Original Article: An Analysis of Risk Management in Financial Markets and Its Effects

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ABSTRACT

This study examines risk management in financial markets and its effects. Risk and capital management can happen anywhere in the stock market. This happens when an investor buys the desired stock on the stock market. Or when the manager of a financial fund with foreign currency derivatives avoids the risk of converting balance sheet assets and liabilities into foreign currency. Financial managers also use strategies such as asset allocation, portfolio diversification, and position estimation to mitigate or effectively manage risk in the stock market. Although technical analysis of risk and capital management can provide useful information, it does not completely address an investor's concerns. In the field of behavioral finance, it has contributed to an important element in the equation of risk and capital management by showing the asymmetry of how individuals' perspectives achieve profit or loss. In the language of vision theory, an area of behavioral finance was introduced by Amos Torsky and Daniel Kahneman in 1979 to show investors' hatred of their losses, feeling good, and suffering pressure and unhappiness about loss. This is very important in the field of stock market psychology for managing risk and capital in financial markets.

Introduction

We may all have heard that 90% of people who enter the financial markets fail and only 10% of the winners leave the field. Have you thought about this? Definitely, when someone enters the world of trading and hears these numbers, he says to himself, "I want to be part of that ten percent winner."[1]. So, what if he leaves trading after a while? What is the difference between a winner and a loser? This is where the concept of risk management comes into play and its role in our transactions is highlighted. We live in a world of uncertainty. We do not know the

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result of anything and we do not know at all what the future will bring us. Now consider the life of a trader. Like everyone else, he is involved in uncertainty. From the morning when the market opens until it is in the market and the trade is open, it faces risky conditions. So, the best thing for him to do is to know and understand the risk well and to control it instead of being afraid [2-4]. (Fig. 1).

Figure 1. Graphical analysis of market risk management

The role of risk management in investments

Many people think of risk as soon as they hear the word risk, and think of it as something equivalent to taking a risk. They like to avoid taking risks as much as possible. But the point is such thinking is wrong. Risk management cannot be ignored or eliminated. Risk is inherent in every activity and is essentially the nature of risk-based living. So, one of the keys to success is to know what risks to consider and make sure those risks are reasonable. Always remember that if you do not take risks, you will not learn anything and you will not be able to do anything worthwhile. Thus, the law of life requires that the issue of risk be taken seriously. Make risks a part of your life, so that they happen spontaneously and are under your control, not that they happen accidentally and out of control. Just as avoiding risk at any cost is a mistake and can ruin good opportunities, taking too much risk can mean financial bankruptcy or destruction [5].

Risk acceptance

In trading, flexibility is the most important principle. Since we do not know the future, we must be prepared for anything to happen. Many times, what we expect does not happen, in any case if we do not have flexibility, we find ourselves in unresolved situations. If we think only of a particular result from the beginning, if that result is not achieved and we are not prepared to show the appropriate reaction, we will face bad consequences. But if we are flexible and react properly to changing circumstances, we will suffer far less harm [6].

It is better to always listen to the great philosopher who said that "the only thing that always remains constant and unchanged is change itself." Markets are constantly changing, so this statement is true more than anywhere else in the trading world. It is important to note that flexibility does not

mean that we change our trading strategy at the first loss, but it does mean that we have a correct assessment of market conditions and trading situations and using the knowledge and information that we have the ability to make the right decision at any time and to know that as markets change, sometimes it is necessary to make changes in our rules and strategies in order to adapt to the market [7].

Plan a good plan and have alternative plans

It is safe to say that we cannot eliminate the risk completely, but one good way to control risk is to have the right programs, a program in which we consider all the possibilities from the beginning. Consider a trader who buys stock in the hope of making a profit and sees stock growth, and hears positive news about his stock every day. He holds his stock to sell it in a more convenient position and make more profit. But suddenly the stock falls and not only its profits are lost but it also suffers, so much so that he does not even know what the right thing to do is, whether to sell the stock at a loss or keep it in the hope of a return. If this trader had a good plan for his stock from the beginning, he would not be desperate now. A program in which everything is specified, including trading volume, entry point, exit point with profit and exit point with loss [8].

