# Unsystematic Risk

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## What Is Unsystematic Risk?

Unsystematic risk is unique to a specific company or industry. Also known as “nonsystematic risk,” "specific risk," "diversifiable risk" or "residual risk," in the context of an investment portfolio, unsystematic risk can be reduced through diversification.

This can be contrasted with systematic risk, which is inherent in the market.

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## Understanding Unsystematic Risk

Unsystematic risk can be described as the uncertainty inherent in a company or industry investment. Types of unsystematic risk include a new competitor in the marketplace with the potential to take significant market share from the company invested in, a regulatory change (which could drive down company sales), a shift in management, and/or a product recall.

While investors may be able to anticipate some sources of unsystematic risk, it is impossible to be aware all or when/how these might occur. For example, an investor in healthcare stocks may be aware that a major shift in health policy is on the horizon, yet she/he cannot know in advance the particulars of the new laws and how companies and consumers will respond. The gradual adoption and then potential repeal of the *Affordable Care Act,* first written into law in 2010, has made it very challenging for some investors in healthcare stocks to anticipate and place confident bets on the direction of the industry and/or specific companies.

a portfolio. There isn't a formula for calculating unsystematic risk; instead, it must be extrapolated by subtracting the systematic risk from the total risk.

KEY TAKEAWAYS

- Unsystematic risk, or specific risk, is that which is associated with a particular investment such a company's stock.
- Unsystematic risk can be mitigated through diversification, and so is also known as diversifiable risk.
- Once diversified, investors are still subject to market-wide systematic risk.

## Company-Specific Risk

Two factors cause company-specific risk:

- Business Risk: Both internal and external issues may cause business risk. Internal risk relates to the operational efficiency of the business. For example, management failing to take out a patent to protect a new product would be an internal risk, as it may result in the loss of competitive advantage. The Food and Drug Administration (FDA) banning a specific drug that a company sells is an example of external business risk.
- Financial Risk: Financial risk relates to the capital structure of a company. A company needs

Operational risks can result from unforeseen and/or negligent events such as a breakdown in the supply chain or a critical error being overlooked in the manufacturing process. A security breach could expose confidential information about customers or other types of key proprietary data to criminals.

A strategic risk may occur if a business gets stuck selling goods or services in a dying industry without a solid plan to evolve the company's offerings. A company may also encounter this risk by entering into a flawed partnership with another firm or competitor that hurts their future prospects for growth.

Legal and regulatory risks can expose a company to a myriad of liabilities and potential lawsuits from customers, suppliers and competing firms. Enforcement actions from government agencies and changes in laws can also be difficult to guard against.

## Example of Unsystematic Risk

By owning a variety of company stocks across different industries, as well as by owning other types of securities in a variety of asset classes, such as Treasuries and municipal securities, investors will be less affected by single events. For example, an investor, who owned nothing but airline stocks, would face a high level of unsystematic risk. She would be vulnerable if airline industry employees decided to go on strike, for example. This event could sink airline stock prices, even temporarily. Simply the anticipation of this news could be disastrous for her portfolio.

By adding uncorrelated holdings to her portfolio, such as stocks outside of the transportation industry, this investor would spread out air-travel-specific concerns. Unsystematic risk in this case affects not only specific airlines but also several of the industries, such as large food companies, with which many airlines do business. In this regard, she could diversify away from public equities altogether by adding US Treasury Bonds as an additional protection from fluctuations in stock prices.

Even a portfolio of well-diversified assets cannot escape all risk, however. The portfolio will still

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