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Investing in Financial Markets: An Analysis of Risks

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Abstract

In the financial world, risk management is the process of identification, analysis and acceptance or mitigation of uncertainty in investment decisions. Essentially, risk management occurs when an investor or fund manager analyzes and attempts to quantify the potential for losses in an investment, such as a moral hazard, and then takes the appropriate action (or inaction) given the fund's investment objectives and risk tolerance. In investing, risk and return are highly correlated. Increased potential returns on investment usually go hand-in-hand with increased risk. Different types of risks include project-specific risk, industry-specific risk, competitive risk, international risk, and market risk. Return refers to either gains and losses made from trading a security.The return on an investment is expressed as a percentage and considered a random variable that takes any value within a given range. Several factors influence the type of returns that investors can expect from trading in the markets.Diversification allows investors to reduce the overall risk associated with their portfolio but may limit potential returns. Making investments in only one market sector may, if that sector significantly outperforms the overall market, generate superior returns, but should the sector decline then you may experience lower returns than could have been achieved with a broadly diversified portfolio.

Introduction

History shows that when people invest and stay invested, they're more likely to earn positive returns in the long run. When markets start to fluctuate, it may be tempting to make financial decisions in reaction to changes to your portfolio. But people who base their financial decisions on emotion often end up buying when the market is high and selling when prices are low. These investors ultimately have a harder time reaching their long-term financial goals. Investments are important because in today's world, just earning money is not enough. You work hard for the money you earn. But that may not be adequate for you to lead a comfortable lifestyle or fulfill your dreams and goals. To do that, you need to make your money work hard for you as well.

This is why you invest. Money lying idle in your bank account is an opportunity lost. You should invest that money smartly to get good returns out of it.

Types of Investments in India

The Indian investor has a number of investment options to choose from. Some are traditional investments that have been used across generations, while some are relatively newer options that have become popular in recent years. Here are some popular investment options available in India.

Stocks

Stocks, also known as company shares, are probably the most famous investment vehicle in India. When you buy a company's stock, you buy ownership in that company that allows you to participate in the company's growth. Stocks are offered by companies that are publicly listed on stock exchanges and can be bought by any investor. Stocks are ideal long-term investments. But investing in stocks should not be equated to trading in the stock market, which is a speculative activity.

Mutual Funds

Mutual funds have been around for the past few decades but they have gained popularity only in the last few years. These are investment vehicles that pool the money of many investors and invest it in a way to earn optimum returns. Different types of mutual funds invest in different securities. Equity mutual funds invest primarily in stocks and equity-related instruments, while debt mutual funds invest in bonds and papers. There are also hybrid mutual funds that invest in equity as well as debt. Mutual funds are flexible investment vehicles, in which you can begin and stop investing as per your convenience. Apart from tax-saving mutual funds, you can redeem investments from mutual funds any time as well.

Fixed Deposits

Fixed deposits are investment vehicles that are for a specific, pre-defined time period. They offer complete capital protection as well as guaranteed returns. They are ideal for conservative investors who stay away from risks. Fixed deposits are offered by banks and for different time periods. Fixed deposit interest rates change as per economic conditions and are decided by the

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banks themselves. Fixed deposits are typically locked-in investments, but investors are often allowed to avail loans or overdraft facilities against them. There is also a tax-saving variant of fixed deposit, which comes with a lock-in of 5 years.

Recurring Deposits

A recurring deposit (RD) is another fixed tenure investment that allows investors to put in a specific amount every month for a pre-defined period of time. RDs are offered by banks and post offices. The interest rates are defined by the institution offering it. An RD allows the investor to invest a small amount every month to build a corpus over a defined time period. RDs offer capital protection as well as guaranteed returns.

Public Provident Fund

The Public Provident Fund (PPF) is a long-term tax-saving investment vehicle that comes with a lock-in period of 15 years. Investments made in PPF can be used to earn a tax break. The PPF rate is decided by the Government of India every quarter. The corpus withdrawn at the end of the 15-year period is completely tax-free in the hands of the investor. PPF also allows loans and partial withdrawals after certain conditions have been met.

Employee Provident Fund

The Employee Provident Fund (EPF) is another retirement-oriented investment vehicle that earns a tax break under Section 80C. EPF deductions are typically a part of an earner's monthly salary and the same amount is matched by the employer as well. Upon maturity, the withdrawn corpus from EPF is also entirely tax-free. EPF rates are also decided by the Government of India every quarter.

National Pension System

The National Pension System (NPS) is a relatively new tax-saving investment option. Investors in the NPS stay locked-in till retirement and can earn higher returns than PPF or EPF since the NPS offers plan options that invest in equities as well. The maturity corpus from the NPS is not entirely tax-free and a part of it has to be used to purchase an annuity that will give the investor a regular pension.

Where should you invest your money

Since there are so many types of investment vehicles, it is normal for an investor to get overwhelmed. Someone new to investing would not where to invest their money. Making the wrong investment choice can lead to financial losses, which is something that no one wants. This is why you should use the following factors to decide where to invest your money.

Age

Typically, younger investors have fewer responsibilities and a longer time horizon. When you have a long working life in front of you, you can invest in vehicles with a long-term view and also keep increasing your investment amount with an increase in your income. This is why equity-oriented investments like equity mutual funds would be a better option for young investors, as compared to something like fixed deposits. But on the other hand, older investors can opt for safer avenues like FDs.

Goal

Investment goals can be either short-term or long-term. For a short-term goal, you should opt for a safer investment and use the return-generating potential of equities for long-term goals. Goals can also be negotiable and non-negotiable. For non-negotiable goals like children's education or down payment for a house, guaranteed-return investments would be a good choice. But if the goal is negotiable, which means that it can be pushed back by a few months, then investing in equity mutual funds or stocks can be beneficial. Plus, if these investments do really well, then you can even meet the goal before time.