Therefore, it is necessary to draw a clear and transparent plan for ourselves from the beginning. Then, let's plan an alternative program so that if the first plan does not go according to our wishes, we will face the second plan (Fig. 2).

Just as in project work, the project manager anticipates all possible situations and even considers the worst-case scenario that may occur, a trader must also enter before entering. Think of the worst possible deal. If we know before the transaction that the probability of losing in the transaction is high, in the event of such an event, we will not be harmed emotionally and it will definitely be easier for us to bear the loss. So, we set our tolerance threshold or the same amount of risk from the beginning [9].

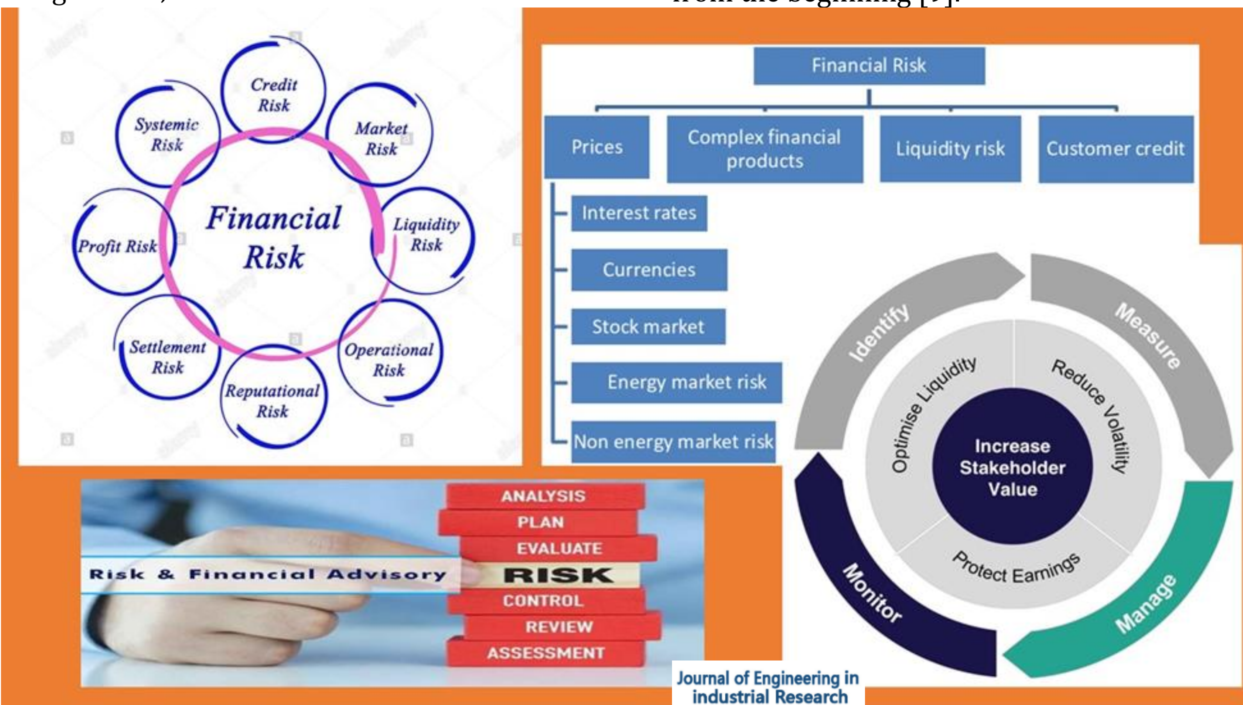

Figure 2. Financial risks

One of the problems that most people struggle with is focusing on results. If the result is good, it is good, and if the result is bad, it is bad from the beginning. The situation is the same in trading. If a deal is profitable, it is a good deal, and if it is a loss, it is a bad deal.

