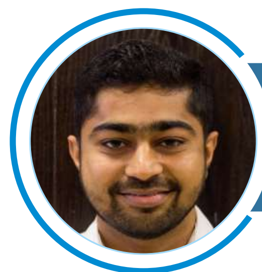
KNOW YOUR RISK



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Humans have different personality traits and we all are exposed to same nature of risk in our day-to-day life, but not all of us are exposed to the same risks in the same proportion. This is the most important aspect and hence we need to understand the risks associated with the decisions that we take.

Investing today has become invariably easy as there is so much more information available today on how to be a successful investor than ever before, then why do people usually fail in investing? So, we have a basic human nature that, by definition causes many of us to be lazy, greedy, ambitious, selfish, ignorant, indecisive, not having any view or opinion and most importantly not understanding the risks and rewards associated with our daily investing ideas and our investment decisions.

Perhaps, so far, the most common mistake is that of not understanding the risks and this is what we're going to understand in this article.

While there are different instruments providing returns with an attached risk profile, we will talk more about risks from an equity investments point of view. Hence, it's very important that the investors *must be willing to and should* understand the risks that they're exposed to.

But what is risk?

Risk implies degree of uncertainty about any future expected outcome i.e., difference in the actual outcome versus the expected outcome. And this difference may be positive or negative.

Initial step is to calculate an outcome which is made of probabilities and likelihood of various possible outcomes. Then, risk is associated with predicting these uncertain outcomes.

We will be talking of risks in a long-term investment and how to tackle them i.e., there WILL be some costs to being short term wrong while being long term right.

Forms of risks:

While you know there are different types of risks such as market risk, re-investment risk, inflation risk, interest rates risk, credit risks etc. being an investor, you have to be aware and deal with these types of risks. But beyond these types, there are different FORMS of risks, if I can use this word, which really defines the character of a risk.

There are three forms of risks to be evaluated:

- Destination Risk: Risk that your view will go wrong and will lose money (permanent loss)

  For any investments that you do, you always have a view about the direction and trajectory of how your investments will perform and based on that, you set targets (exit price). Here the risk is of losing your investment money / capital because of adverse eventual outcome.

- Tenor Risk: Risk that your investment thesis takes more tenor to play out as compared to your expectations (higher holding and opportunity costs)

  Breaching of tenor is a very common risk, because a lot of investments do take more time as thought to play out. There may be costs to this lengthened tenor like interest costs, rollover costs, alternate opportunities cost, etc.

- Journey Risk: Risk that equity prices fluctuate while you hold your investments (MTM or temporary loss)

  This risk is very important since downside volatility in prices will lead to a lot of fear and loss of confidence. The ability to tackle this risk will define whether the loss is temporary or permanent in nature.