Profile

Another thing to think about when choosing an investment option is your own profile. Factors like how much you are earning and how many financial dependants you have are also critical. A young investor with a lot of time on hand may not be able to take equity-related risks if he also has the responsibility to take care of his family. Similarly, someone older with no dependents and a steady source of income can choose to invest in equities to earn higher returns.

This is why it is said that when it comes to investments, one size doesn't fit all. Investments not only have to be chosen carefully but also planned properly to get the most out of them.

Analysis of Risks

All investments involve some degree of risk. In finance, risk refers to the degree of uncertainty and/or potential financial loss inherent in an investment decision. In general, as investment risks rise, investors seek higher returns to compensate themselves for taking such risks.

Every saving and investment product has different risks and returns. Differences include: how readily investors can get their money when they need it, how fast their money will grow, and how safe their money will be. In this section, we are going to talk about a number of risks investors face. They include:

Business Risk

With a stock, you are purchasing a piece of ownership in a company. With a bond, you are loaning money to a company. Returns from both of these investments require that that the company stays in business. If a company goes bankrupt and its assets are liquidated, common stockholders are the last in line to share in the proceeds. If there are assets, the company's bondholders will be paid first, then holders of preferred stock. If you are a common stockholder, you get whatever is left, which may be nothing.If you are purchasing an annuity make sure you consider the financial strength of the insurance company issuing the annuity. You want to be sure that the company will still be around, and financially sound, during your payout phase.

Volatility Risk

Even when companies aren't in danger of failing, their stock price may fluctuate up or down. Large company stocks as a group, for example, have lost money on average about one out of every three years. Market fluctuations can be unnerving to some investors. A stock's price can be affected by factors inside the company, such as a faulty product, or by events the company has no control over, such as political or market events.

Inflation Risk

Inflation is a general upward movement of prices. Inflation reduces purchasing power, which is a risk for investors receiving a fixed rate of interest. The principal concern for individuals investing in cash equivalents is that inflation will erode returns.

Interest Rate Risk

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Interest rate changes can affect a bond's value. If bonds are held to maturity the investor will receive the face value, plus interest. If sold before maturity, the bond may be worth more or less than the face value. Rising interest rates will make newly issued bonds more appealing to investors because the newer bonds will have a higher rate of interest than older ones. To sell an older bond with a lower interest rate, you might have to sell it at a discount.

Liquidity Risk

This refers to the risk that investors won't find a market for their securities, potentially preventing them from buying or selling when they want. This can be the case with the more complicated investment products. It may also be the case with products that charge a penalty for early withdrawal or liquidation such as a certificate of deposit (CD).In stock market there is strong relationship between risk and return. Greater the risk, greater the return generally! In financial terminology risk management is the process of identifying and assessing the risk and then developing strategies to manage and minimize the same while maximizing the returns.

Risk Management and Stock Market

Every investment demands a certain amount of risk and for an investor to assume this risk he has to be compensated duly. This compensation is in the form of something called as the risk premium or simply the premium. Risk is therefore central to stock markets or investing because without risk there can be no gains. Successful investors use stock market risk management strategies to minimize the risk and maximize the gain.

In financial markets there are generally two types of risk; first the Market risk and second the Inflation risk. Market risk results from a possibility in increase or decrease of financial markets. The other risk i.e. the Inflation or the purchasing power risk results from rise and fall of prices of goods and services over time.

The inflation risk is an important consideration in long term investments where as the market risk is more relevant in the short term. It is the market risk that can be managed and controlled to a certain extent, inflation risk cannot be controlled.

There are certain strategies that can be employed to mitigate the risk in a stock market. The strategies are as follows:

1. **Follow the trend of the market:** This is one of the proven methods to minimize risks in a stock market. The problem is that, it is difficult to spot trends in the market and trends change very fast. A market trend may last a single day, a month or a year and again short term trends operate within long term trends.
2. **Portfolio Diversification:** Another useful risk management strategy in the stock market is to diversify your risk by investing in a portfolio. In a portfolio you diversify your investment to several companies, sectors and asset classes. There is a probability that while the market value of a certain investment decreases that of the other may increase. Mutual Funds are yet another means to diversify the impact.
3. **Stop Loss:** Stop loss or trailing tool is yet another device to check that you don't lose money should the stock go far a fall. In this strategy the investor has the option of making an exit if a certain stock falls below a certain specified limit. Self-discipline is yet another option employed by some investors to sell when the stock falls below a certain level or when there is a steep fall.

Ask warren buffet, the greatest investor of all time, what is your advice to investors and he says 'don't lose money!' But stock market connotes risk and fortunately there are enough strategies for a wise investor to safeguard his money and ensure gain. A careful and timely exercise of these options helps you see of the risk involved.

Conclusion

Indian share owners throw light on the general investment pattern and preferences of households, there is no other detailed investigation on the investment practices of the small equity investors in the 21stcentury. The truth is that a lot of ground is yet to be covered in the direction of pattern, risk return perception, post investment satisfaction and evaluation. The importance and impact of small equity investors on our economic development, changing capital market scenario and explosion of information and communication technology have contributed to the changes in small equity investor behavior and have provided scope for further research in this direction. Hence, an attempt has been made by the researcher in the present study to analyze the current investment decisions; pattern, risk-return perceptions, and factors influencing investors, post-investment satisfaction and evaluation of the small equity investors in the 21stcentury, with a view to help the corporate issues and strengthen small equity investor participation in India

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