

Risk and its Types

The risk is the degree of uncertainty in any stage of life. For instance, while crossing the road, there is always a risk of getting hit by a vehicle if precautionary measures are not undertaken. Similarly, in the area of investment and finance, various risks exist since the hard-earned money of individuals and firms are involved in the cycle. **Risk** implies future uncertainty about deviation from expected earnings or expected outcome. **Risk** measures the uncertainty that an investor is willing to take to realize a gain from an investment. Description: **Risks are of different types** and originate from **different** situations.

Types of Risk

- **Systematic Risk** does not have a specific definition but is **inherent risk existing in the stock market**. These risks are applicable to all the sectors but can be controlled. If there is an announcement or event which impacts the entire stock market, a consistent reaction will flow in which is a systematic risk. For e.g. if Government Bonds is offering a yield of 5% in comparison to the stock market which offers a minimum return of 10%. Suddenly, the government announces an additional tax burden of 1% on stock market transactions, this will be a systematic risk impacting all the stocks and may make the Government bonds more attractive.
- **Unsystematic Risk** is an industry or firm-specific threat in each kind of investment. It is also known as "Specific Risk", "**Diversifiable risk**" or "Residual Risk". These are risks which are existing but are unplanned and can occur at any point in causing widespread disruption. For e.g., if the staff of the airline industry goes on an indefinite strike, then this will cause risk to the shares of the airline industry and fall in the prices of the stock impacting this industry.

One should keep in mind the below formula which in a nutshell highlights the importance of these 2 types of risks faced by all kinds of investors:

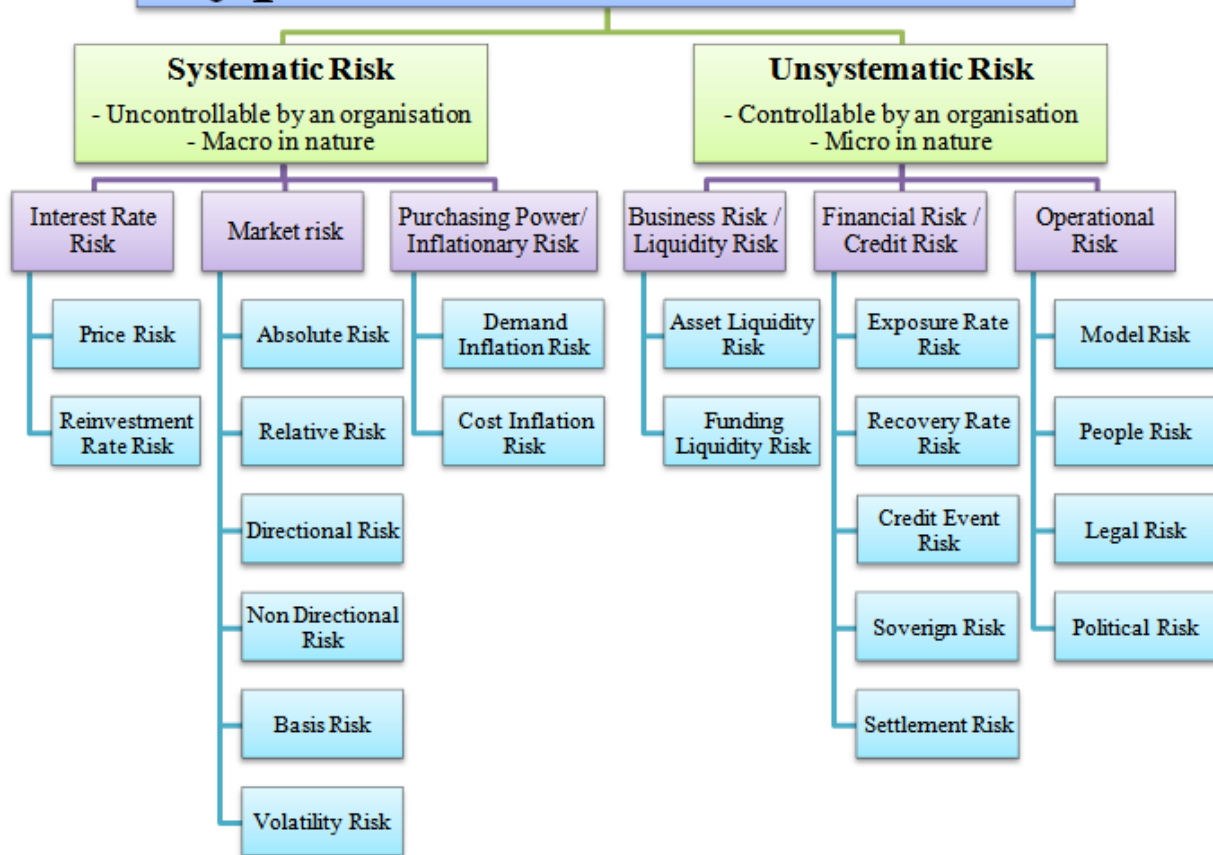
$$\textit{Total Risk} = \textit{Systematic Risk} + \textit{UnSystematic Risk}$$

The above risks cannot be avoided but the impact can be limited with the help of diversification of shares into different sectors for balancing the negative effects.

Comparison Chart

BASIS FOR COMPARISON	SYSTEMATIC RISK	UNSYSTEMATIC RISK
Meaning	Systematic risk refers to the hazard which is associated with the market or market segment as a whole.	Unsystematic risk refers to the risk associated with a particular security, company or industry.
Nature	Uncontrollable	Controllable
Factors	External factors	Internal factors
Affects	Large number of securities in the market.	Only particular company.
Types	Interest risk, market risk and purchasing power risk.	Business risk and financial risk
Protection	Asset allocation	Portfolio diversification

Types of Risk in Finance



How do you calculate systematic risk?

Systematic risk is that part of the total **risk** that is caused by factors beyond the control of a specific company, such as economic, political, and social factors. It can be captured by the sensitivity of a security's return with respect to market return. This sensitivity can be calculated by the β (beta) coefficient.