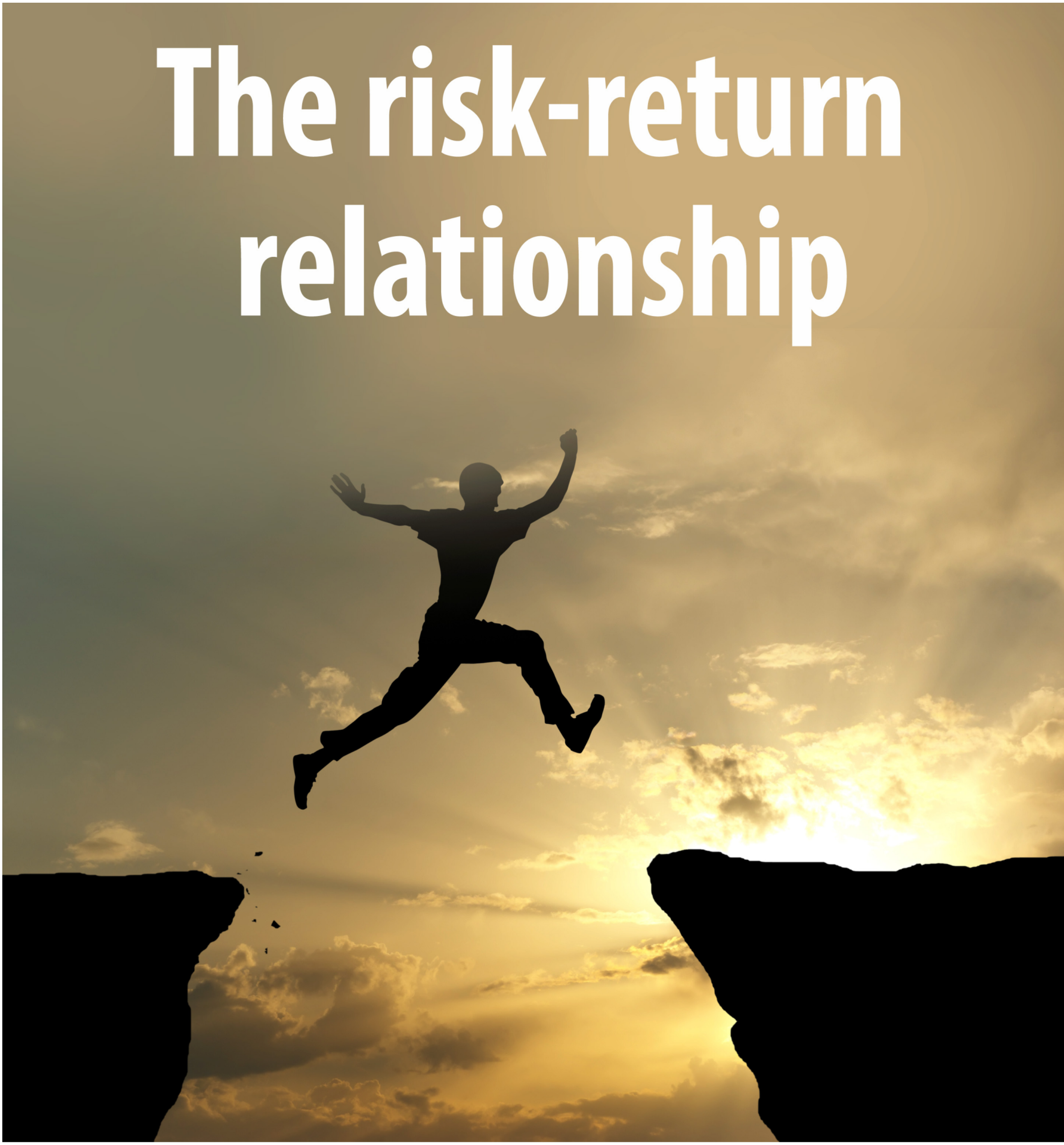
The risk-return relationship



IFE Academy

Education Simplified

INVESTORS FINANCIAL EDUCATION ACADEMY

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First Edition: 2019

About this book

Risk and Return play a big role in deciding how much you will need to save for your future. So, understanding how they work and your attitude to risk can help you make investment decisions that best meet your financial needs and goals.

Generally, the higher the potential return of an investment, the higher the risk. There is no guarantee that you will actually get a higher return by accepting more risk. Some investments carry low risk. With these low-risk investments you are unlikely to lose money. However, they have a lower potential return than riskier investments and they may not keep pace with inflation.Time plays an important role when it comes to investing. As a general rule, it's your time in the market, not your timing of the market that tends to give you the greatest opportunity to maximise your potential to achieve superior long-term returns.

