International Journal of Academic Research
ISSN: 2348-7666; Vol.3, Issue-5(1), May, 2016
Impact Factor: 3.075; Email: drtvramana@yahoo.co.in

Risk Management and Investment Decision Making

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Abstract

Every organization manages its risk, but not always in a way that is visible, repeatable or consistent, to support effective decision making. The task of risk management is to ensure that an organization makes cost effective use of a process that includes a series of well-defined steps. The aim is to support better decision making through a good understanding of risks and their likely impact. Investment is the employment of funds on assets with the aim of earning income or capital appreciation. Investment has two attributes namely return and risk. Risk management is the practice of defining the risk level a firm desires, identifying the risk level a firm currently has, and using derivatives or other financial instruments to adjust the actual level of risk to the desired level of risk. This paper focuses on nature and scope of risk management, characteristics of risk management, framework and the approaches to investment decision making.

Key words: *uncertainty, financial instruments, Investment*

Introduction:

Risk is composed of the demand that bring in variations in return of income. The main forces contributing to risk are price and interest. All investments are risky, whether in stock or capital market or banking and financial sector, real estate, bullion gold etc. The degree of risk, however, varies on the basis of features of assets, investment instrument, mode of investment or issuer of security etc.

Risk is the probable measurement of uncertainty. When uncertainty is reduced to a number of possible results to alternative courses of action, it is called risk. Thus, risk is a state of knowledge in which the result of every alternative is expected to be one of the certain possible results. Thus, risk is a condition where there is a possibility of an adverse deviation from a desired outcome that is expected or hoped for. Risk may be defined as the chance of variations in actual return.

It arises out of uncertainty. When risk is said to exist, there must always be at least two possible outcomes. If it is known for certain that a loss will occur, there is no risk, and at least one of the possible outcome is undesirable.

Investment is the employment of funds on assets with the aim of earning income or capital appreciation. Investment has two attributes namely time and risk. Present consumption is sacrificed to get a return in the future. The sacrifice that has to be borne is certain but the return in the future may be uncertain. This attribute of investment indicates the risk factor. The risk is undertaken with a view to reap some return from the investment. For a layman, investment means some monetary commitment. A person's commitment to buy a flat or a house for his personal use may be an investment from his point of view. This cannot be considered as an actual investment as it involves sacrifice but does not yield any financial return.

Financial investment is the allocation of money to assets that are expected to yield some gain over a period of time. It is an exchange of financial claims such as stocks and bonds for money. They are expected to yield returns and experience capital growth over the years.

Investment decisions, as decisions of strategic nature which initiate action in the present to improve the strategic position of the company for the foreseeable future, must be subjected to risk analysis that often fundamentally changes the decision. In this way, risk management becomes the basis for decision making. Risk is unavoidable until the moment we do not know what the future brings. As a result, all management decisions are the choice of the size of the risk taken and ways of managing such risk. Accordingly, the assessment of risk in the investment process is a function of investment options for you to decide.

Risk Management:

Every organization manages its risk, but not always in a way that is visible, repeatable or consistent, to support effective decision making. The task of risk management is to ensure that an organization makes cost effective use of a process that includes a series of well-defined steps. The aim is to support better decision making through a good understanding of risks and their likely impact.

Risk Management is the identification, assessment, and prioritization of risks followed by coordinated and economical application of resources to minimize, monitor, and control the probability and/or impact of unfortunate events. Risks can come from uncertainty in financial markets, project failures, legal liabilities, credit risks, accidents, natural causes and disasters as well as deliberate attacks from an adversary.

Risk management is the practice of defining the risk level a firm desires, identifying the risk level a firm currently has, and using derivatives or other financial instruments to adjust the actual level of risk to the desired level of risk. In this approach, risk management is closely identified with the types of instruments that can be used to manage risk.

Nature and scope of risk management:

Risk refers to the uncertainty that surrounds future events and outcomes. It is the expression of the likelihood and impact of an event with the potential to influence the achievement of an organization's objectives. Risk is unavoidable and present in virtually every human

situation. It is present in our daily lives, public and private sector organizations.

The idea of risk is central to modern society, both as a productive and as a troublesome concept. On the one hand, risk refers to a situation of opportunity. Only those who undertake a risk, bear the uncertainties and face the potential adverse consequences may gain the rewards. On the other hand, risk refers to fundamental uncertainty, at the time of risk taking, one cannot know for sure whether the opportunity concerned will be realized, in the worst case, the costs incurred might be greater than any benefit. Risk, therefore, increase the scope for both rational and seemingly irrational decisions, without the willingness to undertake a risk some opportunities may never be realized, the costs of an unsuccessful risky decision, however, may be intolerably high and may thus disqualify the whole enterprise in hindsight.

