UNIT II

RISK OF INVESTMENT

Risk can be defined as a situation where the possible consequences of the decision that is to be taken, are known. Uncertainty is generally defined to apply to situation where the probabilities cannot be estimated.

Risk is composed of the demands that bring in variation in return of income. The main force contributing to risk are price and interest. Risk is also influenced by external and internal considerations.

Accordingly the risks of investment are classified as under:

I. Systematic Risk (External Risk)
II. Unsystematic Risk(Internal Risk)

1. **Systematic Risk**: Systematic risk is non-diversifiable and is associated with the securities market as well as the economic, sociological, political and legal considerations of the prices of all securities in the economy. Different types of systematic risks are:
   a) Market risk: Market risk is referred to as stock variability due to changes in investor's attitudes and expectations. The investor's reaction towards tangible and intangible events is the chief cause affecting market risk. Market risk includes such factors as business recession, depressions, and long term changes in consumption in the economy. The following are tremendous psychological factors in the market:
      1. Unexpected war 2. An election year 3. Political instability 4. Death of president
      5. Speculation activity in the market.6. The out flow of bullion market.

2. Interest Rate risk: A major source of risk to the holders of high quality bonds is changes in interest rates, commonly referred to as interest rate risk. The prices of high quality bonds are determined mainly by the prevailing level o interest rates in the market.

As a result if interest rates fall, the prices of these bonds will rise and vice versa. Changes in interest rate have the greatest impact on the market price of long term bonds, since the longer the period before the bond matures, the greater the effect of a change in interest rates.

2. Purchasing power risk (inflation risk): Purchasing power risk arises out of change in the price of goods and services and technically it covers both inflation and deflation periods. In India this risk is associated with inflation and rising prices in the economy both in wholesale price index and consumer price index.

Whenever investors desire to preserve their economic position overtime, they utilize investment outlets whose market values vary with price level. They select investment whose market values changes with consumer prices which compensate them for cost of living increases.

3. **Unsystematic Risk (internal risk):**

Unsystematic risk is unique to an enterprise or industry. It does not affect an average investor. The importance of this risk arises out of the uncertainty surrounding a particular enterprise or industry due to factors like a) labour strike b) irregular disorganized management policies c) consumer preferences.

4. **Business Risk (Operating risk):**

Business risk is the risk associated with the normal day to day operations of the enterprise. It represents the chance of loss and the variability of returns created by an enterprise's uses of funds. It is concerned with earnings before interest and taxes. There are two types of risk here; a) internal business risk b) external business risk.

a) Internal risk: This risk may be represented by an enterprise's limiting environment within which it conducts its business. This risk will be of different degrees in each enterprise and the degree to which each firm achieves its goal and attainment level, is reflected in its operating efficiency.
b) External business risk. There are certain specific external factors which are beyond the control of the enterprise, but are responsive to specific operating environmental conditions. Such factors responsible for external risk of business are a) demographics factors b) Geographical factors c) Political factors d) monetary policies of RBI e) economic environment of the economy influencing the enterprise and cost and revenues.

5. **Financial Risk:**

Financial risk in an enterprise is associated with the method through which the enterprise plans its financial structure. If the capital structure of an enterprise tends to make earnings unstable, the enterprise may fail financially. Financial risk is created by the use of fixed cost securities i.e. debt and preferred stock and it is concerned with earnings available to common stock.

Debt financing provides a low cost source of funds to funds to an enterprise, at the same time providing financial leverage for the common stockholders. Large amount of debt financing increases the variability of returns of the common stockholders and thus increases their risk.