This book details on the risk associated with Capital Market and how you can handle it. We hope you would find this information useful.

Happy reading!

Rs.40/-

Published by
Investors Financial Education Academy
5A, 5th Floor Kences Towers, No. 1, Ramakrishna Street,
North Usman Road, T.Nagar, Chennai-600017

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INVESTMENT RISK IN CAPITAL MARKETS

The term risk generally refers to the volatility of a particular security. Investments typically have an associated risk based upon their exposure to markets and the fluctuations within them. Risk is differentiated from “uncertainty” because it is measurable; therefore, investors must methodically research the securities they invest in to mitigate loss. Their research and analysis are crucial in deciding what kind of position, if any, should be taken. Markets price securities to incorporate all available information, and react quickly to incorporate the effects of new information into the price of securities. Investors, however, can only predict future information and its effect on the pricing of securities.

RISK AND RETURN

Risk is one of the most fundamental aspects of investing and lies within the core of research. Investors seek securities that will offer a high return without losing principal investment. The investments often deemed “risky,” in many cases, are subject to greater return than those considered risk-averse. It is this concept that leads money managers to seek out risky investments that they believe will yield a high return. Without knowing how the overall economy and its various macro-economic factors, the company or underlying assets tied to the security, and how the investor's own financial situation will perform and change, the investor has no way of accurately predicting the performance of any security or class of securities. There are several kinds of risks such as business risk, liquidity risk, political risk etc. which will be explained in detail in our inner pages of this issue.

INVESTMENT RISKS AN INVESTOR SHOULD KNOW & HOW TO MANAGE THEM

The fact is that you cannot get wealthier without taking risks. Risks and rewards go hand in hand; and, typically, higher the risk you take, higher the returns you can expect. The secret to getting wealthier is to take calculated risks, not reckless risks. Every investment opportunity carries some risks or the other. In some investments, a certain

type of risk may be predominant, and others not so significant. A full understanding of the various important risks is essential for taking calculated risks and making sensible investment decisions. Seven major risks are present in varying degrees in different types of investments.

Default risk

The risk of non-payment refers to both the principal and the interest. For all unsecured loans, e.g. loans based on promissory notes, company deposits, etc., this risk is very high. Since there is no security attached, you can do nothing except, of course, go to a court when there is a default in refund of capital or payment of accrued interest. So it's always good to look at the CRISIL / ICRA credit ratings for the company before you invest in company deposits or debentures.

Business risk

The market value of your investment in equity shares depends upon the performance of the company you invest in. If a company's business is doing excellent then the company performs well & the market value of your share can go up sharply & vice versa. When you invest money in Companies with poor financials & poor managerial decisions, there is always a possibility that you may lose your hard-earned money.

Good Financial

Poor Financial

Liquidity risk

Money has only a limited value if it is not readily available to you as and when you need it. In financial jargon, the ready availability of money is called liquidity. An investment should not only be safe and profitable, but also reasonably liquid. An asset or investment is said to be liquid if it can be converted into cash quickly, and with little loss in value. Liquidity risk refers to the possibility of the investor not being able to realize its value when required. This may happen either because the security cannot be sold in the market or prematurely terminated, or because the resultant loss in value may be unrealistically high. Current and savings accounts in a bank, National Savings Certificates, actively traded equity shares and debentures, etc. are fairly liquid investments. In the case of a bank fixed deposit, you can raise loans up to 75% to 90% of the value of the deposit; and to that extent, it is a liquid investment. Some banks offer attractive loan schemes against security of approved investments, like selected company shares, debentures, National Savings Certificates, Units, etc. Such options add to the liquidity of investments. The relative liquidity of different investments is highlighted overleaf:

Liquidity of various Investments:

SL.No	Liquidty	Examples
1	Very high	Cash, gold, silver, savings and current accounts in banks, G-Secs
2	High	Fixed deposits with banks, shares of listed companies that are actively traded
3	Medium	Fixed deposits with companies enjoying high credit rating, debentures of good

