PGIM
India Mutual Fund

The Three Types of Risks

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Ajit Menon
CEO

Dear Investors and Partners,

While investing in a market-linked product like mutual funds, one has to first understand the risks involved on an ongoing basis and then try and also understand that risk cannot be destroyed or eliminated altogether but only mitigated or transferred. Transfer of risk simply means that if one doesn't take risk right now in order to generate the required threshold of returns, then one may end up taking a lot more risk later on if the corpus falls short of the desired amount. Risk mitigation on the other hand refers to minimizing it as far as possible and thus looking to optimize the outcome.

For equity-oriented products, there are two well-known risks known as unsystematic risk (specific to sector or company) and systematic risk (risk inherent to entire market, for e.g. War). Many experts point to the difference between volatility and risk too. Volatility simply is the daily fluctuations in prices, whereas risk can be thought of the inability to produce or achieve long-term financial goals or outcomes. Thus, equities can be said to be volatile but perhaps not that risky, whereas a guaranteed, traditional, fixed income product can be non-volatile but relatively riskier.

Coming back to different types of risk, there are enough strategies to mitigate the risks involved in equities. Unsystematic risk can be mitigated by diversifying the portfolio over different stocks, sectors, investment styles etc. till a point, whereas systematic risk can be mitigated to an extent, simply by increasing the time horizon and holding equities for sufficiently longer term. Both these thoughts are covered in our portfolio construction process at PGIM India. We look at corporate governance standards, earnings track record and sustainability, long-term perspective and focus on capital efficiency as some of the factors which ensure risk is mitigated to a large extent in our portfolios. Second-level filters for identifying stocks based on lower debt to equity ratio, positive operating cash flow over past cycles to essentially build downside protection in our portfolios. We supplement this by looking at various other parameters like PEG ratio (Price/Earnings to Growth), which show us that we are mindful of how much we are paying today for future growth potential. A recent example of our processes has been to successfully avoid large drawdowns due to our non-participation in some of new age tech company IPOs. Our investment filter on positive cash flows worked in our favour in this case.

The third type of risk which is less talked about by experts is the Behaviour risk. This refers to our biases as money managers and investors both, which prevent us from looking at the data objectively and thereby lead to errors. Sometimes these can lead to permanent loss of capital. The tendency to hold onto stocks, which have corrected due to deteriorating fundamentals, in hope, is one such example. Popularly known as the disposition effect, here we tend to sell our winners while keeping our losers in the portfolio. There are in fact other aspects which help us for e.g. the equity research analyst team internally discuss their various viewpoints which also acts as a strong mitigant for behaviour risk, as ideas gets debated a lot from different perspectives. Another thing which adds to our perspectives is the support and inputs from our global teams, which helps us to understand global events and developments, and their implication on markets, in a more granular manner. All these combine to mitigate individual behavior risk to a great extent along with the quantitative filters that we discussed above.

As enumerated above, our investment processes at PGIM India are set up precisely to mitigate all three types of risk in the portfolio. This can sometime lead to relative underperformance in the short term, but eventually the market acknowledges the realities and fundamentals drive the share prices over the long term. Thus our focus remain on delivering risk-adjusted returns for our investors over the long term. Therefore, if one is comfortable with volatility in an equity-linked product, but wants to mitigate any unwanted risks in investment, an objective, process-driven portfolio has a better chance of doing so over the long term.

Stay safe & happy investing.

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