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Risk Management: The Effective Tool To Minimise Losses And Maximise Profits

Risk Management is crucial not only to minimise losses but also to maximise profits. **Karan Bhojwani** shares best risk management practices that if applied can lead to improved portfolio performance

As a trader/investor, it is impossible to avoid volatility in the markets. We are daily exposed to the wild up and down swings in the market. We are often present for each tick, each bit of breaking news, and every gossip heard on the street emanating from all corners of the world that triggers outrageous market variances. Those very market fluctuations help a trader to earn his bread and butter. There are numerous factors at work in the markets which causes volatility; fear, greed, supply and demand are among the most evident and generally known. In reality, these factors drive much of the day-to-day activities, but it is important to understand that they are not the only forces at work. Other factors such as government's reforms, geopolitical risks, political tensions, global economic policy, macro and micro economic principles are all contributing factors to what make the stocks we trade go up and down.

There are a large number of individual traders and investors in the stock market. Every investor or trader follows a strategy which suits him/her and he/she acts accordingly. But regardless of this, the one common denominator that everyone shares when exposed to the markets is "RISK". In this article we will not talk about investing opportunities or different trading strategies, but we will talk and focus on one thing which is common to every individual who trades or invests in the markets: RISK. Whether you are short-term trader or a long term investor, your chances of being successful over your investing career are higher when you understand risk management. Hedge fund titan Paul Tudor Jones has warned, "Don't focus on making money, focus on protecting what you have'. To be a successful investor and a profitable trader, you must learn to master your risk. Be that as it may, before mastering the risk part, it is imperative to comprehend risk and how it impacts our markets, individual stocks and psychological abilities to manage your positions as a trader.

What is risk management and why is it a defining factor for a trader/investor? Risk management is a process which involves two important things; first thing is, where an investor or trader determines his/her risk exposure in a particular trade and once the investor/trader has determined his exposure, the second thing is determining the suitable method to apply for mitigating that risk as best as one can. In other words, the trader or investor needs to identify areas of risk, assesses impact and then prioritize necessary remedial action.

Types of risk exposures in markets:

- **Market Risk**
- **Operational Risk**
- **Legal or Legislative Risk**

MARKET RISK

This is the most familiar of all risks. The market risk is also referred to as 'systematic risk'. Market risk is the risk that the value of an investment will decrease due to changes in market factors. These factors will have an impact on the overall performance on the financial markets and can only be reduced by diversification into assets that are not correlated with the market. This risk includes war, hackers attacking the exchanges, rumours about terrorist attacks, and macroeconomic news from other countries that impact our own financial markets.

Basically, it is the one type of risk you cannot avoid or ignore when trading or investing. It is inevitable that at some point in your trading career, you will have a face-to-face experience with systematic risk. And, you will know when it happens.

OPERATIONAL RISK

Investopedia defines Operational Risk as the risk a company undertakes when it attempts to operate within a given field or industry. Operational risk is the risk not inherent in financial, systematic or market-wide risk. It is the risk remaining after determining financing and systematic risk, and includes risks resulting from breakdowns in internal procedures, people and systems. This is the kind of risk where everything is fine in the market, but your stock is going against the market trend. You check the press releases or read news about your stock and come to know about the employees' strike at the company's manufacturing plant or the involvement of the company's CEO in some tax case.

LEGAL OR LEGISLATIVE RISK

Legislative risk is defined by financial dictionary as the risk of loss due to change in law in a particular jurisdiction. In general, legislative risk is same as political risk; thought the latter encompasses situations like coups and terrorism, while legislative risk refers to change in law according to due process. This is the risk to investors when a state government puts ban on sale of alcohol in the state or unexpected change in the law on industry regulations set forth by the government can also impact the way companies do business, thereby affecting their stock prices and market value.

Having looked at the types of risks, we now provide some simple ways a trader or investor may formulate an effective risk management strategy.

