Managing Investment Risks: Modern V/s Traditional Knowledge and Practices

Rakesh Swami

Doctoral Research Scholar, Suresh Gyan Vihar University Jaipur

Email : rakesshswwami@gmail.com

&

Trilok Kumar Jain,

Director, Ecosystem for Innovation and Entrepreneurship, Suresh Gyan Vihar University, Jaipur

www.gyanvihar.org email: trilokkr.jain@mygyanvihar.com tkjainbkn@yahoo.co.in jain.tk@gmail.com

Abstract

The present study is a comparative study between modern investment tools and old investment tools. The study has been conducted in Rajasthan (India) and therefore the old tools of investment available in Rajasthan have been identified and compared with the modern tools. The primary purpose of the study was to compare the risk management tools available a common investor. The researchers found that the traditional tools or the old tools were also very good, but the modern tools offer more systematic and secure options. The researchers conclude that the modern tools are better in comparison to the traditional tools.

Keywords : investment, risks, mutual fund, traditional, risk management

Introduction

The word risk has originated from the Latin word "RESCUM" which denotes risk at sea. Business entrepreneurship and risk are closely related. Risk has positive correlation with profit and therefore a balance must be trade- off between the two. Risk is defined as "exposure to uncertainty." Risk exists due to our inability to make perfect forecast. Forecasts cannot be made with perfection or certainty since the future events on which they depend are uncertain. Scholars have tried to define risk as "Risk can be defined as the standard deviation around the expected return. However, standard deviation is risk surrogate, not synonym for risk. The variability of return around the expected average is thus a quantitative description of risk."

A large number of researches have been carried out on managing investment risks. Vidyashankar (1990), Sarkar (1991), Agarwal (1992), Sadhak (1991), Sharma C. Lall (1991), Samir K. Barua *et al.*, (1991), Sandeep Bamzai (2001), Atmaramani (1995), Atmaramani (1996), Subramanyam (1999), Krishnan (1999), Ajay Srinivsasn (1999) looked at the strategies of the mutual funds in managing risks for common investors. Raja Rajan (1997) segmented investors on the basis of their common beliefs, expectations and characteristics. Friend, et al., (1962) made an extensive and systematic study of 152 mutual funds and found that they were able to generate annual return of 12.4 percent for the investors. However, there were no researches to compare the investment risk management practices of the modern times with those of the old times. It is difficult to collect data on old times, however, with some efforts a research can be conducted to identify and compare the two. Therefore this research was conducted by the researchers.

There was a fundamental question about risk management tools and options. It is a common understanding the people are by nature risk averse and they wish to invest their money carefully to protect their future and to prepare for any uncertainty. Therefore risk management is natural to every human being. Present paper has the following objectives with regard to this subject : -

a. To identify and compare modern and traditional investment tools and options
b. To identify and compare modern and traditional approaches towards investment management at the level of individual
c. To compare modern and traditional investment options and compare their advantages
d. To compare human behavior with regard to investments in modern time with that of the old times

The mode of research here is based on interviews and interactions with experts and those who have some knowledge of the field. The researchers have conducted indepth interviews and identified investment options and methods.

Modern tools of investment management have become very advanced and sophisticated. They help an investor in protection. They enable an investor in protecting money and enable that investor in using the money at the time of need. There are different options for investments, which give reasonable returns. There are some options, which offer higher returns, but also carry higher risks. However, there are also those options, which carry minimum risks and also carry some returns (which are less in comparison to riskier investment options). Investor has to choose between different options and take up the investment option, which can provide reasonable returns and carry less risks.

Investment and saving in a portfolio can take different forms. An investor can either deposit directly in banks or in government bonds or in shares and Securities, or can deposit through an investment or portfolio management company, also referred to as a mutual fund. An investment firm or a mutual fund is a financial intermediary that collects money from investors and invests in different securities on their behalf.

As a saving and investment instrument mutual fund can be defined as a trust that pools the savings of a number of investors who share a common financial goal. The money thus collected is then invested by the fund manager on behalf of the investors in different types of securities. The income earned through these investments and the capital appreciated realised by the scheme are shared among scrip holders in proportion to the number of scrips held by them.