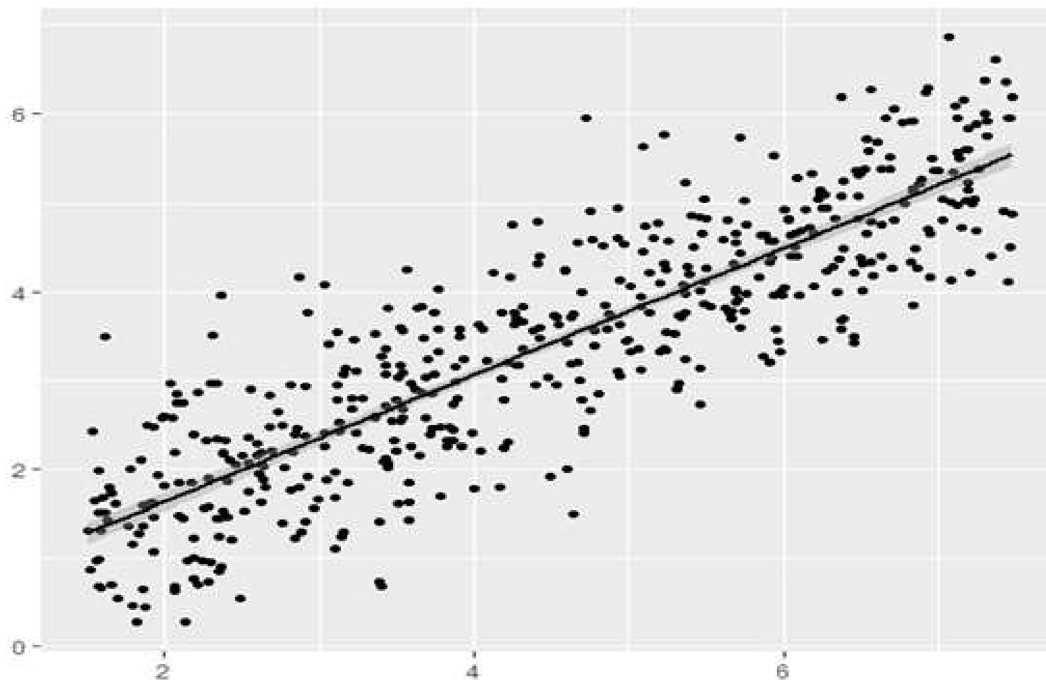
  Everyone's definition of risk may be different based on the appetite of risk, money (loss or MTMs) to be put to work, greed and fear. We think, there are four quadrants about someone's risk appetite and every risk will find a place in one of the quadrants:

Near term temporarily wrong (MTM loss): This may happen because of a sudden downtick or certain unfavourable events happening to the investments or a severe broader macro level volatility. Since this is temporary, surviving of these MTMs and the nerve to HOLD is key.	Near term permanently wrong (MTM loss converted into a definite booked loss): This happens because of short sight due to fear and shake in confidence about the destination (your eventual view). Also, MTMs cannot be survived may be because of over leverage (if not delivery).
Long term temporarily wrong (MTM loss): You remain under water for a long period of time, and probably your investment thesis is doubted again and again. As long as the investments thesis is ON, you HOLD these with strong conviction.	Long term permanent wrong (definite booked loss on exit): This happens when your eventual view goes wrong and you are forced to exit your investment.

Whenever we talk about RISK REDUCTION or tackling of risks, its only about various steps to be taken for risks that exist in the above four quadrants.

How are risks assessed:

Mathematically risk is nothing but standard deviation (SD). In simple terms, SD difference between various probable / actual outcomes and the average line (of all those outcomes) as shown below. Each outcome will have a risk which is technically outcome value minus the average line value.



SD is a way of measuring risk on the past events / outcomes. This SD is then used to project future risks too in most of the cases after incorporating any variable changes in the assumptions.

Any investment thesis will have a risk attached to it i.e., deviations it can have from the projected various probabilistic outcomes. Maximum risk is the outcome which is a clear outlier and farthest from the average line / real outcome.

After having assessed SD on day 0, it is important how you live with those risks that you face for the entire duration of the investment journey. Hence calculating of risks is one small part of assessing risk; tackling those risks is a major part. There are different ways to look at risk, either standalone or in relation to some parameters. We discuss few points to consider while assessing risk.

- Risk needs to be seen from a temporary and permanent loss of money. We should be less worried about temporary drawdowns, infact temporary movements provide an opportunity to add more of the investments
- Permanent losses come mainly from your eventual VIEW on investment going wrong
- The ability to withstand a negative MTMs / temporary loss: behaviourally we panic when we see a draw down on our investments.
- Risk per unit of expected return needs to be seen, which is calculated by dividing expected returns with expected risk. Lower the per unit risks, better.
- Only in some cases, returns should NOT be looked by comparing risks, when you think you are going to be very sure on your view turning out to be right.

