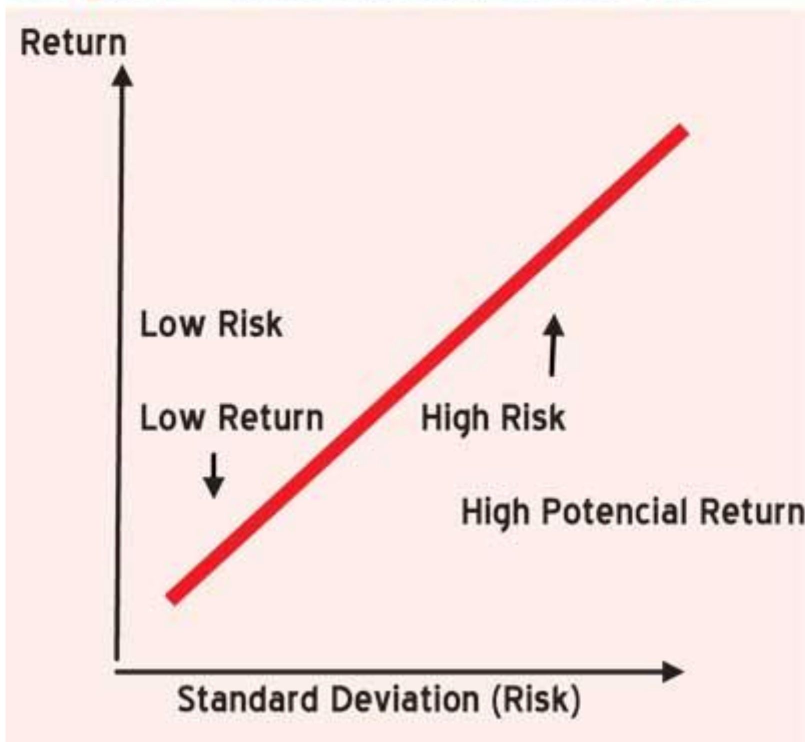
Calculated risk taking in the stock market

Tom Fernando retired last week after a 45-year long career. He intended to invest his life savings of Rs.5 million and enjoy his retirement. One day, a handsome young stock market advisor, the son of Fernando's friend, came to meet him. The lad introduced a business plan to invest his savings. He pledged to double Fernando's savings within five days by investing in the stock market. Fernando was impressed by the offer. Subsequently, he opened an account and handed over his life savings.

Fernando handed over the money without adequate evaluation on the proposed investment. He was blinded by the unusual and unrealistic returns. What are the stocks he would invest in? How could he guarantee a fixed return? How can he promise quick returns from the market? It is not possible to accurately predict stock prices as they are determined by demand and supply that are influenced by a myriad of other factors. Further on, the market is necessarily a long-term investment.



Handing over the money to the lad in spite of these grey areas exposed his investment to undue risk that could have been avoided. The article will infer in to the risk involvement when investing in the equity market and draw a clear distinction between undue risks (within the investor's control) and market (beyond the individual's control) forms of risk.

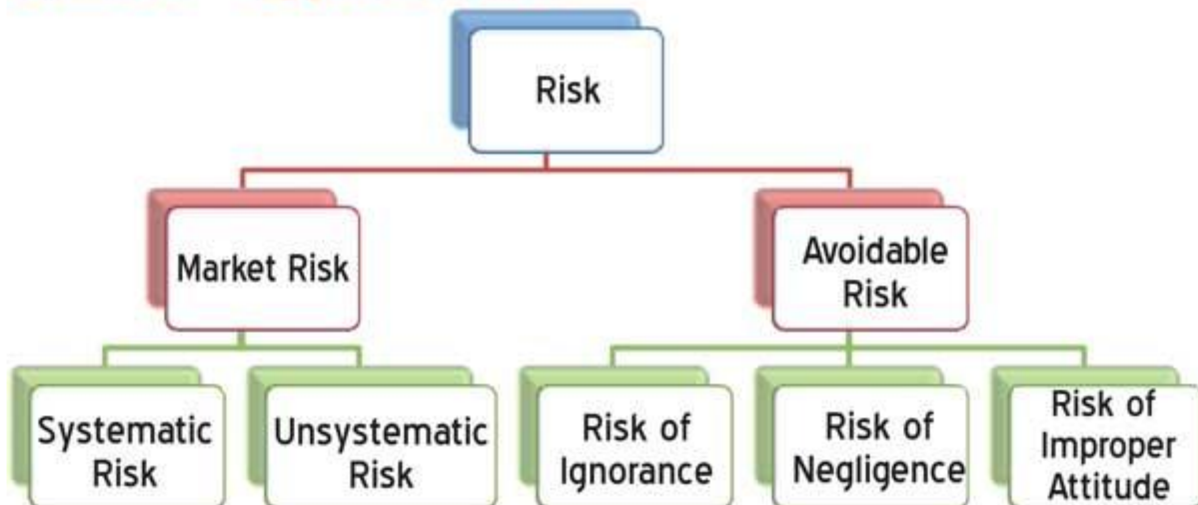
Why do we take risk?

Risk of improper attitude

This question could be answered by referring to the risk-reward trade-off principle. The risk-return trade-off is the balance between the lowest possible risk and the highest possible return. Low levels of uncertainty (low risk) are usually associated with low potential returns and high levels of uncertainty (high risk) are associated with high potential returns. Graph 1 shows an example of the risk/return trade-off.

Based on this relationship we could explain why the return on equity is relatively higher compared to Treasury bills that entail lower levels of risk.

