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Chapter 3.2

Stock and Market Risks

SHARE AND MARKET RISKS

Share and CFD trading involve risk. Traders accept these risks every day as they risk a portion of their capital in the hope of receiving a return on their investment. You win some and you lose some. However, the better you understand the risks that affect you as a trader the better you can protect yourself from those risks.

Traders have to confront many forms of risk as they evaluate and manage their trades. For instance a trader who owns shares in Wal-Mart (WMT:xnys) has to be concerned not only with how well Wal-Mart as a company is performing but also with the general condition of economies around the world. They also have to be concerned with how well the U.S. stock market is performing and whether or not the value of the U.S. dollar is strong or weak, rising or falling.

As you , you will have to understand all manner of risks if you are to counteract the forces that are going to push your and CFD prices higher and lower. Once you understand the risks facing your trades it is possible to minimize the affect they can have on your profitability.

CFD traders welcome the various risks shares face in the market because they can easily make money whether the share price is moving higher or lower. When risks are low and companies are doing well, CFD traders can profit as share prices go up. Conversely, when risks are high and companies are doing poorly, CFD traders can profit as share prices go down.

In this next section, we will discuss the following types of risk and how you can account for them in your portfolio:

Contents

- Systematic, or market, risk
- Unsystematic risk
- Credit/Default risk
- Exchange-rate risk
- Interest-rate risk
- Political risk

SYSTEMATIC RISK

Systematic risk is the risk you face because you are operating within a system - the share and CFD markets. Whilst traders are able to take steps to hedge against certain types of risk, there is no way to hedge against systematic risk. If you want to participate in the markets then you have to be willing to accept the risks that come with being a part of the market.

Systematic risk typically rears its ugly head in the form of stock market crises, like Black Monday in 1987 or the Asian financial crisis in 1997, which push the majority of shares lower.

Traders often refer to the benefits and drawbacks of systematic risk with the saying, "A rising tide floats all boats." If the tide is coming in and pushing the entire stock market higher, you have little to worry about from systematic risk. On the other hand, if the tide is going out and pulling the entire stock market lower then you may have to hedge your trades.

UNSYSTEMATIC RISK

Unsystematic risk is the risk you face by dealing with a particular share or CFD. When you trade shares and CFDs in an individual company you are aligning yourself with the fate of that company. If you have bought the share or CFD and the company performs well then your investment in that company should also perform well. If you have bought the share or CFD, and the company performs poorly, your investment in that company is liable to likewise perform poorly.

Many factors affect company performance, and you face the risk that any one of those factors could affect the performance of your investment at any time. The following is just a small list of unsystematic risk factors:

- Unexpectedly low earnings
- Lawsuits
- Scandals
- Technology obsolescence
- Employee strikes

Any one of these risk factors, or others, could cause the value of a company's shares to plummet.

Unlike systematic risks you can combat unsystematic risk by diversifying your investments across a broad spectrum of companies, sectors and markets. You can also hedge your positions to protect any profits that you may have to prevent further losses.

CREDIT/DEFAULT RISK

Credit/Default risk is the risk you face that a company in which you own shares or in which you hold associated CFDs may default on its debts or be viewed as a credit risk in the market. Although it doesn't happen too often, companies can become insolvent and default on repayment of the debts they owe - whether they be debts owed to banks or debts owed to holders of company bonds.

Insolvency can be the result of a tightening credit environment, corporate fraud or other company performance issues. Regardless of the cause when a company runs out of cash it loses its ability to function effectively. Cash is, after all, the life-blood of a company.

Whilst share and CFD holders may not be directly affected by loan repayment issues because they are not recipients of loan repayments from the company, they are indirectly affected because other traders know a company is fundamentally in trouble when it can't repay its debts, and they start decreasing the value of the company's share.

EXCHANGE-RATE RISK

Exchange-rate risk is the risk that investors face when they buy and hold investments in a currency other than their native currency. Currency prices fluctuate up and down just as shares do. If the currency in which the investment is held gains value compared to the investor's native currency, the investment will be worth more to the investor. However, if the currency in which the investment is held loses value compared to the investor's native currency, the investment will be worth less to the investor. Exchange-rate risk can even offset any gains the investment may have made on its own.

For example, imagine a British investor buys a U.S. share for $30 when the exchange rate between the British pound and the U.S. dollar is 1.5000 - which means every £1 is worth $1.50. In this case you would have to pay £20 for the $30 share ($30 ÷ 1.5 = £20). Now imagine that the share increases in value from $30 to $36, a 20-percent increase. However, at the same time, the exchange rate between the British pound and the U.S. dollar changed from 1.5000 to 2.000 - which means you have to pay $2 for every £1. If you were to cash the share that is now worth $36 and convert it into British pounds, you would end up with £18 ($36 ÷ 2 = £18).

In this example even though the share gained 20 percent, the investor ended up losing £2 on the transaction due to exchange-rate risk.

INTEREST-RATE RISK

Central banks such as the U.S. Federal Reserve, the Bank of England and the European Central Bank have an incredible impact on global and local economies when they announce their interest-rate decisions. Generally when central banks increase interest rates it becomes more difficult for companies to borrow money to grow and expand. This, in turn, negatively affects the future outlook for the company's growth and tends to pull down its share price.

Conversely, when central banks decrease interest rates it becomes easier for companies to borrow money to grow and expand. This, in turn, positively affects the future outlook for the company's growth and tends to push up the company's share price.

POLITICAL RISK

Political risk is the risk you face that the political environment in the country (or countries) where a company does business may become unfavourable for business growth and expansion.

At one end of the scale political risk can take the form of a company being nationalized by a government, causing shareholders to lose much of the investment that their shares represent.

At the other end of the scale political risk can take the form of tax reform that increases corporate tax rates or tariffs that cut into company profit margins, both of which will cause shareholders to likewise lose much of the investment that their shares represent.


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Risk warning: All investments involve risks. Leveraged investments carry a correspondingly higher degree of risk and may result in magnified losses.

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