Answer on Question #51388, Economics, Finance

What is meant by unsystematic risk? How is it different from the systematic risk? Describe the sources of unsystematic risk. What will the required rate of return be when the level of systematic is high?

Explanation:

Unsystematic risk associated with the financial situation of a particular issuer's securities. Its evaluation requires some effort on the part of market intermediary's financial assets and on the part of investors.

The category of non-systematic risks includes the following types of risks: liquidity risk, industry risk, commercial and financial risks. In other words, we can say that unsystematic risk is the risk that sources and sensitivity of which are not considered in the model of risk assessment and management. In the construction of an adequate model of unsystematic risk should not result in any significant loss of many and for a large number of them do not have to be related to each other.

With respect to non-systematic risk should act the law of large numbers identified in the analysis of individual elements of the organization, the individual components of a portfolio of securities, at some small interval of time together as a whole organization, or portfolio over time, their contribution to the losses will tend to zero. Unsystematic risk is usually ignored in solving risk assessment and management. Liquidity risk refers to possible delay implementation of the security market. Any investor should be sure that, if necessary, it can sell its security and draw investment capital in cash. Industry risk associated with changes in the state of affairs in a given sector (ups and downs). The commercial risk associated with the possibility of making a profit or loss as a result of specific activities separate securities market.

Unsystematic risk affects a relatively small number of companies, rather than the entire market. For example, the risk of food poisoning is unsystematic risk as inherent only for companies operating in the food industry. In some companies, there are some outstanding managers, whose departure is likely to cause a significant drop in the stock price. Unsystematic risk is inherent in individual stocks, generally subject to a quantitative assessment based on statistical regression analysis. Like all other forms of risk, it is rated as return volatility resulting from changes in the market value of the shares and from dividends received.

From the point of view of the investor, any risk is negative. However, some species have a minimal risk of adverse effects than others. For example, the unsystematic risk is less harmful than regular since its negative effect can be almost completely neutralized in a diversified portfolio. Therefore, it is also sometimes referred to as diversifiable risk.

The investment market does not reward investors for what they take unsystematic risk. In other words, investors do not receive compensation in the form of additional income for the fact that they were the risks specific to individual stocks. Competition in the investment market leads to a decrease in the value of shares to a level that eliminates any compensation for this

risk. Effective investors neutralize the negative impact of unsystematic risk through diversification of efficient portfolio.

The key differences the unsystematic risk from systematic is that it is associated with a particular security, at a time, when the systematic risk is not associated with any particular security and determines the overall risk to the entire set of investments in equity instruments. Unsystematic risk can be reduced through diversification, so it is called diversifiable, back to this, systematic risk can not be reduced through diversification.

Unsystematic risk is the risk that applies only to one specific company. Poor performance, product returns or recalls, employee strikes or office calamities are all examples of unsystematic risk. Diversification among the two will help prevent a portfolio from suffering too greatly by one affected company or industry or some other type of financial calamity. Unsystematic risk is significant if an investor has a large portion of his portfolio invested in one specific company or industry. The need to balance the effects of unsystematic risk, so that a portfolio is not completely wiped out by a single event, is why advisors usually suggest investors diversify their portfolio.

In general form, we can note the following sources of unsystematic risk:

1. Risk from the nature of the operation (business risk);

2. Risk from the financing decisions (financial risk).

The main factors of commercial risk include solvency and financial stability of the issuer, the quality of management; availability of sufficient, reliable information from the investor; awareness.

Financial risk is the risk of losses due to unprofitability or bankruptcy of the issuer's securities. The financial position of the company is largely determined by the ratio of debt to equity, capital structure. In general, the financial risk as a measure of economic and social uncertainty can be characterized by:

By the value - high, medium, low;

On the admissibility - acceptable risk when they lose part of the income, profits; critical (local) risk that fully lost income and there is a need to compensate the expenses; catastrophic risk of total loss of property;

On objects - the risk of entrepreneurs, enterprises, banks, insurance companies, separate legal entities and individuals;

By type of activity - production risk, intermediary, trade, transport, consulting, insurance, security, and other activities;

Economic content - pure risk as an objective possibility of a loss (zero-sum) and speculative risk as a subjective possibility of obtaining a positive or negative result of certain activities

In the nature - operational, inflation, credit, interest rate, foreign exchange.

Operational risk is associated with the error or the wrong organization, the wrong choice of the method of a particular transaction. Inflation risk is determined by the degree of accuracy of forecasting inflation and its impact on financial - economic activity. Credit risk is considered as a risk of credit default and non-payment of interest thereon. Interest rate risk is manifested in changes in interest rates on credit facilities granted. Currency risks are possible in case of changes in exchange rates, as well as the political situation in which exchange rates are fixed, and the possibility of free circulation of currency is limited. These risks are related to the revaluation of the balance sheet items of foreign affiliates of enterprises in the national currency and inverse operations. Currency risks inherent in clearing payments and exchange of goods barter.

In order to measure the market risk associated with investing in securities, used factor "beta". Beta is a measure of the volatility, or systematic risk, of a security or a portfolio in comparison to the market as a whole, gives a sense of a stock's market risk compared to the greater market. The principle of formation a portfolio of securities in which the risk reduction achieved through a portfolio of a large number of different stocks, called diversification. Diversification is a strategy to reduce the risk as much as possible while maintaining the required level of profitability; it consists in choosing such assets, the yield of which will have the least possible correlation.

Expected return is regarded as a measure of the potential rewards associated with a specific portfolio, and the standard deviation - a measure of the risk associated with a given portfolio. In this important assumption is that the investor with all other conditions prefer higher return if given two portfolios with the same standard deviation. If the investor will have a choice between portfolios having the same level of expected return, the preferred portfolio with minimal risk, that is, in fact, getting more income with minimum possible deviation.

The Security Market Line (SML) shows the relationship between risk as measured by beta and the required rate of return for individual securities. The SML equation can be used to find the required rate of return on Stock i:

$$r_i = r_{RF} + (r_M - r_{RF})b_i$$

r_{RF} is the rate of interest on risk free securities, b_i is the ith stock's beta, and r_M is the return on the market or, alternatively, on an average stock. The basic idea of CAPM is that investors should receive 2 types of compensation: for the time (time value of money) and risk.

Time value of money is represented by the risk-free rate and an investor compensation for the fact that it places the funds in any investments for a certain period of time.

The level of risk of individual securities is determined on the basis of these values:

β = 1 - average risk;

β> 1 - a high level of risk;

β <1 - low risk.

Stocks with a high beta (β> 1) is called aggressive, with a low beta (β <1) - protective. For example, aggressive are the stocks of companies whose revenues depend substantially on the market conditions. When the economy is booming, aggressive actions bring big profits. For example, shares of automotive companies are aggressive. Investors are waiting for economic recovery, buying aggressive actions to ensure a greater level of profitability in a growing market than protective. Shares of companies, whose profits are less dependent on market conditions, are protective (stocks of public utilities). Income of such companies is reduced to a lesser extent in the economic downturn. Therefore, the use of protective actions in times of crisis allows the investor to reap great profits in comparison with aggressive promotions.

On the securities portfolio is calculated as the average weighted β - coefficient of certain types of investments in the portfolio, where the weight is taken their share in the portfolio. Thus, the more relaxed the portfolio, the greater the rate β, and hence income must be higher, and vice versa. Consequently, the CAPM model demonstrates a direct link between the risk of a security and its profitability, which allows it to show a fair return relative to the existing risk and vice versa.

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