The basic objective sought to be achieved by Mutual Fund is to provide an option for lower income groups to acquire secured returns without much risks. They cater mainly to the needs of the individual investor whose means are small and to manage investors portfolio in a manner that provides a risk free source of regular return

Characteristics of modern investment options

1. The Risk-Return Trade-Off:

The most important relationship to understand is the risk-return trade-off. Higher the risk higher the returns and lower the risk lower the returns. Therefore it is up to the investor to decide how much risk to take. Investors have different options. If they wish to take risk, they can directly invest in shares. If they are completely risk averse, they may invest in banks or government bonds. If they want a reasonable return against reasonable risk, they may go for mutual funds or other such options.

2. Market Risk:

Risk associated with demand and supply is called market risk. This is due to uncertainity with regard to market reaction. Sometimes prices and yields of all securities rise and fall. Broad outside influences influencing the market in general lead to this. This is true, may it be big firms or smaller mid-sized firms. This is known as Market Risk. A Systematic Investment Plan ("SIP") that works on the concept of Rupee Cost Averaging ("RCA") might help minimize this risk.

3. Credit Risk:

Credit risk refers to the ability of the lender to repay back the money. This is the risk associated with regard to default. If an investor deposits money with a cheat person, the money may not be recovered and therefore there is a credit risk. However, investment in banks or government bonds or reputed mutual funds is comparatively safer. The debt servicing ability (may it be interest payments or repayment of principal) of a firm through its cash flows determines the Credit Risk faced by you. This credit risk is measured by independent rating agencies like CRISIL who rate firms and their paper. A 'AAA' rating is considered the safest whereas a 'D' rating is considered poor credit quality. A well-diversified portfolio might help minimize this risk.

4. Inflation Risk:

The root cause, Inflation. Inflation is the reduction of purchasing power over time. A lot of times people make conservative investment decisions to protect their capital but end up with a sum of money that can buy less than what the principal could at the time of the investment. This happen when inflation grows faster than the return on investment. A well-diversified portfolio with some investment in equities might help minimize this risk.

5. Interest Rate Risk:

In a free market economy interest rates are difficult if not impossible to predict. Changes in interest rates affect the prices of bonds as well as equities. If interest rates rise the prices of bonds fall and vice versa. Equity might be negatively affected as well in a rising interest rate environment. A well-diversified portfolio might help minimize this risk.

6. Political / Government Policy Risk:

Changes in government policy and political decision can change the investment Environment. They can create a favorable environment for investment or vice versa.

If mutual funds are emerging as the favorite investment vehicle, it is because of the many advantages they have over other forms and the avenues of investing, particularly for the investor who has limited resources available in terms of capital and the ability to carry out detailed research and market monitoring. The following are the major advantages offered by modern financial institutions including the mutual funds to investors:

1. Portfolio Diversification:

Each investor in the fund is a part owner of all the fund’s assets, thus enabling him to hold a diversified investment portfolio even with a small amount of investment that would otherwise require big capital.

2. Professional Management:

Even if an investor has a big amount of capital available to him, he benefits from the professional management skills brought in by the fund in the management of the investor’s portfolio. The investment management skills, along with the needed research into available investment options, ensure a much better return than what an investor can manage on his own. Few investors have the skill and resources of their own to succeed in today’s fast moving, global and sophisticated markets.

3. Reduction/Diversification Of Risk:

When an investor invests directly, all the risk of potential loss is his own, whether he places a deposit with a firm or a bank, or he buys a share or debenture on his own or in any other from. While investing in the pool of funds with investors, the potential losses are also shared with other investors. The risk reduction is one of the most important benefits of a collective investment vehicle like the mutual fund.

4. Reduction Of Transaction Costs:

What is true of risk as also true of the transaction costs. The investor bears all the costs of investing such as brokerage or custody of securities. When going through a fund, he has the benefit of economies of scale; the funds pay lesser costs because of larger volumes, a benefit passed on to its investors.

