BUSINESSSTANDARD

Investment and risk goes hand in hand

Money Matters

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YOU want to make money – YES, but first you must be ready to lose it. Not taking risk is the biggest risk of all, so remember "Risk is unavoidable. And therefore, risk and returns goes together. Higher the risk – higher the returns, and conversely lower the risk – lower the returns.

Having said so, we must remember that risk is an integral part of any investment which we can't weed out completely but for sure we manage the risk well.

The risk-return relationship is directly proportional to each other, as higher the risk - higher the returns and conversely lower the risk - lower the returns.

Numerous investment research studies throughout the years have confirmed that the general investing public, or non-professional investors, have a pronounced tendency to focus on investment returns. While risk is not necessarily ignored, it certainly seems to play a second fiddle to returns in most individual investors' decision-making processes. That being the case, there is an urgent need to explore the so called 'risk-return-relationship' for a better understanding.

The relationship between risk and return is a fundamental financial relationship that affects expected rates of return on every existing asset investment. The Risk-Return relationship is characterised as being a "positive" or "direct" relationship meaning that if there are expectations of higher levels of risk associated with a particular investment then greater returns are required as compensation for that higher expected risk. Alternatively, if an investment has relatively lower levels of expected risk then investors are satisfied with relatively lower returns.

This risk-return relationship holds for individual investors as well as for business managers. Greater degrees of risk must be compensated for with greater returns on investment. Since investment returns reflects the degree of risk involved with the investment, investors need to be able to determine how much of a return is appropriate for a given level of risk. This process is referred to as "pricing the risk".

In order to price the risk, we must first be able to measure the risk (or quantify the risk) and then we must be able to decide an appropriate price for the risk we are being asked to bear. So in layman's language, it is a universally accepted principle of investing that risk and return are commensurate. This fancy terminology simply tells us that the level of risk determines the level of return. As a result, it is unusual that a low-risk investment will produce a high return. Of course, the inverse of this relationship is also true.

Remember, risk is an inherent part of investing. In order to get a reasonable return on an investment, risk has to be present. A risk free asset will produce little or no return. The intelligent investor manages risk by recognizing its existence, measuring its degree in any given investment and realistically assessing his or her capacity to take risk. There is nothing wrong with investing in a high-risk fund if the corresponding fund's return is equally high.

The questions to ask are: Can I afford the loss if it occurs? Am I emotionally prepared to deal with the uncertainties of high-risk investments? Do I need to take this kind of risk to achieve my investment goals? A prudent investor will seek to match and/or offset risk by diversifying his/ her portfolio and not putting all eggs in one basket. While doing so, one can find those that are characterised as having returns that exceed their risks, or at least match them. This would represent a favorable risk-return profile, or spread, and is a key fund investment quality.

So from here-on, whenever you need to take any investment related decision please do not concentrate on the returns part alone, as assessment of the implied risk relating to that investment is equally important. Cheers!!!