1. Diversification:
There is a famous saying 'Don't put all your eggs in one basket.' This is one piece of advice that investors/traders should always abide. It simply means that one should not concentrate all efforts and resources in one area as one could lose everything and go broke. It is easier to lose money if you invest all your investment capital in a single stock than if you spread across several stocks. Some win, some lose, this is the way the market works. But diversifying is not just about spreading risk, it is also about creating opportunity.

2. Managing risk with a hedge:
As per business dictionary "Hedging is defined as a risk management strategy used in limiting or offsetting probability of loss from fluctuations in the price of securities." Usually traders and investors who have large portfolios manage risk with a hedge. They usually use derivative instruments to manage risk.

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Special Report

Milan Vaishnav, *CMT, MSTA,* Consultant Technical Analyst

"Behind Every Successful Trader Or Investor There

If we look around while speaking and interacting with large number of investors and traders alike, one would observe that the concept of "Risk Management" has different interpretations by the market participants. It will be no surprise if we see that majority of market participants, whether they are traders or investors, will start thinking about "Risk" only when the markets are too choppy to handle, or if they are marking fresh highs every day, or if they are caught in a volatile corrective actions. Unless any of these three things happen, we find that the concept of "Risk Management" largely remains neglected.

At this point, we need to correct this perception. Every trader or an investor does have a different mindset. Each one of them has a unique perception of the markets and most of them believe they have a unique trading method which is often perceived by them as "Safe" or "Risk Free".

This is not true. We need to understand that at no point in our trading or investing career we have been operating in a risk-free environment. Risk has always remained omnipresent in our professional existence as a trader or an investor. There is a golden truth about risk – Risk can never be 100% eliminated. It can only be mitigated". The sooner we learn this, the sooner we will see our portfolios and capital operating in a risk-mitigated environment, reducing our exposures to uncalculated and unexpected losses.

"Risk Management", as a concept, should be applied methodically and continuously while we are exposed in the markets and not just when a particular situation in the markets arises. Risk management methods should remain perpetual in existence. It is a bitterly learnt lesson for most traders that "You should know your trade well before you execute it".

While we deal with our portfolios, we have so far concentrated only on the reward side–as we find this more interesting and enjoyable. However, this is just half of the portfolio equation. The other half is the money management and risk management, which deserves equal or sometimes more importance than the first half.

BASICS OF RISK MANAGEMENT

Without going deeply into highly technical methods of risk management, we will try and focus on some simple yet fundamental methods of risk management, which traders and investors can apply in their simplest form.

Embracing risk is more important than measuring risk. Understanding and accepting each day's losses and series of losses is essential for survival. Risk cannot be eliminated, as much as traders try to make each trade a profit or engineer systems to minimize losses. You can move the profits and losses around, but you cannot eliminate them or make them so small that they are meaningless.

This is done usually by creating a counter and market-neutral positions by using (selling) Futures Contracts or buying Put Options. Some traders hedge their day trading position by taking a long position in one stock and a short position in another stock of the same sector, hoping to profit on both.

3. Avoid Speculation:
Very often we see individual traders/investors take position based on herd mentality. By taking a position in a stock which you are not much aware of, you unknowingly expose yourself to risk as you do not have any idea about the fundamentals or technicals of the stock.

You just hop on to the stock bandwagon based on recommendation by a close relative or colleague. It is better to do proper due diligence and not let emotions dictate where you put your hard-earned money. After you have done proper research, or at least you know the rationale of your investment, you are aware of the risk you are taking.

Hence, better be an informed or evidence-based trader/investor as this will help you to reduce risk.

4. Quality of Stocks:
It is very much necessary to include stocks that are essentially frontline, provide good liquidity and are relatively less volatile. As we know, there are over 2,000 stocks listed on the stock exchanges. However, out of these, the top 350-400 stocks represent about 70-80% of the market capitalization.It is important for a trader/investor to stick to a stock that ensures good liquidity, better spreads and measureable volatility. In recent times, we have seen a case where SEBI acted swiftly and restricted trading in stocks of 331 suspected shell companies. Hence, sticking to good quality stocks helps to mitigate this risk.