At this juncture, it is important to infer into the type of risk investors take. There are certain forms of risk that are not within the control of investors; these forms of risk are inherent even in international markets. There is also another form of risk that is within the control of investor. This type of risk is caused due to investor negligence, ignorance and greed.



Market risk

There are two main types of risk that are common for equity and bond markets. You will encounter these types of risk even in developed markets.

- Systematic risk - Systematic risk influences a large number of assets. For an example, a significant political event could affect several 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 - for an example, news that affect a specific stock such as a sudden strike by employees. Having discussed the fundamental types of risk, let’s look at more specific types of risk.
- Credit or default risk - Credit risk is the risk that arises when a company or individual is unable to pay the contractual interest on its debt obligations. This type of risk is of particular concern to investors who hold debt in their portfolios.
- Country risk - Country risk refers to the risk that occurs when a country won’t be able to honour its financial commitments. When a country defaults on its obligations, this can harm the performance of all other financial instruments in the country as well as other countries it has relations with (e.g. Greece).
- Interest rate risk - It relates to the risk of the value of a security reducing due to changes in interest rates. Interest rate changes directly affect bonds. On the other hand, there lies a negative relationship between stock prices and interest rates. When interest rates increase usually investors transfer their funds to interest generating assets (fixed deposits). Sudden shift in interest rates could have an adverse effect on stock prices.
- Inflation risk - It is the risk that occurs due to the increase in prices of goods and services. This will reduce the value of money and negatively impact the value of investments. For instance, let’s say the price of a bun increases from Rs.20 to Rs.40. In the past, with Rs.40 you would buy two buns, but now with Rs.40 you can buy only one, resulting in a decline in purchasing power of money.
- Political risk - Political risk represents the financial risk that will be caused due to political turmoil.
- Price risk - This is the most familiar of all risks. Also referred to as volatility, price risk is the day-to-day fluctuation in a stock’s price. As a whole, stocks tend to perform well during a ‘bull market’ and poorly during a ‘bear market’. Volatility is essential for returns, and the more unstable the investment the more chance there is that it will experience a dramatic change in either direction.

Even though you cannot completely avoid market risks, these forms of risks can be mitigated to a certain extent by diversification—not just at the product or sector level but also the time duration.

Avoidable forms of risk

The incorrect attitude when entering the market can expose your portfolio to undue risk. Let's refer back to the caption given above. Fernando blindly gave money with the hope or receiving quick returns. In order to receive quick returns many invest in 'penny stocks'. They fail to realize the undue risk involved in such investments. Generally prices of these stocks are inflated far above its intrinsic value.

When manipulators exit the stock, prices drop drastically. It is observed how our local investors entered the market simply to earn quick returns. It is interesting to note that most of the stocks they flocked around suffered from financial issues, had critical court cases and some of the companies owned assets that were highly questionable. The lessons learnt were very bitter.

It was observed during the last few weeks that certain illiquid stocks were pushed up without a significant reason. Many rallied around these stocks and exposed their portfolios towards undue risk.

This form of undue risk could have been avoided if investors had the correct attitude and acted vigilantly. If investors do not have the holding power it is best for them to refrain from entering the market rather than taking unwanted risk.

Table 1
Equity Risk Premium Estimates for Sri Lanka

Period	Number of Years	(1) Average Market Return (%) (with dividends)	(2) Average 12- Month Treasury Bill Yield (%)	(3) = (1) - (2) Equity Risk Premium
1985 - 2014	30	25.91	13.99	11.92
2001 - 2014	14	31.54	11.79	19.76
2009 - 2014	6	41.22	10.83	30.40

Risk of negligence

Inability to be vigilant when taking investment decisions can expose your investment to risk. Fernando gave the money without inferring in to the stocks that will be purchased. Similarly, we come across many who have invested without sufficient knowledge. Some would invest based on a hearsay basis. As stated in the example, the young lad who took the money was known to Fernando. Many tend to blindly believe the recommendations given by a known party.

There is also a current trend of accepting recommendations shared on social media as gospel truth. In reality these recommendations are in most cases used as tools for fraudsters to attain their financial goals. The illiquid stocks that were described earlier are usually pushed up by recommendations that are shared on equity blogs. Investors fall prey to these recommendations due to their negligence.

The article published last week elaborated the impact social media has on the stock market. The article can be viewed on http://www.dailymirror.lk/90899/social-media-and-the-sri-lankan-stock-market.
It is equally important to monitor the portfolio. Many fail to refer the documents sent by the Central Depositary System (CDS) and the stockbroking firm. As a result, they may incur losses if there are certain irregularities. The risk exposure is greater if discretionary power is vested on the advisor.

Risk of ignorance

Lucrative returns in the market prompt people to enter the market without sufficient knowledge. Such individuals are more vulnerable towards certain irregularities in the market. This was witnessed during the market boom we experienced in the recent past. Investors randomly invested in stocks without a proper analysis. Their ignorance compelled them to invest money they obtained by mortgaging/selling their fixed assets.

These types of risk can be easily avoided if investors think and act vigilantly. When investors are faced with similar situations they turn towards the regulator. They fail to perceive that it is their misconduct that brought about such a plight.

Risk taking is required for higher returns. Yet, risk taking based on ignorance, negligence and greed cannot be justified.

- See more at: http://www.dailymirror.lk/91749/calculated-risk-taking-in-the-stock-market#sthash.xPAaVklX.Y51wMuGP.dpuf

Source: Daily Mirror