Review of literature:

Kushalappa S, Akhila (2013), Modern portfolio theory has one central theme "In constructing their portfolios investors need to look at the expected return of each investment in relation to the impact that it has on the risk of the overall portfolio". It primarily involves reducing risk rather than increasing return. The main objective of the study is to construct an optimal of the 30 index stocks of BSE. The analysis is based on stock returns of 30 companies for 5 years from 31st March 2007 to 31st March 2012.

Kushalappa S, Sowmya B (2013), Return is the primary motivating force that drives investment. Risk refers to the possibility that the actual outcome of an investment will differ from its expected outcome. More specifically, most investors are concerned about the actual outcome being less than the expected outcome as the wider the range of possible outcomes, the greater the risks. In fact valuation and an understanding of the trade-off between risk and return from the foundation for maximizing shareholder wealth. An investor always looks into an investment avenue which gives maximum return for minimum risk.

Sebastian Ceria, Anureet Saxsena, Robert A Stubbs (2012) focus on the interaction of three key elements that are part of the quantitative portfolio management process, namely the expected returns model, the risk model and the constraints that are used to formulate the portfolio construction problem. They generally refer to the issues caused by this interaction as factor alignment problem. The authors present a detailed investigation of these alignment problems, survey some of their common cources, analyse and document their effects on the ex post performance of optimized portfolios and conclude with a practical and effective remedy in the form of augmented risk models.

Objectives of risk management:

1) To ensure the management of risk is consistent with and supports the achievement of the strategic and corporate objectives.
2) Initiate action to prevent or reduce the adverse effects of risk.
3) Minimize the human costs of risks, where reasonably practicable.
4) Minimize the financial and other negative consequences of losses and claims.
5) Minimize the risks associated with new developments and activities.

Characteristics of risk management:

Risk permeates the organization:

The risk management function has evolved to become a core area of business practice, driven by the board but embedded at every level of the organization. The aim is no longer simply to avoid losses, but to enhance reputation and yield competitive advantage.

Dangers lurk in non-traditional risks:

Risk managers consider their organizations to be handling the traditional areas of credit, market and financial risk well, and reputational risk fairly well. In other areas, such as human capital risk, regulatory risk, information technology risk and tail risks, such as terrorism and climate change, confidence is weaker.

Many drivers to strengthen the function:

Efforts in risk management are being driven by internal and external factors. Principal among the first is the board, but a more complex value chain also figures prominently. The main external drivers are the demand of regulators and investors.

Awareness of risk is the key:

With the battle for support from the board largely won, the key determinant of success in risk management has become the need to ensure that a strong culture and awareness of risk permeates every layer of the organization. Setting a clear risk appetite and establishing well defined systems and processes to monitor ongoing risks are also crucial.

Companies create a figurehead for risk:

The practice of appointing a Chief Risk Officer to carry responsibility for developing and implementing the risk management framework is reaching maturity, with most of those companies that favour the approach having already adopted it. The approach is most popular in the financial sector, where two thirds of firms have appointed, or plan to appoint, a Chief Risk Officer.

Increase in investment is predicted:

Firms of all sizes and in all areas of the world are planning to increase investment in most areas of risk management over the coming years, suggesting that this business discipline, although evolving rapidly, will continue to expand and deepen its reach within organizations.

Risk management in organization:

An organization grow larger, one of their major challenges can be described as making sure that the right hand knows what the left hand is doing. In other words, risks must be recognized and managed across the entire organization. First of all, it needs to be emphasized that the goal of risk management is not to eliminate risk, but to ensure that risk remains at a predetermined level of acceptability. In some cases, firms may be practicing good risk management on an exposure by exposure basis, but they may not be paying close enough attention to aggregation of exposures across the entire organization. Also, one should keep in mind that risk and reward often go together. Higher expectations of rewards may expose the organization to a higher level of risk. Similarly, higher levels of risk should provide a higher possibility of return; otherwise, it is not worthwhile to expose the organization to

that level of risk. Rapid growth can place considerable pressure on, among other areas, an organization's management information systems, change management controls, strategic planning, credit concentrations, and asset liability management.

Risk management framework:

A good quality risk management system brings various benefits to an organization such as improving the risk awareness which is actively courted by the company, more objective performance appraisal based on risk adjusted capital employed, generating proactive approach towards future risks and its timely identification, bringing the system to the process of risk quantification, enabling the assigning of value to estimated risk of loss.

The risk management policy needs to identify issues in risk management that the business must address. A number of factors need to be agreed on and defined while preparing risk management policy for an organization. The risk management framework should be well defined taking into account the background and the present and future business of the organization, its regulatory and business environment as well as other organizational factors.