5. Using 2% and 6% Rule:
The 2% Rule says that a trader should never risk losing more than 2% of his available capital on a single trade. For example, if you have ₹500,000 in your trading account, you should not lose more than ₹10,000 on any one trade. One can create an "Iron Triangle of Risk Control" in the following way.

A. Your maximum rupee risk for the trade you are planning (usually never more than 2% of your Account Value)

Exists A Robust Risk Management System"

Let us examine some pragmatic and common sense-based risk management methods. Risk control is as much an issue of common sense as it is of complex rules and mathematics. Most of this chapter shows how various rules, measurements, and leveraging techniques can reduce risk for both discretionary and algorithmic trading; however, successful traders have applied common sense, without complex formulas, for a long time. Some of these successful principles are:

1. Only risk a small amount of total capital on any one trade. The total amount risked should allow you to comfortably survive a number of losses in a row. No trade should ever risk more than 5% of the invested capital.
2. Know your exit conditions in advance. There should be a clear exit criterion for every trade, even if the exact loss cannot be known in advance.
3. Large profits mean large risk. If the average profits or average losses are too large relative to the investment, then smaller positions should be taken.
4. Exit a trade quickly. Exit a trade as soon as you recognize that it has gone wrong. Don't try to manage the loss. Many floor traders believe that the smartest trader is the first one out.
5. Don't meet margin calls. Experienced traders believe that a margin call is an objective statement of a trade that's gone wrong, or a system that is not meeting expectations. It is a time to review trading performance rather than invest more.
6. Liquidate your worst position first when lightening up. The profitable trades have proved that they are trending or performing properly; the losing ones have proved they are not. Stay with the good positions and liquidate the worst.
7. Be consistent with your trading philosophy. If you are a trend follower, then keep losses small and let profits run. You cannot be a trend follower by taking profits whenever they occur.
8. Be sure the trading profile is compatible with your risk preference. You cannot follow a strategy that takes risks that are uncomfortably large. Be sure that profile is agreeable to you.
9. Plan for contingencies. Nothing ever goes as planned, and you must be prepared for infrequent but important exceptions, such as a price shock. Do not be undercapitalized.

While we conclude, it is evident that the risk management techniques work constantly behind-the-scenes and we need to ensure constant applicability of these methods. Just like behind every successful man there is a woman, it would not be wrong to say that behind every successful trader or investor, there exists a robust risk management system.

We need to ensure that such risk management systems remain perpetually in place in our life as an active investor or trader.

B. The distance – In absolute rupee terms, from your entry to your stop loss – your maximum risk per share

C. Divide "A" by "B" to find the maximum number of shares you can trade.

The 6% Rule asks us as to what will happen if all our trades go in opposite direction of our positions? While we use the 2% Rule to set stops and determine trade sizes, the 6% Rule will limit the maximum total loss that our account may suffer.

It adds up total open risks on all the open trades and prohibits a trader to trade if the total unrealized loss on the portfolio is equal to or more than 6%. The 6% Rule changes the usual question—"Do I have enough money for this trade?"—to a much more relevant one—"Do I have enough risk available for this trade?" That limit—risking no more than 6% of your equity account in any given month—keeps your total risk under control, ensuring long-term survival.

6. Trailing Stop Loss:

This is one of the most effective tools for an investor/trader to tackle the never-ending fight of "greed and fear". It is also referred as "progressive stops". This is used to mainly avoid the potential loss of profits. "Trailing" or "Progressive" stops are absolute necessity because if the stock continues trading in an uptrend overtime, the price gets further higher and higher from the point of entry and, at one point of time, it becomes necessary to protect the profits and prevent them from getting washed away due to sudden reversal or an unexpected volatility. The most common method to plot trailing stop losses is to use trendline joining all minor bottoms. Generally, whenever a minor bottom is formed and the stock moves up again, that minor bottom or reversal point becomes a "trailing" or a "progressive" stop.

BOTTOM LINE:

It has been observed that most traders focus on finding the right trading set up or try spending days or weeks finding the best indicator which complements his trading strategies, but successful trading is not only about finding the right set ups or indicators, but it is finding the right balance between trading strategies and risk management. Risk management is what separates successful traders from the masses.