

Uncertainty in forecasting essay sample



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There is no business without a major element of uncertainty. Managers and CEOs are always on their toes for any fortune or misfortune. Shareholders fret about the company's finances, labor worries about their future in the company. In general; the idea of uncertainty or risk is given a negative sense, although this is a sheer misconception. Risk can be either upside (for instance profit for an investor) or low side (for instance loss for an investor).

There is a general business concept that higher the risk, higher is the return, thus we usually see that Treasury bills (which are considered virtually risk free) give an investor a 3% annually whereas a common stock (shares of a company) might pay you 10% annually. The reasons are eminent. Treasury bills belong to the government so they have safe backing and a guarantee that the investors might not lose at least his initial investment if the country goes bankrupt. But the return of the company totally depends on the company's performance. A company may be faced with two major types of risks, the unsystematic (unique) risk or the systematic (market) risk. The other risks usually settle in these two broad categories. Note also that although taking more risk means increased return but there is a limit to it after which you are taking risk for nothing, albeit your costs go up exponentially (Borodzicz, 2005).

The systematic risk is only restricted to the company or industry that faces it for example, the death of a reputable investor or CEO, stern government policy, changing consumer demand and labor union strikes. An investor might be too unsure of what will happen next after the company goes through this episode. This might bring the prices of the stocks to a rock bottom level. On the other hand, there may be systematic risks that are

favorable to other sectors causing their stock prices to shoot up. The investors can however reduce systematic risk. This is done through “ diversification”. The investors have ‘ basket of stocks’ (shares of different sectors/industry) in their profile that are negatively correlated. The result is that there is a minimal loss. If share prices many some companies are showing a sliding trend, then the other might be showing a rising trend. Thus the risk as such is minimal.

The unsystematic risk is a macro level risk. It usually affects the whole economy. It can kill a few where as giving the other a perfect chance to grow, for example the rising all prices, the finite resources, the 9/11 event, inflation, political (or any other) hassles and riots, wars and natural disasters. Oil exploration companies usually find themselves profitable in today’s time where as other industries might feel an increasing oil price as a blow on their profits. Systematic risk is calculated through a mathematical formula called the Beta (β). Beta changes every day because of the uncertain market condition. There is no way (such as that found in the systematic risk) as such to minimize risk because event such as described above are not in ones hand. This is how situation buids up and effects the market. Diversification might help in some way if your stocks are negatively correlated. Other wise investors can either plea their government to keep a check on a negative market risk or hope for the best.

Reference:

Borodzicz, Edward (2005). *Risk, Crisis and Security Management (Kindle Edition)* , Wiley

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