

Investment Education Series

ROAD MAP FOR MANAGING INVESTMENT RISK



GTB Asset Management

Understanding risk is one of the most important parts of financial education. Even far more important than making profit; for we tend to think of "risk" in predominantly negative terms, as something to be avoided or a threat that we hope won't materialize. However, risk is inseparable from performance represented by either loss or gain, and rather than being desirable or undesirable, it is simply necessary in the investment world.

Risk is a fundamental idea in finance that an investment's actual return will be different than expected. Risk is deviation from an expected outcome that can be expressed in absolute terms or relative to something else like a market benchmark. It includes the possibility of losing some or all of the original investment and the compensation it provides for investors willing to take additional risk for greater returns.

In this edition of GTBAM education series we will highlight cardinal principles that can serve as road map for investors seeking to effectively manage their risk profile and maximize investment gains. The start off point to understanding investment risk however is knowledge of your personal profile as an investor.

Are you a **Trustee** investor, with little knowledge of investment and relying primarily on your investment advisors and others for direction? Or are you a **Partner** investor, armed with medium level knowledge of investment that enables you make investment decisions as well as seek professional assistance from your investment advisors ?Or you could be a **Controller** investor equipped with varied experience and sophisticated knowledge of the investment process and fully in charge of your investment decisions. Whatever your investment status, this study will be of immense benefit to your wealth creation and protection aspiration.

Types of Risk

Traditional sources of risk causing variability in returns can be categorized into two general types: systematic risk and non-systemic risk.

Systematic Risk, also referred to as market risk, is the part of total risk that cannot be eliminated or reduced, no matter how well an investor diversifies his or her portfolio. Virtually all securities have some systematic risk, whether bonds or stocks, because systematic risk directly encompasses interest rate, market, and inflation risks. Systematic risk cannot be avoided. It is a risk you must assume if you invest.

Non-systematic Risk, or non-market risk, is the risk that is unique to a particular security or asset class and can be associated with such risks as business, financial, country, exchange rate, and liquidity. Non-systematic risk can be reduced and nearly eliminated with a properly diversified portfolio.

Closer examination of these major risk factors shows that; performance risk is generally acknowledged to be common to most people who invest or buy stocks; it might gain value, or incur loss for the investor. And while market fluctuations occur because individual investment vehicles have unique characteristics and qualities that affect their changes in value.

Stocks follow a general trend as a market, as do bonds and other securities as dictated by forces of inflation and interest rates causing your investments to gain or lose value in their individual market as well as controls the rise and fall of fixed- rates securities returns respectively.

The essence of this study therefore is to outline time tested strategies proposed by investment management experts to guide you in making wise investment decisions as follows:

Know your risk tolerance status

Knowing your risk tolerance status is an important key to achieving investment success because knowledge of your risk tolerance profile will help you decide how to invest your money and manage investments twin risks: the risk that your investments can lose principal as well as lose purchasing power and enables you to have an entry and exit strategy on your stock holdings or investment of any kind.

In determining your risk tolerance, your investment time horizon must take your biological age into consideration, because young and old investors have different risk tolerance perspectives which broadly fall into long and short terms respectively.

The amount of **risk capital** (asset available to invest or trade with that will not affect your lifestyle) and **net worth** (asset minus liabilities) available should be an important consideration when determining risk tolerance.

Understanding your investment objective is essential when calculating your risk tolerance. Whether you are saving for a child's college education or your retirement plan, you must fully understand your motive and make provision to be able to meet up with your responsibilities as well as apply an appropriate investment strategy.

An investor's investment experience must also be considered. For beginners, it's prudent to venture in investing with some degree of caution and strive for preservation of capital while seasoned investors risk tolerance is based on their wealth of experience

Don't pursue "hot tip" stocks.

Be cautious about accepting tips on "hot" stocks whether the tip comes from your uncle, your brother, your neighbor or even your broker, you shouldn't accept it. When you make an investment, it's important you know the reasons for doing so; do your own research and analysis of any company before you even consider investing your hard-earned money. Relying on a titbit of information from someone else is not only an attempt at taking the easy way out; it's also a type of gambling. To be a successful investor in the long run, you need to make informed investment decisions.

Diversify your portfolio

Diversification in investing mixes a wide variety of investments within a portfolio and can include investing in different markets, regions or countries all aimed at reducing the risk without substantial reduction in returns. Diversification reduces risk because markets do not always move in tandem and many financial instruments will react differently to market conditions. A balanced portfolio will be less volatile than one that is concentrated on a single asset and can include the following strategies: Spreading the portfolio among multiple investment vehicles, varying the risk in securities and spreading industry or geographical location.

Adopt a long-term perspective.

Though large short-term profits can often entice those who are new to the market, adopting a long-term horizon and dismissing the "get in, get out and make a killing" mentality is a must for any investor. This doesn't mean that it's impossible to make money by actively trading in the short term. Trading involves very different risks that buy-and-hold investors don't experience. Note that investing and trading are very different ways of making gains from the market and while neither investing style is necessarily better than the other; both have their pros and cons. But active trading requires certain specialized skills and can be wrong for someone without the appropriate time, financial resources, education and desire.

Naira cost averaging

Adopt cost averaging strategies to enable you make timed investment of regular amounts over specific periods. This technique relieves investors of worrying about entering the market at the bottomed out point and protects investors from putting all their money in the stock market at the inappropriate time because it ensures even spread and safeguards against an investor missing out on good investment opportunity.

Hold the winners and sell the losers

Don't underestimate or sell a stock that is performing well by sticking to some rigid personal policy to sell after a stock has increased by a certain multiple - say three, for instance. Because the theory that much of an investment overall success is due to a small number of stocks in the portfolio returning big holds true. You need though to have a good understanding of the potential of your investment to enable you stir clear of taking arbitrary and limiting rules.

Selling a losing stock is important to avert further losses because there is no guarantee that a stock will bounce back after a protracted decline. While it's important not to underestimate good stocks, investors must also be realistic about investments that are performing badly. It's important to be honest when you realize that a stock is not performing as well as you expected it to.

Pick a strategy and maintain it

There are many ways to be successful and no one strategy is inherently better than any other. However, once you find your style, stay with it. An investor who flounders between different stock-picking strategies will probably experience the worst, rather than the best, of each. Constantly switching strategies effectively makes you a market timer, and this is definitely a territory investors should avoid. The bottom line remains to choose a method to pick stocks that will fulfill your investment goals.

Discipline your emotions

Many investors are too greedy to sell at market tops and buy at market bottoms for fear of losing more. Fear and greed should never dictate any investment decision. Rather investment decisions should be based on fundamentals such as current and future economic conditions, how a specific sector will perform in those conditions, and the fundamentals of a company within that sector. If your buy/sell decisions are based on following the crowd versus market fundamentals, then you are gambling rather than taking a calculated risk.

A disciplined emotion is an invaluable virtue investor must attain. You need to have a plan, when it works, you stay with it, when it doesn't, keep emotions out of it and change your plan based on facts.

The guidelines above are not fool proof as there are exceptions to every rule, but we hope that you find them very useful.

An investor's knowledge of his risk profile is a starting point in understanding and prioritizing all relevant dangers in the context of the investment situation. A fundamental trap arises when many people are unaware of the risk they are really taking, but investors can avoid this pitfall by ensuring that they read or ask enough questions about an asset or financial product to understand truly what they are getting.

Investors should bear in mind that seeking the counsel of an investment adviser can lower their investment risk considerably as well as foster partnership that can help them in achieving their investment goals.