CHAPTER – 8
RISK ATTITUDE

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Contents

Risk Defined

Aven and Renn, (2009), “Risk refers to uncertainty about and severity of the events and consequences (or outcomes) of an activity with respect to something that humans value”.

Risk = Consequence x Probability of Occurrence

- Kaplan and Garrick (1981) explained risk as follows:

  Risk = Uncertainty + Damage

- Elmiger and Kim (2003) defined risk as the following equation:

  Risk = Danger + Opportunity

Types of Risk

- **Interest Rate Risk**
- **Business Risk**
- **Credit Risk**
- **Taxability Risk**
- **Call Risk**
- **Inflationary Risk**
- **Liquidity Risk**
- **Market Risk**
- **Reinvestment Risk**
- **Political/ Social/ Legislative Risk**
- **Currency/ Exchange Rate Risk**

Standard Finance View of Risk

According standard finance, there can be either an upside risk (earning returns higher than what is expected) or a downside risk (earning returns lower than expected).

Risk is measured by

- Standard deviation
- Beta coefficient
- Variances, Skewness, Kurtosis and Mean absolute deviation are other measures of risk.

Risk-return trade-off.

There are two important theories which explains risk–return relationship

- **Modern Portfolio Theory given by Markowitz**
- **Capital Asset Pricing Model by Sharpe**

BEHAVIOURAL FINANCE VIEWPOINT OF RISK

- Prospect theory given by Kahneman and Tversky explains that people are risk averse and therefore are more concerned about avoiding losses than achieving gains.
- Subjective risk helps in influencing perception and reaction of individuals which affects their decision making.
- Behavioural finance considers that perceived risk (subjective aspect) helps in investment decision making more than objective aspect of risk.

Risk Perception

Olsen (2001)

- That risk is multi attribute.
- There are social and cultural factors like trust, democracy and fairness which affects individual's perception about risk.
- And risk always has an emotional side.

Selto and Cooper described "perceived (or subjective) risk as the perception of the attributes of objective risk, wherein perception may be imperfect and which may be affected by many attributes of the choice"

Sitkin and Weingart (1995) define "risk perception as an individual's assessment of how risky a situation is in terms of probabilistic estimates of the degree of situational uncertainty, how controllable that uncertainty is, and confidence in those estimates".

Behavioural Finance Influence on Investors' Perception of Risk

- **Heuristics**
- **The Availability Heuristic**
- **Overconfidence**
- **Loss aversion**
- **Representativeness**
- **Framing**
- **Anchoring**
- **Familiarity bias**
- **Perceived control**
- **The role of Affect (feelings)**
- **The influence of worry**

Risk Attitude

- According to Etti Baranoff, Patrick L. Brockett, and Yehuda Kahane there are three types of risk attitude that prevails in our lives. These are:
- **Risk Averse**
- **Risk Seeker**
- **Risk Neutral**

Barclays defining risk attitude:

Risk attitude has two perspectives:

- **Ability or capacity to take risk**
- **Willingness to take risk**

Factors Affecting Risk Attitude

- **How much is investor's ability to bear losses**
- **Do you have Emergency Reserve fund**
- **Time horizon for investment**
- **Age and health Conditions**
- **Set Investment targets**
- **Source of investment fund**
- **Percentage of portfolio to be invested**

There are other factors which can influence the risk attitude of the investor. These are:

- **Familiarity**
- **Media attention**
- **Personal vs. Societal**
- **Trust**
- **Voluntariness**
- **Benefit**
- **Knowledge**

Emotional Intelligence and Risk Attitude

- **Recognize Emotions**
- **Understand Emotion**
- **Appropriately Express Emotions**
- **Manage Emotions**

Implications for Investment Managers

- There should be detailed analysis of all the components of the investment.
- Assessment of risk attitude of investor should be conducted through some risk assessment scale.
- Invest in the company which is familiar to you.
- Diversification can help reduce risk of your portfolio.
- One must invest keeping in mind investment goals.
- Expert advice can be taken to take appropriate level of risk.

THANK YOU

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PERSONALITY, INVESTOR MODELS AND INVESTMENT DECISION MAKING

Continued...