Lecture 23

Risk Management

What's Risk ?

An action or an activity that has a potential to go wrong.

There are many things in life that can be risky: skiing, skydiving, being in a relationship, making an investment, trading.

Why do we take risk? For the Reward.

Knowing the risk is necessairy in order to manage it.

Systematic Risk: The risk inherent to the entire market or an entire market segment. Systematic risk, also known as "undiversifiable risk," "volatility" or "market risk," affects the overall market, not just a particular stock or industry. This type of risk is both unpredictable and impossible to completely avoid. It cannot be mitigated through diversification, only through hedging or by using the right asset allocation strategy.

Unsystematic Risk: Company- or industry-specific hazard that is inherent in each investment. Unsystematic risk, also known as "nonsystematic risk," "specific risk," "diversifiable risk" or "residual risk," can be reduced through diversification. By owning stocks in different companies and in different industries, as well as by owning other types of securities such as Treasuries and municipal securities, investors will be less affected by an event or decision that has a strong impact on one company, industry or investment type.

Risk Management: Risk management is the process of identification, analysis and either acceptance or mitigation of uncertainty in investment decision-making. Essentially, risk management occurs anytime an investor or fund manager analyzes and attempts to quantify the potential for losses in an investment and then takes the appropriate action (or inaction) given their investment objectives and risk tolerance.

Risk mitigation

Risk mitigation is defined as taking steps to reduce adverse effects.

Risk Acceptance: Risk acceptance does not reduce any effects. However it is still considered a strategy.

Risk Avoidance: Risk avoidance is the opposite of risk acceptance. It is the action that avoids any exposure to the risk whatsoever.

Risk Limitation: Risk limitation is the most common risk management strategy used by businesses. This strategy limits a company's exposure by taking some action. It is a strategy employing a bit of risk acceptance along with a bit of risk avoidance or an average of both.

Risk Transference: Risk transference is the involvement of handing risk off to a willing third party.

Risk Limitation

Ways to limite losses:

- Stop losses
- Hedging