

How risky is risk

[Literature](#), [Russian Literature](#)



" The human understanding, once it has adopted an opinion , collects any instance that confirm it, and though the contrary instances may be more numerous and more weightily, it either does not notice them or else rejects them, in order that this opinion will remain unshaken. " Francis Bacon, 1620. Risk is a very interesting thing; people normally tend not to realize the real effect that risk takes in their lives.

There are many kinds of risk, we want to focus on studying the financial risk, the perception of it, the effect that it has on the private banking behavior, their clients, and how they would be treated, the effect that it has on decision making, and the effect that it has on behavioral finance. Because when you start talking about behavioral finance you need to try to understand what risk represents and all of the effects it has. During this article we want to show why over 10% return margins shouldn't be viewed as something risky, but as something worth analyzing.

Because in this times people are going to need over 10% margins if they still want to be making profits out of their investments. And once people understand what risk represents, what it represents and all of its effects, they can start analyzing what they want and need out of their investments. And once they understand that, they are going to do anything to accomplish it, because as it is said in the quote at the beginning once the human understanding acquires a goal and an opinion on how to get to the goal, he will do anything to end up successfully. . Risk Risk by definition, is the potential of gaining something of value, weighed against losing something of value but, The term " risk", means financial risk or uncertainty of financial loss" (Raglan, 2003). After using these terms for the purpose of this paper e <https://assignbuster.com/how-risky-is-risk/>

will divide the study of risk into 3 parts: types of financial risk, the ways to measure IR and perception of risk. 2. 1 Types of risk There are many types of risk; we are going to focus on 5: credit risk, market risk, operational risk, regulatory risk, environmental risk.

All of these are top priorities for banks to analyze throughout the operational process. Credit risk, is the potential that a borrower fails to meet his obligations on the terms that were agreed. There are 2 key components on defining credit risk, quantity of risk and the probability of default. The banking system manages credit risk using exposure ceilings, review renewal, risk rating, risk based in scientific pricing and portfolio management. Market risk is the possibility of loss caused by changes in market variables, it sums up to four components.

Liquidity risk, this is divided into funding risk, time risk and call risk. Interest rate risk, which is the potential of negative impact coming from changes in rates. Foreign exchange risk and country risk. Operational risk: Human error risk. Regulatory risk: The risk implied by the government 's ability to make new laws and modify regulation. . 2 Ways to measure risk There are several methods to measure risk, we will be focusing on the most common ones and the ones that are better suited for Hedge Funds. VaR is used to quantify the exposure to the market risk, using standard statistics techniques.

It measures the minimum expected loss that a firm may suffer under normal circumstances, over a set time period at a desired level of significance. One of the biggest setbacks with VaR is that it's useless in times of booms and crisis as it doesn't prevent you from being part of them. Another big problem

with Vary is that it is one of the most common risk measures and people tend to trust it too much without hesitation. (CITE) Standard deviation is a measure of dispersion of a set of data from its average. It is usually applied to the annual rate of return of an investment to measure the investment's volatility. (CITE) After taking a look at these 2 methods that are the most commonly used, we will be talking about the ones more suitable for the Hedge Fund industry, which are the following: Seminarian's or downside deviation is the average of the squared deviation of values that are less than the mean or a "minimum acceptable return". This method is similar to variance, the difference between the two is that seminarian's focuses only on the negative fluctuations of the asset neutralizing all the values above the mean. This method primarily provides the estimate of loss that a portfolio could incur, keeping the estimated risk realistic. (CITE) Kurtosis is a statistical measure used to describe the distribution of observed data used around the mean. Kurtosis is also known as the measurement for the volatility of volatility. Its main purpose is to describe the trends in charts. Keenness describes asymmetry from the normal distribution in a set of statistical data. Keenness can come in the form of "negative keenness" or "positive keenness", depending on whether data points are skewed to the left (negative skew) or to the right (positive skew) of the data average. (CITE) After analyzing these methods, we can conclude that for a Hedge Fund and especially for clients investing in these it is better to use the seminarian's, kurtosis and keenness methods to analyze the risk of an investment. These three focus more on the downside risk of the portfolio instead of using the Vary that is only good on stable periods and doesn't account for drastic

mimes, besides standard deviation and variance can be very deceiving in the context of analyzing the real risk that a portfolio can have focusing also on outlying positive returns. 3.

Private banking What we want to analyze is the way private banks operate and especially how clients needs are met, how they are treated, how their money gets almost frozen with interest rates that barely covers their money from the effect of inflation, and how private banks earn a lot of money while clients barely earn real returns. Banks offer annulled returns between 3 and 5 percent which is usually not enough to meet paying expenses or inflation for the wealthy clients. An American study showed the following: " Americans said they need to earn average annual gains of 9. Percent above inflation to make their financial needs. Natives officials noted that inflation since 1964 has averaged 4. 2 percent annually, which means the average American has to generate 14 percent to meet their needs. " fee, 2014) having this in mind clients can realize that they need to expect a bigger profit on their investments because they are actually losing money, their money is losing value and the only way f stopping this from happening is by demanding higher returns using alternative investments. High returns while taking minimal risk is a pipe dream; if asset growth is your priority, taking risk is crucial" Oaf, 2014), and that is why clients need to be sure that risk is being managed in the most efficient manner. 3. 1 Clients The most important part of any financial institution are the clients, and most important thing about them is recognizing that every client is different and every client has different needs. Every client has to be treated differently to help them meet his/her goals. As the investigation of Dry.