But the truth is that the story goes beyond these professions.

The outcome of a business or transaction depends on a number of factors, many of which may be beyond our control. The only thing we can do is focus on our decisions, not on the results. For example, before entering into a transaction, analyze that transaction thoroughly and carefully and consider all aspects of the matter. Determine the profit and loss limits and enter into a deal after making sure that we act in accordance with our strategy. Now the best thing to do is to assume from the beginning that the deal is going to be a loss. Instead, think of these as actions that you must take on a regular basis to see if the transaction is profitable. Whatever the outcome of the deal, we will be spiritually safe. If it becomes profitable, we will not be too happy and we will not feel that we are right, and if it loses, we will not perish [10].

So, the best thing we can do as a trader is to focus on the decisions instead of focusing on the results because decisions are under our control but not results. So, it does not make sense to focus on things we do not have control over. Everyone is afraid of the unknown and uncertainty, but perhaps it is time to say goodbye to our unnecessary and irrational fears. Fear causes us to pay too much attention to emotions and reduces our ability to think, so it affects our decision-making process. It is unwise to allow our fears to dominate our lives. The less fear we have, the more willing we are to take risks. Sometimes fear causes us to follow the group without reason and without logic. Traders who struggle with irrational fear may not trade at first for fear of loss, but when they see that their friends have made very good profits, they feel that they have lost a simple income. So, they enter the trade, unaware that they are at the bottom of a bullish market. The best thing to do to overcome fear is to think to yourself that if I am going to do this, I have to go to sea and act as soon as possible.

Balance at risk

Definitely when it comes to managing, controlling and balancing risk, as much as accepting risk is important for risk-averse people and going to the heart of the matter, risk-takers also need the ability to wait a moment, and learn to think about the consequences of taking too much risk. Some traders are looking for excitement and betting instead of using risk as a tool to improve their trades and make reasonable profits. They get used to the current level of risk over time, and like addicts who need a higher dose of drugs after a while, they are forced to deal with higher risks. So, keep in mind that ignoring danger and acting as if nothing is hurting us is just as irrational as avoiding risk.

Investing in the stock market and its management

The acquisition of wealth and return on investment is always accompanied by a category called risk or risk because it is associated with the passage of time; investment is usually made by ignoring current benefits in order to achieve greater prosperity in the future. In fact, the category of investment faces a wide range and diversity. Investing in certificates of deposit, bonds, common stock, mutual funds, etc. can be examples of types of investment.

Among the various disciplines of investment, risk management in the stock market is very complex. An investment advisor can help investors in this regard. The existence of risk in the stock market is due to the fact that many factors will play a role and influence in making decisions in the capital market; including what kind of stock should be bought and sold at what time, at what price and in what amount of the total portfolio to minimize risk and maximize profit expectations [1].

Therefore, to reduce risk in the capital market, choose a combination optimally, or more precisely, a portfolio that includes diversified stocks. Obviously, the degree of risk-taking varies from investor to investor, and investors who take a high risk expect a

high return, and vice versa, risk-averse investors receive a lower risk.

Usually, the stock market is more risky than other markets and its fluctuations are more severe. Because in this market, stock prices are predicted based on future cash flows, the amount and timing of which are completely variable and an obligation to pay certain amounts at certain times for they do not exist.

Compare this with the fixed-income securities market, such as equity securities, where there is a certain obligation to pay certain amounts at certain times and therefore, the investor very accurately predicts future cash flows and their timing. So, because stock prices are based on future expectations of companies, there is a lot of risk. On the other hand, the investment horizon in stocks is long, and the longer the investment horizon, the greater the risk of unexpected events.