Identification of risks and their consequences, clarity of objectives, in particular those situations that the corporation hopes to avoid, and preserving or bringing about risk management needs to be clearly spell out. Before deciding risk management policy, a risk awareness and risk culture survey must be conducted in the organization. Internal or external factors that limit application of any risk risk management strategies also should be clearly identified and ground rules should be established that constitute successful risk management within the system.

Types of risk:

Risks are usually defined by the adverse impact on profitability of several distinct sources of uncertainty. Although banks share many of the same risks as other business, the major risks that especially affect banks are:

Interest rate risk:

Interest rate risk is the chance that an unexpected change in interest rates will negatively affect the value of an investment. A bank's main source of profit is converting the liabilities of deposits and borrowings into assets of loans and securities. It profits by paying a lower interest on its liabilities than it earns on its assets the difference in these rates is the net interest margin. Banks make money by borrowing at short term rates and lending at long term rates.

However, the terms of its liabilities are usually shorter than the terms of its assets. In other words, the interest rate paid on deposits and short-term borrowings are sensitive to short term rates, while the interest rate earned on long term liabilities is fixed. This creates interest rate risk, which in the case of banks, is the risk that interest rates will rise, causing the bank to pay more for its liabilities, and thus reducing profits.

Liquidity risk:

Liquidity risk is the risk that a sudden surge in liability withdrawals may leave an financial institution in a position of having to liquidate assets in a very short period of time and at low prices.

Liquidity risk is the potential inability to meet the bank's liabilities as they become due. It arises when the banks are unable to generate cash to cope with a decline in deposits or increase in assets. It originates from the mismatches in the maturity pattern of assets and liabilities.

Regulators also are equally concerned with liquidity risk of both asset and liability side and various guidelines are issued from time to time manage liquidity risk. A simple way is to look at future net cash flows on a daily basis.

Credit risk:

Credit risk is the risk due to uncertainty in a counter parties ability to meet its obligations. Because there are many types of counter parties from individuals to sovereign governments and many different types of obligations from auto loans to derivative transactions, credit risk takes many forms. A bank or a financial institution enters into a large number of financial transactions. In these transactions, the bank is exposed to a risk linked to the financial strength of the contemporary. It is originates from the point where financial institution has completed its transaction and the obligation of counter party starts. All types of banks and financial institutions face credit risk. Those banks which are exposed to longer term investment or loans are more exposed to this risk in comparison to the banks having short term assets.

Exchange rate risk:

The risk that exchange rate changes can affect the value of the assets and liabilities of an financial institutions located abroad. It is the change in the domestic currency value of assets and liabilities to the changes in the exchange rates. This may be positive or negative. The positive exposure gives rise to gain and the negative exposure gives rise to loss. It is measured by the variance of the domestic currency value of asset, liability or an operating income, which can be related to unexpected changes in the exchange rates.

Approaches to investment decision making:

The basic tenets of the fundamental approach, which is perhaps most commonly advocated by investment professionals, are there is an intrinsic value of a security and this depends upon underlying economic factors. The intrinsic value can be established by a penetrating analysis of the fundamental factors relating to the company, industry and economy. Superior returns can be earned by buying undervalued securities and selling over valued securities.

The psychological approach is based on the premise that stock prices are guided by emotion, rather than reason. Stock prices are believed to be influenced by the psychological mood of the investors. When greed and euphoria sweep the market, prices rise to dizzy heights. On the other hand when fear and despair envelop the market, prices fall to abysmally low levels. Over the last five decades or so, the academic community has studied various aspects of the capital market, particularly in the advanced countries, with the help of fairly sophisticated methods of investigation.

The electric approach draws fundamental analysis is helpful in establishing basic standards and benchmarks. However, since there are uncertainties associated with

fundamental analysis, exclusive reliance on fundamental analysis should be avoided. Equally important excessive refinement and complexity in fundamental analysis must be viewed with caution.

Technical analysis is useful in broadly gauging the prevailing mood of investors and the relative strengths of supply and demand forces. However, since the mood of investors can vary unpredictably excessive reliance on technical indicators can be hazardous. More important complicated technical systems should ordinarily be regarded as suspect because they often represent figments of imagination rather than tools of proven usefulness.

Conclusion:

It is concluded that risk management is the process of analyzing risk exposure and attempting to minimize risk through various effective means, including diversification and selection of portfolio. A portfolio consists of number of different securities or other assets selected for investment. The aim of investment decision making is not a just profit maximization in a certain period of time, but depending on the priority of the decision maker, there is a compromise between to increasing the expected return on investment and efforts to minimize the risk at a lower level. The risk in the investment decision making is measured by the probability of every possible effect of investment in accordance with the constant uncertainty in the environment.

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