Rene Fischer and his team in the book "Wealth Management in new Realities", "we identify 7 engagements that are shaping client behavior and needs" (Fischer, De Conge, OK, Topper, 2013), with this in mind we will take a look at those seven trends to give clients the best service possible while maintaining a steady margin of returns. Engagement one: Changing demographics. The population is growing and also the markets, clients need security and information that their money is secure and generating profit.

Engagement two: Globalization and future markets. With the Gap's of various developing countries rowing at a fast pace, clients are starting to look at investing in new markets. Engagement three: Scarce resources and climate change. Global awareness is growing for environmental issues that can create new opportunities in clean energies, and a new set of investments in ecological matters for clients. Engagement four: Economic crises and insecurities. With the volatility of the market, clients are starting to be insecure about their money.

It is the financial institution's job to keep clients informed about the situation their money is in, and make them feel safe that their money is in good hands. Engagement five: Dynamic technology and innovation. With all the changes in information technologies, "more and more people are getting connected and are sharing information on the go" (Fischer, De Conge, OK, Topper, 2013), this makes clients better informed and more aware about what is happening to their money.

Engagement six: Sharing global interest responsibility. With the shift towards global cooperation and MONGO's gaining power, clients are demanding

socially responsible investments. Engagement seven: Global knowledge society. This trend goes hand in hand with trend number five, with new technologies of information, society has easier access to new information and the tools to know what is happening.

With all these trends happening, clients want to be more informed and still get the same yield, but with the misinformation, manipulation and misunderstood promises from the monetary agents, the clients think that having their money working to win just a little over inflation just to avoid losing money might be wrong, because with the globalized economy that we have these days studies that are being made all around the world can be generalized, so if something is happening in Europe you could assume that something similar is happening somewhere else.

So with this in mind after taking a look in some studies made in India we saw that the inflation is not the same for every social class and that the general inflation that everyone takes for granted does not really have much effect on the middle and high class, because it is made out from an average of items that don't really affect those two classes, and we are focusing on them because they are the ones that are clients of the financial institutions, and the prices of the items that they acquire are going up stronger than the regular inflation, so that is why they are not retorted with the interest rates that they receive, and they are in fact losing money which is the one thing that they were trying to avoid.

4. Behavioral finance There are many factors involved in the process of understanding behavioral finance.

To understand this you have to start with risk perception, understanding why people tend to make certain decisions, and after that study the behavioral biases investors exhibit to see what drives the intuition of most individuals. Behavioral finance can help a financial institution prevent certain human factors that can be mitigated at the time of making decisions and preventing psychological factors to play an important role in the decision making process.

4. 1 Risk perception Risk perception is one of the most important elements of psychological effect on the market. Trying to understand why people tend to make certain decisions at certain times is one of the biggest questions in this matter.

Many investigations have been made about the subject, one that stood out was: " The Psychological Impact of Booms and Busts on Risk Preferences in Financial Professionals" by Cohn, Fear and Marcella. During this experiment they decided to manipulate two different kinds of lotteries giving different options in different controlled markets. Their final conclusion was that there will always be a psychological/emotional factor that can't be measured with precision but you can be sure that during times of booms people tend to be overly optimistic and risk is not their biggest concern, and during times of busts people usually tend to be overly conservative and almost allergic to risk.

This can be obvious in both cases as it is when biases come into play. This is why risk can be a risky thing when you are not certain that is being measured the right way. If the risk is being measured correctly, psychological factors shouldn't have any weight in the decision making

process. 4. 2 Behavioral bias Behavioral biases in finance are tendencies to act in a certain way; they can lead someone to a systematic deviation from a standard of rationality or good judgment. Five biases that we believe can be the most common ones in an investor are the following: 1. - Confirmation bias is the tendency that makes people believe in information only if confirms their beliefs and hypothesis. 2.

Optimism bias is the tendency to think that you are less at risk of experiencing a negative event than others. 3. - Loss aversion bias is the tendency that agents take on when they prefer the option of avoiding a loss than the option of acquiring gains. 4. - Self-serving bias is the tendency to distort a process because of the need to maintain and enhance once self-esteem. 5. - Planning fallacy bias is the tendency to underestimate the time that it will take to complete a task. These are only some of the behavioral biases that play a significant factor in the psychological process of making decisions. It has to be taken into account that all of them could affect an investor 5.

Conclusion " The human brain has evolved to be very efficient at pattern recognition, but as the confirmation bias shows, we are focused on finding and confirming patterns rather than minimizing our false conclusions. Yet we needn't be pessimist, for it is possible to overcome our prejudices. It is a start simply to realize that chance events, too, produce patterns. It is another great step if we learn to question our perceptions and our theories. Finally, we should learn to spend as much time looking for evidence that e are wrong as we spend searching for reasons we are correct. " (Millions,

2008). After looking at previous evidence, it is clear that both Private Bankers and Clients have a misconception about risk.

Behavioral biases transform risk into fear which if not mitigated by Private Bankers leads to inefficient allocation in Client's portfolios, and a controlling position in their relationship. This is why Bankers usually oversee those investments that they are not familiar with and reject them or cause Clients to reject them without studying their process and risk/reward ratio. This is the case with vast majority of Alternative Investments. We encourage Clients to keep a critical point of view with regards to their portfolios and continuously question their Banker's recommendations. By being involved in their investment decisions and being up to date on current market trends Clients will have a correct attitude towards risk when it comes to investing.