

Key Risks in Investing in the Securities Market

Before investing in the securities market, it's essential to identify your financial goals and assess your risk tolerance. Understanding the various types of risks involved will help you make informed decisions. Without a clear understanding of risks, you may overexpose yourself to market volatility or miss opportunities for growth by being overly cautious. Knowledge of risks such as market, liquidity, and inflation helps you create an investment strategy that balances potential rewards with the level of risk you are willing to take. Here we explore some of the key risks of investing in the securities market that you should be aware of:

1. **Market Risk:** The term "market risk," also known as "systematic risk," refers to the inherent risk that investors face due to fluctuations in the overall market. Here are a few common types of market risk:
 - **Interest Rate Risk** arises from unexpected changes in interest rates. This risk is particularly relevant for fixed-income securities, such as bonds. When interest rates increase, the price of existing bonds with lower rates tends to fall, as newer bonds with higher rates become more attractive.
 - **Commodity Risk** is related to price fluctuations in essential commodities such as oil or agricultural products. Changes in the prices of these commodities can have widespread effects on the economy, especially for companies that rely on them for production. If commodity prices rise significantly, it can lead to a supply-side crisis, affecting company profitability, stock prices, and dividends.
 - **Currency Risk**, also known as exchange rate risk, occurs when changes in currency values affect the returns on international investments. For example, if an investor from one country holds assets in another country, a depreciation in the foreign currency can reduce the value of the returns when converted back to the domestic

currency. This risk is particularly important for investors with international portfolios.

- **Country Risk** refers to the potential impact of macroeconomic and political factors on an investment. These factors include political instability, economic policies, fiscal deficits, and even natural disasters.

Because market risk is tied to broad, external factors, it cannot be eliminated through diversification. However, investors can manage it through hedging techniques, where investors use options to protect against potential declines in stock value, limiting extreme losses but also capping returns. Also, staying informed about market trends and changes is crucial - it allows investors to make timely decisions on buying, selling, or holding investments. Investors should remain patient during market fluctuations, understanding that short-term dips may recover over time.

2. **Inflation Risk:** It is a major concern for investors because it erodes the purchasing power of investment returns over time. As prices rise, the value of money declines, which means that even if an investment grows in nominal terms, its real value—adjusted for inflation—may have actually fallen. Several factors contribute to this risk. For example, fiscal policy involving high government spending can increase demand, pushing prices up. Economic growth can also lead to demand-pull inflation when demand exceeds supply. Supply chain disruptions, triggered by global events can cause shortages and raise prices. Also, rising commodity prices, such as those of oil, food, or energy, often fuel inflation, impacting investment returns over time.

Fixed-income investments like bonds are more susceptible to inflation risks. If inflation rises faster than the bond's interest rate, the real return diminishes. While stocks are often considered a hedge against inflation, rapid or unexpected inflation can still hurt stock valuations. To manage

inflation risk, investors can diversify their portfolios. Investors can add inflation-indexed bonds to their portfolio. The interest rate on these bonds is tied to an index, such as the Consumer Price Index (CPI), and is adjusted periodically to match inflation. This makes them an attractive option for investors seeking to preserve the real value of their investments over time.

To effectively manage inflation risk, investors should regularly review and adjust their investment portfolios. As inflation fluctuates, certain assets may lose value in real terms, so it's crucial for investors to reassess their portfolios and ensure their investments are keeping pace with rising prices. By staying proactive, investors can identify underperforming assets and make necessary adjustments.

- 3. Liquidity Risk:** It refers to the risk that an investor may struggle to quickly and easily buy or sell an investment at a fair market price. Several factors can contribute to liquidity risk. Volatile or declining market conditions often reduce liquidity as fewer investors are willing to participate. Also, certain securities, particularly those with low trading volumes, complex structures, or long maturities, are inherently less liquid. The financial health of the issuer also plays a role; companies with poor financials or a history of default often face liquidity issues, making their securities harder to trade. Furthermore, smaller markets or those with fewer participants tend to be less liquid due to limited trading activity.

To manage liquidity risk effectively, diversification plays a key role. By spreading investments across different asset classes and sectors, investors reduce their reliance on any single security that may become illiquid. Diversification ensures that investors have a more flexible and liquid portfolio, reducing the risk of being stuck with assets that are difficult to sell.

