INVESTOR'S GUIDE

A guide to the financial markets, investments and the economy

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NICO Asset Managers

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Topic 241: Risk Management

Last week we concluded the topic on corporate governance by discussing its limitations. This week we will begin a new topic on risk management. Risk management is the process of identification, analysis and mitigation of uncertainty in business decisions. Businesses face all kinds of risks, some of which can cause serious loss of profits and even lead to bankruptcy. This week we will begin the topic by discussing the main types of risks businesses face.

1. Strategic Risks

A strategic risk is a possible source of loss that arises from the pursuit of an unsuccessful business plan. Many businesses have a well-formulated business plan, but sometimes these plans can become less effective, leading to strategic risks. Strategic risks usually arise from poor business decisions, shifts in customer demands, entrance of a powerful competitor in the market or failure to respond to changes in the business environment. These risks can affect a company's growth and performance. For example, if a restaurant's business plan is to provide good quality food at low cost, a competitor may also start providing the same quality of food and undercut its price, this is a strategic risk. In this case, the restaurant's business strategy has become less effective and may struggle to reach its goals.

2. Operational Risks

An operational risk is the prospect of loss that results from a company's failed internal procedures, systems and policies. Operational risks are usually failures that can occur in a company's day-to-day operations.

Operational risks are usually unexpected and difficult to mitigate but can be manageable. For instance, if equipment in a shoe manufacturing factory breaks down, this is an operational risk. This risk may be unexpected and can be hard to control because machines are unpredictable, however plans can be put in place to mitigate losses in such an event.

3. Reputational Risks

A reputational risk is any threat or danger that can affect the good name or standing of a business. Reputational risks can occur directly as a result of the actions of the company or indirectly through the other peripheral factors. Reputational risks are usually hidden but they can pose a serious threat to even the world's biggest financial institutions. Reputational risks are hard to control due to globalization. The increasing use of social media has led to the rapid spread of positive or harmful news relating to companies. If harmful news is spread, this can cause damages that may result in losses in revenue and market capitalization. For instance, a money-laundering scandal can damage a company's reputation and this may influence investors to pull out from the company. This may have serious effects on the company's performance.

4. Financial Risks

A financial risk is any potential risk that may occur from the financial structure and transactions of a company. There are many types of financial risks such as credit risk, liquidity risk, foreign investment risk, equity risk and currency risk. Financial risks usually reflect an investor's uncertainty in collecting returns and the potential for monetary loss. For example, a company with many long term debts may face challenges if interest rates rise, this is a financial risk.

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