5. Liquidity:

Often, investors hold shares or bonds they cannot directly, easily and quickly sell. When they deposit in the scrips of a fund, they can generally cash their investments any time, by selling their scrips to the fund if open-ended, or selling them in the market if the fund is close-end. Liquidity of investment is clearly a big benefit.

6. Convenience And Flexibility:

Mutual fund management firms offer many investor services that a direct market investor cannot get. Investors can easily transfer their holding from one scheme to the other; get updated market information and so on.

Traditional Knowledge and Practices

We look at the traditional knowledge and practices prevailing in Rajasthan (India) and how those options helped the investor in risk management. Based on interaction with old people, we have identified the options for investments and the risk management strategies. Rajasthan was a stronghold of Marwari entrepreneurs, who had their roots in Rajasthan. They used to remain connected to Rajasthan in spite of their trade and business being spread out all over India. We have come to know about traditional investment options based on interaction with old Marwari Entrepreneurs and old people from Rajasthan.

Investment options: -

a. Gold as the best option :

Traditionally the people in Rajasthan considered Gold as the best option and therefore whenever they had surplus money, they would invest that in Gold and whenever they would require money, they would sell the Gold in the market and get cash in return. This practice has been followed for a very long period of time

b. Silver as an option for investment :

Besides gold, the common investors also invested in silver, which also provided them safe source of liquidity. Whenever they wanted their money back, they could recover their money without any problem.

c. Jewelry as a source of Investment :

People used to invest heavily in jewelry, which provided an option for them in case of emergency. Although there are some making charges, still jewlry provided almost perfect liquidity. People invest their surplus money in Jewelry.

d. Loans to entrepreneurs :

People used to give loans to entrepreneurs for enabling them to become successful entrepreneurs. These loans enabled the entrepreneurs to succeed. The entrepreneurs were able to use the money fruitfully and they were able to generate reasonable returns. Therefore the entrepreneurs were able to provide reasonable returns against the loan. This mode had some risks attached as there was a possibility of default. If the entrepreneur failed, the money given as loan would convert into bad-debt. However, the chances of non-payment were very less.

e. Engaging in Hundi or Badla Transactions :

Marwari entrepreneurs used to have many trade practices in earlier times including Hundi, Badla etc. (these practices are extinct now as these practices were banned by the Britishers when they ruled over India). These practices provided an option for the common people also to invest their money. If a person had surplus money, he would offer his money as a badla financier and this was an option for that person to earn reasonable return in a short period of time.

f. Short term investments in consignments :

Marwari entrepreneurs had developed various mechanisms for trading including consignment based transactions. These transactions and consignments could be financed by any person and this was a medium for reasonable returns in a short period of time.

Comparative analysis

The modern tools of investment offer better returns and better information. They offer better options for liquidity. The traditional opportunities were limited. However, the modern tools of investment offer a wide variety of options and offer reasonable returns against reasonable risks. Therefore the modern tools of managing risks are considered to be superior to the traditional tools of managing investment risks.

They are able to cover a wide variety of risks associated with investment and they are able to provide timely information to the investors.

Conclusion

We find that modern tools of managing investment risks are far superior to the traditional tools of managing risks. Although the present study depicts that the modern tools of managing investment risks are superior, covering wide spectrum of risks, yet there is a need to detailed knowledge and study with regard to traditional knowledge and practices, which may give us insights for our future and may help us in improving our tools for the next generations.

References :

Francis J.C. (1991): Investments: Analysis and Management, McGraw-Hill Book Company, Singapore,

Francis J.C. (1993) Management of Investments, McGraw-Hill Book Company, Singapore .

Fuller, Russell J. and Farrell, James L.J. (1987) Modern Investment and Security Analysis, McGraw-Hill Book Company, Singapore.

Singh H K, Meera Singh, (2001) Mutual Funds and Indian Capital Market: Performance and Profitability, Kanishka Publishers, New Delhi, First Edition

Rao, P. M., & Jain, Trilok Kumar. (2002). Management of banking and Financial Institutions. Deep and Deep Publications

Taylor, John H. (1993) Building Wealth with Mutual Funds, Windsor Books, New York,¬