Another important strategy is to focus on securities traded in large, active markets with high trading volumes. These markets offer greater liquidity due to a higher number of participants, making it easier to buy or sell securities without significant price fluctuations. Also, investors should steer clear of assets with low trading volumes, complex structures, or issuers with weak financial health, as these are often harder to trade. Finally, regular portfolio reviews are crucial for monitoring changes in liquidity and adjusting strategies as market conditions evolve.

4. **Business Risk:** This refers to the risk that a company's operations may be disrupted or suspended due to adverse business conditions, financial difficulties, or unfavourable market trends. For investors, business risk carries significant implications. Disruptions in a company's operations can directly impact profitability, potentially leading to lower earnings or even losses. A company facing operational or financial challenges may also experience a decrease in its market value. Also, if a company's financial difficulties are severe enough, the risk of default on debt obligations increases, making it a less attractive investment option.

Investors can mitigate business risk by diversifying their portfolios. With diversification, investors lower their reliance on the performance of any single company or industry. This approach helps protect the overall portfolio, as losses in one area can be balanced out by gains in another.

Another effective way for investors to manage business risk is by focusing on stable and financially sound companies. Well-established companies with strong balance sheets, consistent cash flows, and proven operational stability are generally better equipped to face economic downturns or market volatility. Investors can reduce their exposure to business risk by conducting thorough research into a company's financial health, management team, and competitive positioning before making investment

decisions. Staying informed about market trends and industry developments also helps investors manage business risk.

5. **Volatility Risk:** Stock prices can fluctuate significantly over short periods, leading to potential losses if the market moves unfavourably in the short term. Several factors drive this volatility, including international, regional, and national economic policies such as changes in interest rates, tax rates, or trade restrictions.

One effective approach to managing market volatility is to maintain a long-term investment outlook. Short-term market fluctuations are normal, and making impulsive decisions based on these movements can often lead to unfavourable outcomes. By keeping a focus on long-term goals, investors can handle periods of volatility and stay aligned with their broader objectives.

Diversification is another key strategy for handling market volatility. By allocating investments across different asset classes and industries, investors can reduce the impact of market fluctuations. When one part of the portfolio experiences a downturn due to specific market conditions, strong performance in other areas can help balance out potential losses.

Experienced investors use hedging techniques, such as options, to shield their portfolios from volatility. Options offer a way to limit losses or secure profits in uncertain market conditions. Stop-loss orders are another tool that can help investors limit downside risk during volatile periods.

Monitoring key market indicators, like the VIX (Volatility Index), can also provide valuable insights into market sentiment and potential price swings. Understanding these indicators allows investors to adjust their strategies as needed and make more informed decisions in response to changing market dynamics.

Do's & Don'ts of Investing in Capital Market - NSDL

Investing in Indian markets can be rewarding, but it requires careful planning. Investors should research thoroughly, understand market trends, and follow regulatory guidelines. Staying informed and making decisions based on accurate information can help manage risks and achieve better returns over time. Here are some essential do's and don'ts that every investor should keep in mind.

Do's

Read all documents carefully: Before signing any agreements, take the time to read all documents thoroughly. Understanding the terms and conditions will help you avoid unexpected surprises and make informed decisions.

Deal only with SEBI-registered brokers: Always ensure that you are dealing with a SEBI-registered stockbroker or an authorised person when making investments.

Use banking channels for payments: Always make payments through banking channels to registered intermediaries. Avoid making payments in the name of an employee of the intermediary, as this could lead to fraud.

Be realistic about returns: Remember that nobody can promise you guaranteed returns in the stock market. Such assurances are neither allowed by regulatory authorities nor realistically achievable.

Register your contact details: Ensure that your mobile number and email ID are registered with your trading, demat, and bank accounts so that you receive timely notifications about your transactions.

Don'ts

Don't rely on 'Tip'-based Trading: Never invest or trade based on unsolicited 'Tips'. These often lead to poor investment decisions and significant losses.

Don't share your account information: Never disclose your online trading and demat account passwords to anyone.

Don't share your OTP with anyone: Never reveal One-Time Passwords (OTPs) received from banks or brokers. These are meant solely for your use, and sharing them can lead to fraudulent activities.

Don't invest in unregistered schemes: Avoid putting your money in chit funds, Ponzi schemes, or unregistered collective investment companies. They're unregulated and pose significant financial risks.

Don't follow the herd mentality: Avoid making investment decisions just because everyone else is doing it. Instead, seek advice from qualified professionals and make investment decisions based on thorough research.