

Risk Management Instruments and Techniques

Welcome to Week 7 of our financial management course. This presentation explores the essential instruments and techniques used to identify, assess, and mitigate various types of financial risks. We'll examine both traditional and innovative approaches to protecting investments and ensuring financial stability.



Types of Risk: Understanding the Landscape



Market Risk

Risk arising from movements in market prices, including equity prices, interest rates, foreign exchange rates, and commodity prices.



Credit Risk

Risk of loss resulting from a borrower's failure to repay a loan or meet contractual obligations.



Liquidity Risk

Risk that a company or individual will be unable to meet short-term financial demands due to the inability to convert assets into cash.



Operational Risk

Risk of loss due to inadequate or failed internal processes, people, and systems, or from external events.



Systemic Risk

Risk of collapse of an entire financial system or market, as opposed to risk associated with any individual entity.

Hedging Techniques Overview

Hedging is a risk management strategy employed to offset potential losses in investments by taking an opposite position in a related asset. Effective hedging requires:

- Clear identification of specific risks to be hedged
- Selection of appropriate hedging instruments
- Calculation of optimal hedge ratios
- Regular monitoring and adjustment of hedge positions
- Understanding of cost-benefit tradeoffs



Asset Allocation as a Risk Tool

Equities

Higher risk, higher potential return.
Provides growth and inflation protection
but with greater volatility.



Fixed Income

Lower risk, stable income. Provides
portfolio stability and regular cash flow
with reduced volatility.



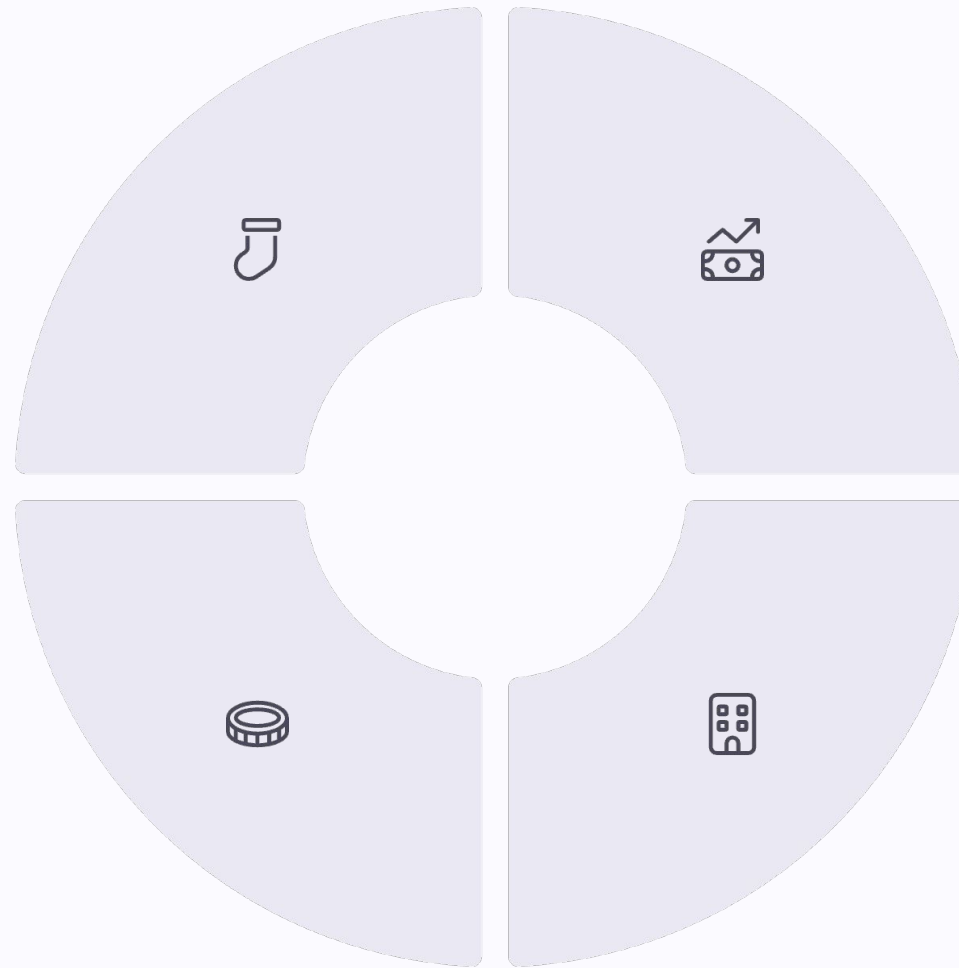
Cash & Equivalents

Lowest risk, lowest return. Provides
liquidity and capital preservation during
market downturns.



Real Estate

Moderate risk with income and
appreciation potential. Offers
diversification and inflation hedge.



Derivatives for Hedging: Options & Futures

Options Contracts

Provide the right (not obligation) to buy or sell an asset at a predetermined price.

Call Options: Right to buy at strike price

Put Options: Right to sell at strike price

- Premium paid upfront for protection

Futures Contracts

Obligate the buyer to purchase an asset at a predetermined future date and price.

- Standardized contracts traded on exchanges
- Require margin deposits
- Used for commodities, currencies, indices

Insurance and Capital Protection

1 Portfolio Insurance

Systematic approach to limiting downside risk while maintaining upside potential through dynamic hedging strategies that adjust asset allocation based on market conditions.

2 Capital Protection Products

Structured products that guarantee the return of principal at maturity while offering some participation in market gains, typically through zero-coupon bonds combined with options.

3 Credit Default

Swaps
Contracts that transfer the credit risk of fixed income products between parties, functioning as insurance against default by paying a premium to protect against potential losses.

Secure your future



Stop-Loss and Limit Orders

Stop-Loss Orders

Automatically sell a security when it reaches a specified price, limiting potential losses.

- Protects against significant downside
- Removes emotional decision-making
- Can be triggered in volatile markets

Limit Orders

Sets maximum purchase price or minimum selling price for a security.

- Ensures execution at desired price or better
- Provides discipline in trading strategy
- May not execute if price doesn't reach limit

Combining Tools for a Holistic Strategy

Risk Assessment

Identify and quantify specific risks facing your portfolio or business operations.

Tool Selection

Choose appropriate combination of asset allocation, derivatives, insurance, and trading tools.

Implementation

Execute risk management strategy with proper position sizing and correlation analysis.

Monitoring & Adjustment

Regularly review effectiveness and adjust as market conditions and risk profiles change.

