Balancing risks and rewards in investing

Risk can be defined as the probability that the actual return on an investment will be less than the expected return or the investment may result in a loss. Whenever an investor puts his money in a financial product, he or she has to be prepared for an element of risk.

Some risks associated with investments

- **Credit risk:** This risk arises in debt funds when counterparty does not meet their contractual obligations. Usually there is no risk of default in government issued securities whilst in other securities the risk is rated by credit rating agencies. The lower the rating assigned by the rating agency the higher the risk.
- **Interest rate risk:** Over a period of time, interest rates can change depending on inflation, borrowing and other economic factors in an economy. Securities like bonds offer interest rates that are fixed over the period of the bond. When interest rates rise, the demand for newer high interest rate securities rises whilst older bonds offering lower interest rates depreciate in value. This is interest rate risk.
- **Liquidity risk:** This implies the ease of trading in debt securities. It depends on the volumes traded in the secondary markets. Difficulty in finding a buyer for a debt security is known as liquidity risk.
- **Reinvestment risk:** Bonds usually pay out or distribute the interest due to investors. Interest rates prevailing at the time of receipt of the interest income will determine at what rate the bond investor can reinvest this pay out amount. This is known as reinvestment risk.
- **Systemic risks:** These risks include changes in the country's economic growth, exports, currency value, domestic consumption, inflation, etc. For instance, if a company is an export-oriented one, any adverse change in the currency value will impact the value of its exports.
- **Company Specific risks:** These risks include changes in management, labour issues, availability of raw materials, etc. For instance, if a company faces labour unrest, it would affect its production and, in turn, its sales.

In addition to these risks, stock market investments are prone to price fluctuations on daily basis. Trading volumes and settlement period related risks also exist in all securities investments.

Risk and reward go hand-in-hand

There can be no reward without risk in financial investments, and, at times, greater the risk, greater is the reward. While there are risks in investing, those risks can always be reduced through smart decision making.

Investing in equities carries risks, but they can be reduced through investing in companies with a good track-record, by purchasing shares that have a good dividend history and by diversification. Risk in debt investing can be reduced by purchasing instruments with a higher credit rating, tax benefits and the possibility of sale prior to maturity.

A smart way to manage risk is to invest through mutual funds. Mutual Funds allow the investor to mitigate risk with the expertise of evaluating various risks that an individual may not normally have. This is done by fund managers employing smart strategies and diversifying their investments into different financial instruments depending on the investment objective of each Mutual Fund scheme.

The risk-reward ratio

Investors should be aware of their own risk profile before investing.

- **Risk capacity** is the amount of risk an investor can take in terms of his demographics (age, income, number of dependants, etc.). Naturally, greater the number of dependants, older the individual, etc., lower will be the risk-taking capacity.
- **Risk tolerance** implies the investor's affinity towards risk. Some individuals are risk-averse while others like taking risks. Risk tolerance has more to do with an individual's personality and attitude towards risk.

When one combines risk capacity and risk tolerance of an individual, one obtains the individual's investment risk profile. This can be done using a number of risk profiling tools. Based on this, the individual's investment profile can be categorized as high risk, medium risk and low risk. This then helps to work out the investor's asset allocation (i.e. what percent of his investments should be in high risk investments such as Equity and in low risk investments such as debt etc.)

Taking risk in investing is inevitable. However, one must figure out how much risk one can and should take before investing. Few people have the ability or time to gauge the risks on their investments periodically. At such times, engaging the services of an mutual fund distributor would help steer you on your investment path.

IDBI Asset Management Limited (Investment Manager to IDBI Mutual Fund)
CIN: U65100MH2010PLC199319. **Regd. Off.:** IDBI Tower, WTC Complex, Cuffe Parade, Colaba, Mumbai - 400 005. **Corp. Off.:** 4th Floor, IDBI Tower, WTC Complex, Cuffe Parade, Colaba, Mumbai - 400 005. **All India Toll Free No.:** 1800-419-4324
Tel. No.: (+91 22) 6644 2800. **Fax No.:** (+91 22) 6644 2801
Email ID: contactus@idbimutual.co.in **Website:** www.idbimutual.co.in

Please consult your mutual fund distributor before investing.

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