Purchasing power risk, or Inflation risk

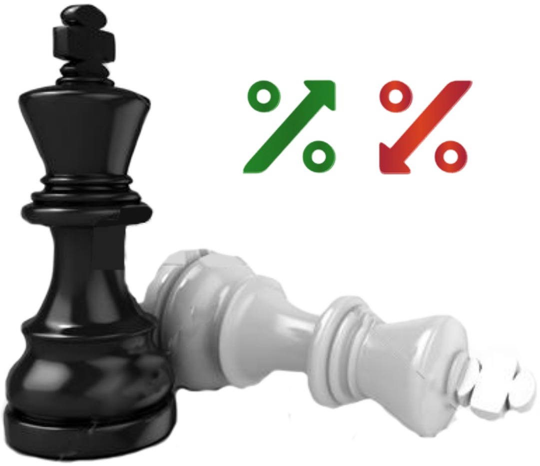
When prices shoot up, the purchasing power of your money goes down. Some economists consider inflation to be a disguised tax. Given the present rates of inflation, it may sound surprising but among developing countries, India is often given good marks for effective management of inflation. The average rate of inflation in India has been around 4-5% p.a. during last decade.

Ironically, relatively "safe" fixed income investments, such as bank deposits and small savings instruments, etc., are more prone to ravages of inflation risk because rising prices erode the purchasing power of your capital. "Riskier" investments such as equity shares are more likely to preserve the value of your capital over the medium term.

Interest rate risk

In this deregulated era, interest rate fluctuation is a common phenomenon with its consequent impact on investment values and yields. Interest rate risk affects fixed income securities and refers to the risk of a change in the value of your investment as a result of movement in interest rates. Suppose you have invested in a security yielding 8 percent p.a. for 3 years. If the interest rates move up to 9 per cent one year down the line, a similar security can then be issued only at 9 percent. Due to the lower yield, the value of your security gets reduced.

Political risk

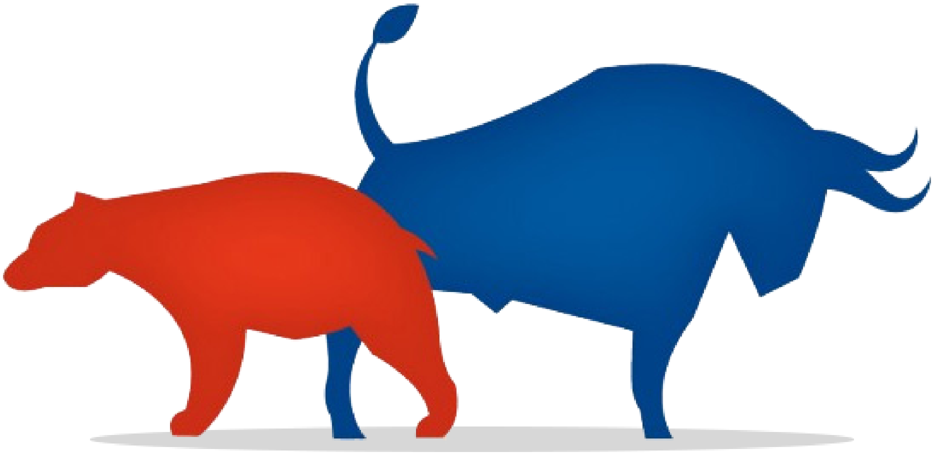


The government has all the powers to control the economy; it may introduce legislation affecting some industries or companies in which you have invested, or it may introduce legislation granting debt-relief to certain sections of society, fixing ceilings of property, etc. One government may go and another comes with a totally different set of political and economic ideologies. In the process, the fortunes ofmany industries and companies undergo a drastic change. Change in government policies is one reason for political risk. Whenever there is a threat of war, financial markets become panicky. Nervous selling begins. Security prices plummet. In case a war actually breaks out, it often leads to sheer pandemonium in the financial markets. Similarly, markets become hesitant whenever elections are round the corner. The market prefers to wait and watch, rather than gamble on poll predictions. International political developments also have an impact on the domestic scene, what with markets becoming globalized. This was amply demonstrated by the aftermath of 9/11 events in the USA and in the countdown to the Iraq war early in 2003. With the new initiatives taken by the Government, India is likely to become much more prone to political events in its trading partner-countries.

Market risk

Market risk is the risk of movement in security prices due to factors that affect the market as a whole. Natural disasters can be one such factor. The most important of these factors is the phase (bearish or bullish) the markets are going through. Stock markets and bond markets are affected by rising and falling prices due to alternating bullish and bearish periods, Thus:

- Bearish stock markets usually precede economic recessions.
- Bearish bond markets result generally from high market interest rates, which, in turn, are pushed by high rates of inflation.
- Bullish stock markets are witnessed during economic recovery and boom periods.
- Bullish bond markets result from low interest rates and low rates of inflation.