Risk is divided according to different approaches

One of the risk classifications is based on the risk factor, some of which are:

1. Purchasing power risk (inflation), which is the probability that purchasing power due to cash flows earned in the future will be different from the forecast. In other words, due to inflation, the purchasing power of money changes;

b) Political risk, which is the probability of the occurrence of political events that can affect the return or risk of investment opportunities and cause stock prices to fluctuate;

1. Interest rate risk: It is always possible that interest rates in the economy will change and prices will change as a result of central bank decisions or other factors; and

2. Exchange rate risk: The possibility of exchange rate fluctuations and changes in the value of the national currency against other currencies, which can change the amount of real cash flows.

What is the difference between systematic and unsystematic risk? Risk is classified into two types, systematic and non-systematic, based on whether it is specific to a stock or affects the stock as a whole. Systematic risk is the risk that affects the entire market (albeit in different amounts), in other words, all stocks are affected to different degrees. This type of risk exists in any case and investors have to bear it to get a return. But unsystematic risk affects only a certain stock. This type of risk can be reduced by forming a diverse portfolio of stocks. Because by forming a stock portfolio, the outcome of unsystematic risks related to different stocks is close to zero.

Advise stock market investors to manage investment risk

Before starting a trade or investing in a market, traders and investors must develop a risk management strategy and keep in mind that financial risks cannot be completely avoided. In general, risk management is how to deal with risks and certainly not just reduce their severity and it is better to completely study and analyze to avoid various risks. Risk management is about identifying, evaluating, and monitoring the risks according to the conditions and strategy, it is personal. This process helps us find the best risk-reward ratios and have good and profitable trades. One of the common mistakes of traders in the capital market is the calculation error in risk.

We are all inherently familiar with the concept of risk. But the risk in everyday life is slightly different from the risk in the capital market. Without good knowledge of how to manage risk, good trades cannot be done. Ordinary people or investors who have just entered the capital market, believe that the loss in the stock market is the same as buying a house, and eventually 20% can be a loss to us. If this is not the case, you can lose up to 50% in a short period of time in the stock market. Investors who are very active in the stock market know that in the capital market, in order to trade with a profit, you must first consider the risk of trading, measure and be

able to protect your liquidity against market losses.

If their investment information is limited, it is better to buy units of investment funds indirectly and not be directly involved in investment activities. Invest only after a thorough review and sufficient assurance of their knowledge of the stock. What follows are some guidelines:

1. Think long-term and do not enter this market with a short-term investment horizon;
2. stock market excitement may lead the investor to risky decisions. Therefore, they should avoid hasty behaviors and unintentional decisions;
3. if they do not intend to invest in the long run, they should have a certain price range for entering and leaving a share. With this approach, the investor leaves as soon as the specified price is reached. This rule of investing causes the investor not to be too greedy and to insist on his previous wrong decisions;
4. always invest in a portfolio of stocks that are not highly correlated with each other and do not devote all their capital to buying a stock;
5. always consider their tolerable risk and invest based on it; and
6. predetermine the maximum tolerable losses for their portfolio so as not to allow the value of their portfolio to fall below the specified amount and thus have a definite exit strategy for critical situations.

Conclusion

Learning the basics of risk and capital management in Forex training helps to reduce the loss in trading. Also, following the rules of capital management correctly helps the trader not to lose all his capital in case of loss. Risk management is a very important task, and if it is started on time during the start of a project, it can be beneficial and be a powerful tool for early identification of weaknesses. In general, risk management determines how we deal with risks. Risk management wants to tell us that we are not going to run away from high-risk jobs, rather we are going to move cautiously and move forward in a way that takes the least risk. Risk management is not an exercise that you only do at the beginning of projects, but it is an ongoing task that you have to spend time and attention on. Risk management becomes more important, especially in less predictable markets such as the stock market. All people in the capital market should be trained in risk and capital management in the stock market so that they can save their capital in critical situations and not cause more losses in the stock market by hasty behavior. Proper observation of capital and risk management rules is a condition for success in financial markets. Which is unfortunately often ignored by traders. If you do not follow the rules of risk and capital management, the trader can lose all the profits he has made in a long time during one or two losing trades. Note that capital management is a floating concept.

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