Managing risk in publicly traded securities

We can only save money by not spending, and this is a habit we must develop from an early age. Savings allow us to move our present earnings to a later period in time when we are no longer working and will need our savings for living expenses. It is indeed a shame to work all your life, save nothing and during your retirement years face financial hardship. Accordingly, it is very important to start saving as early as possible by reducing your spending and setting aside a fixed amount each month. However, the only way to increase your savings is through investment. Without investing, inflation will slowly eat away the purchasing power of your hard earned savings. It is important for the investor to understand the various investment products that are available in the market place, what returns can be earned, and the risk relative to each investment product.

Risk is inseparable from return and every investment, including government securities carry some degree of risk. It is always important to remind yourself that historical performance is no guarantee of future performance and the need for keeping a long term investment horizon. Further, it is important to rebalance your investment portfolio by reallocating profits earned from good performers to new investments with better future prospects. This will help you reduce risk of loss in the long term and increase the value of your investments. Famous US-based investor, Warren Buffet who runs Berkshire Hathaway Inc. listed on the New York Stock Exchange (NYSE: BRK.A and BRK.B) has become the world's richest man by following these principles.

Remember that by purchasing shares in a publicly traded company, you become a shareholder/ owner in that company. The value of your holding is affected not only by risks related to the industry in which the company operates, but also by the company's standing relative to its competitors, the quality of its products and services, its dividend payment record, future demand for its products and prospects for earnings growth. A shareholder must remain informed about his investment by keeping up to date with respect to market developments that will affect the value of his shares. Successful companies continuously improve their bottom line by developing new market share through improving the quality of their products and services. IPhone maker "Apple" is a good example of such a company. From humble beginnings Apple by focusing on product innovation and marketing has become one of the best performing stocks in the technology sector.

When investing, it is important to understand risks associated with publicly traded securities. A security such as a stock or bond contains a price volatility risk that is made up of two parts, namely, systemic and specific risk.

Systemic risk is caused by the economic, geographical, political and social factors of the specific market where the stock is listed. For example, Pakistan's geographical location adjacent to Afghanistan has subjected its capital market to systemic risk from terrorism, rule of law, perceptions about personal safety, and other negative factors that have adversely affected the capital market's prospects as an investment destination. It may be noted that Systemic risk affects the entire market and all securities listed in that market will be impacted either in the form of a rise or fall in stock prices.

On the other hand, specific risk relates to the particular security whose price may be affected by industry specific risk, regulatory risk, and various business risks related to the particular security. For example, someone investing in a bank stock in Pakistan will be subject to systemic risk related to the entire Pakistan capital market together with the specific risk as it relates to that particular bank such as its earnings outlook, loan portfolio, and financial stability.

Generations of investors have learnt that diversification is a simple yet effective strategy for limiting your exposure to risk. Based on investment objectives, an investor has a wide range of investments in the financial sector available to him such as stocks, bonds, insurance products, savings schemes and bank deposits. Investors should always follow the simple saying "Don't put all your eggs in one basket". Appropriate diversification through allocation between equities and fixed income securities is a pre-requisite for reducing your risk of loss and building your nest egg.

It is important to understand that if investors can diversify their holdings into a reasonably large number of securities, the specific risk as it relates to individual securities can almost be "diluted" away, and they will only be exposed to the systemic risk of the market in which the securities are listed. This technique is used by many investment funds to reduce specific risk. Systemic risk can also be reduced by investing globally and diversifying our investments between local and foreign capital markets.

While diversification is indeed a pre-requisite for reducing risk, ordinary investors around the world and especially in Pakistan have limited knowledge about the level of risk they may be assuming, and whether it is appropriate for their particular risk profile.

Accordingly, it is always advisable to consult with an investment advisor that you are comfortable with, and who is someone you can trust. Your portfolio must be built after taking into account your age and life expectancy, investment horizon, cash flow needs for medical and life time events, risk preference and funds needed for your retirement life.

Management of Investment portfolios and reducing risk of loss is a complicated process requiring fulltime attention and commitment, and should not be attempted by the ordinary investor. Most working individuals even if they are knowledgeable about investment products simply do not have the time to keep pace with various developments that may affect the value of their investment portfolios. The task of managing your investment portfolio is best left to investment professionals who have the requisite education, knowledge and market experience to help you build your nest egg.

If you are considering investing in publicly traded securities, here are some important guidelines that will help you manage your market risk:

- Never invest based on tips or rumours and avoid speculation
- Notwithstanding rumours about fortunes being made in the stock market, it is simply not possible to become rich overnight through active trading in stocks
- Investing in the stock market requires that you keep a long term investment horizon of at least 5-10 years to ride out market volatility
- Understand the role of asset allocation in mitigating risk by investing in different asset classes such as equities , fixed income, money market, precious metals, real estate and commodities
- Conduct your own research using the internet to evaluate and understand the risks involved before making your investment
- Never become overconfident about your understanding of the market place as this may lead to taking on excessive risk and possible loss of principal invested
- Keep in mind that historical performance is no assurance of future performance
- Develop an understanding of the relationships between risk and return as it relates to the specific investment product
- Always use the services of a paid licensed investment advisor that you can trust to evaluate and rebalance your investment portfolio keeping in view your age and future needs
- Small investors should consider investing in mutual funds which can offer you liquidity, professional management , safe custody and diversification

All investments carry risk and investors must walk the tightrope of risk. They must balance their portfolios on a regular basis by reducing exposure to stocks that have no further room for appreciation, and reinvest the proceeds in stocks with better prospects. The role of the investment advisor and his duty of care when guiding clients can play an important role in helping the potential investor realize their investment objectives.

In summary by managing investment risk through appropriate diversification and guidance investors have the opportunity to increase their savings over time, and build a financially secure future that will enable them to enjoy their retirement years. **By: Shaukat Mahmood Malik CPA (USA): Adviser, Investor Education and International Relations Department, Securities and Exchange Commission of Pakistan (SECP).**