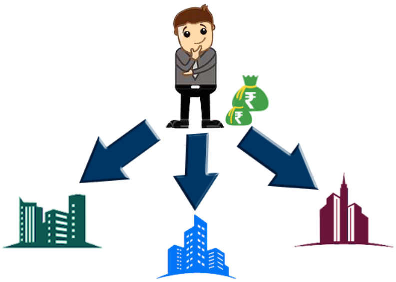
HOW TO MANAGE RISKS

Not all the seven types of risks may be present at one time, in any single investment. Secondly, many-a-times the various kinds of risks are interlinked. Thus, investment in a company that faces high business risk automatically has a higher liquidity risk than a similar investment in other companies with a lesser degree of business risk. It is important to carefully assess the existence of each kind of risk, and its intensity in whichever investment opportunity you may consider. However, let not the very presence of risk paralyse you into inaction. Please remember that there is always some risk or the other in every investment option; no risk, no gain! What is important is to clearly grasp the nature and degree of risk present in a particular case – and whether it is a risk you can afford to and are willing to take.

Success skill in managing your investments lies in achieving the right balance between risks and returns. Where risk is high, returns can also be expected to be high. "Most of the time common stocks are subject to irrational and excessive price fluctuations in both directions as the consequence of the ingrained tendency of most people to speculate or gamble...to give way to hope, fear and greed." - Benjamin Graham.

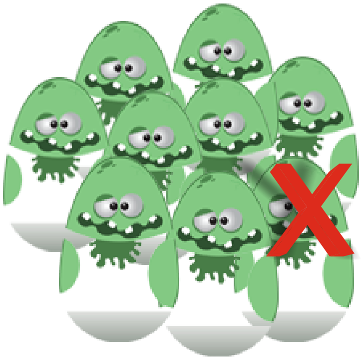
Focus on Fundamentals

In a haste to make quick money from the market, retail investors often tend to overlook the fundamentals of the company they're planning to invest in. Some investors buy shares without analysing the company's basic information or the product or service that the company sells and the probable future for that business. Retail investors often hear at the rumours around them & get carried away by management's over optimistic speeches, tentative expansion plans and are always based towards short-term play, never wanting to miss the current surge in the price of the stock. Investors should look at companies that have consistently delivered earnings growth and good corporate governance. Never invest in a firm without understanding the dynamics of the business.



Buying Blue-chips

A successful investor looks for bargain stocks-the ones which are available for prices lower than their worth and have a strong growth potential. Newbie investors often misinterpret this golden strategy as buying 'cheap' stocks for high percentage gains. Assume that you can buy a dozen fresh eggs for Rs. 48, while rotten eggs are available for only Rs. 4 per dozen. If you have Rs. 4 in your wallet, will you buy one fresh egg or a dozen rotten ones? Retail investors look at the share prices of the stocks. They tend to buy cheap stocks, which might not be very valuable. Returns from your investment in shares do not depend on the number of shares, but the performance of the company. You will have a higher chance of making a profit if you buy just one share of a blue-chip company rather than buying thousands of penny stocks.



Longterm Outlook

Retail investors often look for short-term gains. If you want to make a quick profit from stocks, you should have the ability to time the stock market. Stock prices fluctuate wildly over short periods. Your profit or loss depends on your ability to clinch the deal at the right moment. Due to the turbulent nature of stock markets, it is difficult to profit in short time periods. Retail investors feel left out during phases of a secular bull trend or in times of short-term surges. Retail investors should judge their risk appetite and then take a long-term view.

The equity market almost invariably gives a positive return in the long term, in this case a time horizon of at least three or more years will be most prudent. Also, when you stay invested in a stock for longer than one year, you only attract tax at 10% as it is considered as a long-term capital gain. For investments less than one year, you will have to pay short-term capital gains at 15%.

Review Portfolio regularly

You must have heard stories about investors who bought a company's shares, forgot about them and after a decade or so discovered that they had returned a fortune. While this is an example of how long-term investment is profitable, it's not the best. If you are among those who think that long-term investment means buying shares at low prices and forgetting about them, you are taking a huge risk. The economic environment and market scenario are very dynamic. Apart from global and local policies and macroeconomic factors, there can also be changes in company strategies or management. An investor should review his portfolio at regular intervals. If the outlook of a company improves, or at least remains stable, he should buy or hold the stock. When the assumptions under which he bought the shares no longer hold true, it might be time to offload them.