How risk usually gets added:

After having learnt how to assess risk, there are still in many ways that an investor adds a lot of risk. Most of the risks comes from the deviations in what principles you want to adhere VS what you really adhere in your investment discipline. We discuss few of them:

- Risks have to be known; unknowingly taking up risks is injurious to financial health.
- Greed for higher and quick returns leads to adding big risks in form of:
  - Acting on shallow recent information available on newspaper, social media, tv, etc.
  - Herd mentality: Investors are usually seen following the herd as more and more people start showing interest in a company.
  - Penny stocks: Fancy and dream stocks usually have a run for reasons unknown which excites the investors. In most cases the underlying risks are too high in such investments
  - Momentum: Most of us buy stocks that are quoting ABOVE mean line; then it reverts back to the mean.
- Risk is different from loss: most people misunderstand; they just can not accept a risk with an open mind
- Taking more exposure / over allocation beyond a particular extent i.e., say allocating 15-20% of the total portfolio to a particular idea.
- Over leveraging (assuming you understand leverage) is very risky harmful
- Missing out on an important variable while analysis risk can be fatal.
- Confirmation bias: whenever we read anything positive about our stocks, we then believe the investment has LESSER risk.
- Commonly higher levels of returns are associated with high level of risks and hence risks are taken for granted.
- Most of us invest on borrowed conviction; we don't think independently

Cons of not playing risk well:

The pain of loss is many times greater than the joy from an equal amount of gain. Equity investments are not as difficult as it seems, yet one is not able to generate higher returns. There are consequences of NOT measuring or playing risks well. We have noted few of them below:

- Erosion of capital / net worth
- Loss of opportunities and also opportunities turn into a mishap
- Behaviourally taking not sane decisions
- Greed and fear are usually emoted at wrong times
- Health problems along with financial problems
- Loss of confidence for future investments
- You become loss-averse when even at the slightest hint of loss lurks your mind
- Higher risks don't automatically imply higher returns; returns may not be worth risk taken
- If you are too conservative, you will just watch risks playing out: You will not get injured neither will you make money.

How to play risk:

Risk is mainly associated with returns, and hence anyone risk taker expects to be paid for all risks taken. The ability to respond tactically to a risk has to be a way of life. There is a way to tackle risk as under:

- KNOW YOUR RISKS. You should know what can go wrong (they there may be few variables which can erupt and may not have been modelled by you). But most of the variable must be known and provided for.
- Only on knowing your risks, you can play it well; else you shall FAIL
- Take a VIEW on your investments. Conviction needs to be created (with your research, analysis etc.) about the direction of the investments which helps you to create a VIEW.
- Low conviction increases the risks of taking poor actions (averaging, exiting) whenever there is a downtick on your investments
- Don't average when you don't have a strong conviction on your VIEW.
- Remain under leveraged or on zero leverage as far as possible.
- The most effective strategy against mitigating risks is diversification. Don't do over concentration of a particular investment.
- Buy near the farthest point from the long-term average mean – such that chances of going farer is less and only way is reversion to mean (i.e., try buying bad times and wait for good times)
- The risk-reward ratio (return per unit of risk) is balance between the desire to highest possible return with lowest possible risk.
- Make provisions beyond your calculated risks: there are a lot of risks which you may not have modelled for.

Conclusion:

Risk is the most feared term while dealing with investments. Also, risk is always related to returns but in a wrong manner: high risks don't necessarily mean high return and vice versa high returns don't necessarily mean high risk. So, we have to be cognitive of what RISKS are, and only after having understood them, we know what to do about it.

Risk can vary for every individual based on what return expectations you have and what investment counter options you are exploring, obviously while considering SD. While risk profiling is mostly done considering your age profile, return expectations and financial appetite, we believe risk-based decisions must be done considering knowing your risks, ability to foresee the worst situation and most importantly how you tackle it. Tackling is very important since it involves taking a decision (which is not so easy amongst most of us) at each stage during the tenor of the investment.

Risk comes only when you are trying to capitalize on an opportunity and hence it extremely important tool for someone to really race ahead in term of growing financial wealth using it well.

Like they say, it is only who take risk prosper in every aspect of life. Without risk, growth stops. It is important to have faith and conviction in the investment strategies that one follows, and this be achieved once we understand all the risks and rewards associated with it, and thus its important in ***knowing what you own…***