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MONEY MASTERY

Risk Wrangling:
Playing It Smart

TRANSCRIPT

Introduction

Welcome to today's session, "Risk Wrangling: Playing It Smart," where we turn the daunting into the doable. Remember, every entrepreneur needs to play a little defense, especially when it comes to investments. Today, we'll decode the mysteries of managing risks in investments—no overlap with previous lessons, just pure, undiluted wisdom to bolster your financial acumen.

Let's kick things off with a quote from the legendary Warren Buffett: "Risk comes from not knowing what you're doing." Today, we're going to make sure that's the last thing people can say about you when it comes to investing!

Understanding Investment Risks

First up, let's get familiar with the different types of investment risks. We're talking Market Risk, Credit Risk, Liquidity Risk, and Operational Risk. These aren't just fancy terms invented to intimidate you at cocktail parties—they are real, and they have real impacts on your investments.

- **Market Risk:** This is the risk that the market will belly-flop and take your investments down with it. Think stock market crashes or economic downturns.
- **Credit Risk:** This involves the potential for a loss resulting from a borrower's failure to repay a loan or meet contractual obligations. Essentially, it's the risk that someone can't cover their tab.
- **Liquidity Risk:** Ever tried to sell a diamond ring in a pawn shop? If you can't convert an asset into cash without significant loss in value, you're looking at liquidity risk.
- **Operational Risk:** This is about the mishaps that can occur due to internal system failures, frauds, or other business disruptions.

Let's dive into each kind of investment risk in more detail.

Market Risk

Market risk, also known as systemic risk, is the danger that the entire market will face adverse movements, often triggered by global events such as economic recessions, political turmoil, or major financial crises. This type of risk affects all securities in a similar manner. For example, a major economic announcement like an unexpected hike in interest rates by the Federal Reserve can send shockwaves across the stock markets, leading to widespread losses. It's the kind of risk that you can't diversify away because it impacts all sectors and asset classes. Understanding market risk involves keeping a close eye on economic indicators, market trends, and geopolitical events that could affect your entire investment portfolio.

Credit Risk

Credit risk arises when a borrower may default on a loan, bond, or other forms of credit, impacting the lender or investor. This risk is particularly pertinent when dealing with corporate bonds, mortgages, or any form of credit you extend in business operations. For example, if you invest in a company's bonds and the company runs into financial difficulties, the risk of them failing to make interest payments or repaying the principal increases, potentially resulting in financial loss for you. Credit risk management requires careful assessment of the borrower's creditworthiness, often through credit scores, financial analysis, and considering economic conditions that might affect their ability to repay.

Liquidity Risk

Liquidity risk involves the inability to quickly convert assets into cash without significant loss in value. This risk becomes apparent in markets for assets like real estate or certain types of stocks that are not frequently traded. For instance, during a market downturn, finding a buyer for high-value assets without reducing the price substantially might prove difficult. Effective management of liquidity risk involves ensuring that you have enough liquid assets in your portfolio, understanding the market conditions for your investments, and planning for financial needs without being forced to incur large losses when liquidating assets.

Operational Risk

Operational risk is associated with the internal failures of a business, including processes, systems, and people, or from external events that impact normal business operations. This can range from simple human errors to complex issues like IT system failures or even fraud and compliance breaches. An example of operational risk could be a data breach in a company where sensitive information is stolen, leading to significant financial losses and reputational damage. Managing operational risk requires robust internal

controls, regular audits, compliance with regulations, and a solid framework for managing information security and other operational risks.

It's important to understand and manage these risks to safeguard and grow both your personal and business investments effectively.

Strategies to Manage Risks

Now that we know our enemies, let's talk weaponry—strategies to manage these risks.

- **Diversification:** Don't put all your eggs in one basket. Spread your investments across various asset classes to mitigate risk.
- **Asset Allocation:** This involves dividing your investment portfolio among different asset categories, such as stocks, bonds, real estate, or cash. This tactic aligns with your risk tolerance and investment goals.
- **Hedging:** Think of it as insurance. Hedging can protect against losses by taking a position in a related asset to offset potential losses.
- **Due Diligence:** Essentially, do your homework. Understanding the ins and outs of any investment is crucial.

Let's examine each of these risk mitigation strategies more thoroughly so that you can have some practical application ideas.

Diversification

Diversification is a fundamental investment strategy used to manage risk by spreading your investment portfolio across various asset classes and sectors. By investing in a mix of assets such as stocks, bonds, real estate, and perhaps commodities, you reduce the impact of poor performance in any single asset or market segment on your overall portfolio. For instance, while stocks may suffer during a market downturn, bonds might hold their value or even appreciate, offsetting losses. Diversification isn't just about having multiple investments; it's about selecting investments that react differently to the same economic events. This strategy is critical in helping to smooth out the volatility in your investment returns over time.

Asset Allocation

Asset allocation involves dividing your investment portfolio among different asset categories based on your financial goals, risk tolerance, and investment horizon. This strategic decision dictates the majority of your portfolio's returns and volatility. For example, a younger investor with a high tolerance for risk and a long time horizon may choose a portfolio with a higher percentage of stocks for growth potential, whereas an older investor nearing retirement may prefer bonds and cash for stability and income. Asset allocation is not static; it should be reviewed periodically and adjusted in response to changes in your financial situation, market conditions, or in the asset values themselves.

Hedging

Hedging is a technique used to offset potential losses in one investment by taking a position in a related asset. It's akin to an insurance policy for your investments. Common methods include using options, futures contracts, and derivatives to counteract potential losses. For example, an investor holding a portfolio of airline stocks might hedge against potential industry-wide risks by buying put options on airline stocks, which increase in value as stock prices fall. Hedging helps to manage and limit the downside risk without necessarily giving up the potential for gains, although it can also reduce potential profits and involve additional costs.

Due Diligence

Due diligence in investment terms refers to the comprehensive process of evaluating an investment, taking into account all aspects from financial, legal, and tax considerations to understanding the broader economic environment and specific industry conditions. This involves analyzing the financial statements, market position, management quality, and growth prospects of the entity. For individual investors, due diligence might mean studying historical performance, dividend history, and future growth potential of a stock before purchasing. For more complex investments like real estate or private equity, it could involve assessments of property conditions, market trends, or the business's operational effectiveness. Effective due diligence reduces the likelihood of unpleasant surprises and helps investors make informed decisions based on a thorough understanding of all relevant factors.

Conclusion

Let's put theory into practice. We've created a worksheet that will guide you through a series of exercises designed to help you apply these strategies to real-world scenarios. By the end of these exercises, you'll have a clearer understanding of how to assess and manage risks, ensuring you're not just throwing darts in the dark. I will note that this worksheet is a little different than our normal worksheets since it gets you to look at different scenarios involving some degree of uncertainty.

Remember, managing investment risks isn't about avoiding risk altogether; it's about making smarter choices to maintain control over your financial future. As we wrap up today's session, reflect on Buffett's words and consider how knowing more about your investment endeavors inherently reduces your risk.