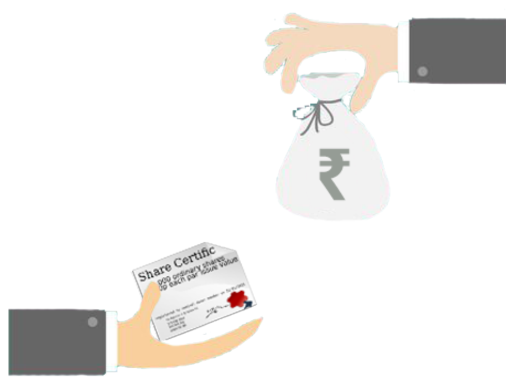
Book losses if required

Investors eagerly cash out small profits on retail investments, but they are often unwilling to book losses on stocks that are sinking. Even when stock prices keep declining, they continue to hold on in the hope that the stock will bounce back and turn profitable sometime.

This often results in bigger losses for the investor. When prices decline, some investors buy more shares in an attempt to reduce the average cost of their stock portfolio. Buying on dips is recommended, but only when the decline is due to a temporary setback and growth prospects remain positive. Retail investors should stop averaging every second stock unless they have a thorough understanding of the company. They should try to explore of the reasons for its under performance. Averaging is not a tool to minimise losses but should be treated as a maximisation instrument. When investing in a stock, you should also set a stop-loss instruction for it. When the price of a stock falls to the stop-loss level, the broker will sell them. If you set a stop-loss order at 10% below your purchasing cost, your loss will be limited to 10%.

Timing the market

The stock market always overreacts to news, be it while rising or falling. Ideally, the price of a share should be proportional to the total capital and earnings prospects of the company. However, a market frenzy results in shares being, generally, overpriced or underpriced. In a bullish market, investors often invest in overpriced shares because everyone else is buying. They become too optimistic and expect stock prices to continue rising. Conversely, in a bearish market, investors become pessimistic and tend to sell shares when they should be buying. Stock markets tend to take wild decisions in the short run but behave rationally in the long term. Successful investors always base their investment decisions on a shares' intrinsic value and hunt for bargain stocks. They will buy shares of a company with strong fundamentals when it's beaten in the market and sell when prices surge.



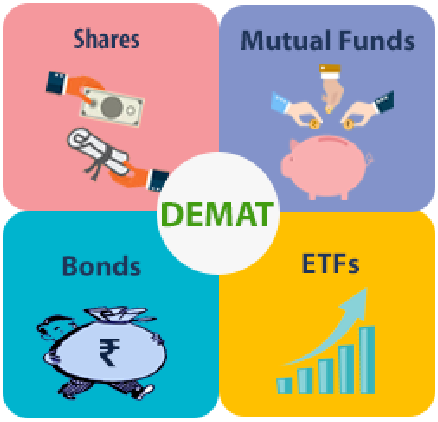
Do not follow tips blindly

Nowadays, bulk SMS messages giving tips about a particular stock to earn huge profits have lured investors. If you have acted on any of these tips, you probably have lost some money. If you haven't, you've done well to stay away from such unsolicited mails and messages.

Even solicited tips can do you harm. If you try to find trading tips on the Internet, you will get a large number of websites and blogs that offer you free advice. Don't take the advice on these sites. It's equally dangerous to buy shares because a friend told you that “its price is going to double in six months”. Stock tips by analysts published in newspapers or aired on television should also be subjected to scrutiny. Always perform due diligence before placing an order with your broker.

Monitoring of portfolio

If you just sign the forms on your agent's instructions and allow him to buy and sell shares on your behalf, be ready for a few shocks. Unscrupulous brokers often use this opportunity to misuse clients' money. Brokers don't get a commission on the profit you earn, but get paid for trade volume. There have been cases of brokers using investor money for intra-day trading without investors' consent. When you get a statement from your brokerage house, you might see your portfolio running losses with a huge amount paid as brokerage. Therefore, it is always advisable that you regularly view your statements for your investments. NSDL sends Consolidated Account Statement (CAS) to all its demat account holders wherein they can view all their investments viz., equity shares, preference shares, mutual funds, bonds, debentures etc. at one go. This information rich statement enables effective monitoring of demat portfolio which is available both in physical & electronic form.



About IFE Academy

IFE Academy was established in 2011 as a Not-for-Profit entity to promote Financial Education. IFE Academy conducts Investor Awareness Programs across the country with the support of other market participants. www.ifea.in is a comprehensive website on Financial Education. It has various sections such as Videos, Puzzles & Games, Financial Calculators and Library. It gives a holistic view on financial education combining various aspects such as Savings, Investments, Credit, Insurance and Pension at a single place. IFE Academy periodically publishes Investor Educational materials and distributes it to general public.

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