Common Misconceptions

- **My organization's Risk Philosophy is well defined:** The head of an organization always feels that things are in control as the organization takes less risk. However, the extent of Risk taken (low / moderate / high) by the team members can differ and still the words 'we are risk-averse' will be used across the ladder. The risk appetite of an organization is usually ***subjective***, leaving the final decision of adhering to "Risk-appetite" with individuals. Thus the Operational Team ends up taking more or less risk than the desired levels.

- **Focus on returns without regard to risk:** Overall health of business is measured using P&L but what amount of risk was taken to reach those profits is generally ignored. This also sets a precedence of focusing of returns rather than risk for most traders.

- **Management of a trading business can be done through periodical reviews just like manufacturing business:** Generally, information sharing is done only for the current situation while the trends are built only periodically (say during a Quarterly review). So the senior management ends-up giving guidance / comments during reviews rather than actively monitoring and averting potentially risky situations and positions.

- **Excel sheets will suffice for making trading and risk management decisions**: Exposures, Realized and M2M P&L, and associated risk should be available at the click of a button for traders and management to take appropriate decisions. Also daily data trend, e.g. 'how portfolio risk has fluctuated over a period of time', is very important. Information flow on positions, views, limits and alerts should be institutionalized through an MIS solution, as they cannot be done in excel.

- **Currency Risk can be managed by locking the exchange rates:** Risk due to the currency fluctuations increases during periods of high volatility in both bull and bear markets, which is not quantified. So the impact of a wrong directional call on currencies is not factored in the form of a risk.

- **The hierarchical structure required for operations and trading is same:** Trading decisions are typically taken at either end of the hierarchy (by the boss or by a trader) while a manager in the middle will play a spectator role, resulting in ***Independent decision-making silos***. A sound Risk Management process typically requires hierarchical delegation of authority and decision-making that should be divided based on the extent of risk involved in each decision.

- **We don't require a comprehensive Risk Management Policy:** Board approved unified policy document of all Risk management processes, controls, limits and alerts is generally absent in most organizations, while the contents of that policy might be there in bits and pieces. The absence of the philosophy and operational guidance document will create a lot of differences across the ladder. Also ***absence of implementation tool / software*** will result in a document for document sake scenarios.

➢ **Hedged positions are risk-free:** Sometimes due to different settlement dates and different set of market players operating in the physical and derivatives (like futures) markets, there exists a difference in the volatility levels of both the markets resulting in 'basis risk'

➢ **Traders being moved by sentiments:** Price view taken by the trader is usually based on market sentiments instead of basing it on sound fundamental analysis of price drivers and on technical analysis.

➢ **Risk can be managed using Quantity / M2M Value / stop loss Limits:** During volatile periods, trying to manage risk by restricting the Open Quantity through Quantity limits is a flawed approach used by most trading organizations (As illustrated in the following charts)

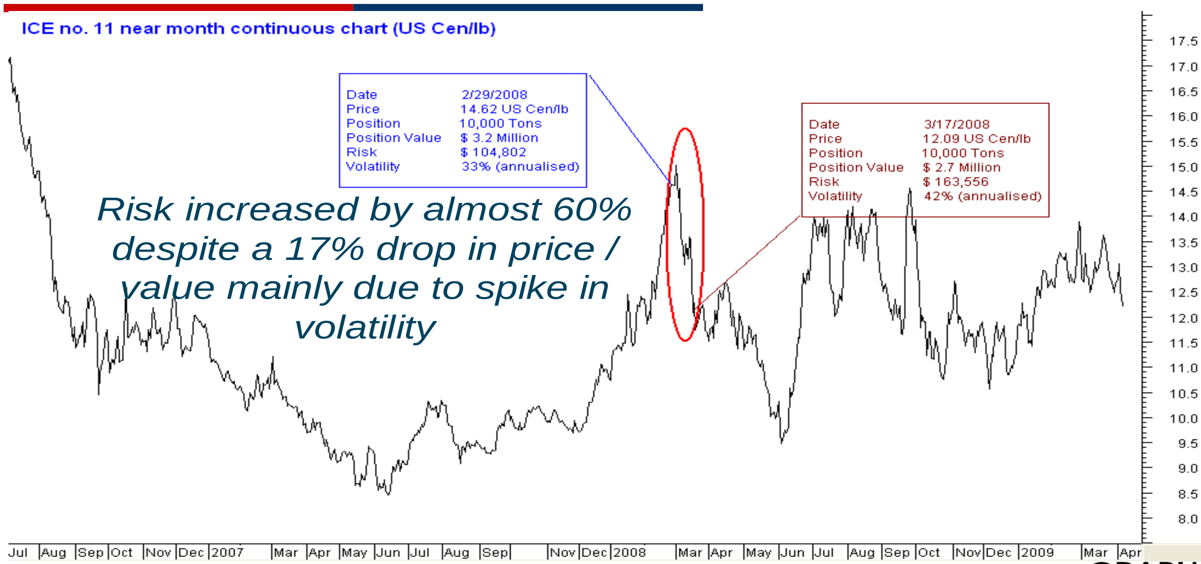
Commodity - Sugar

Quantity Limits – A Flawed approach to managing Risk

* *Risk is the estimated Value-at-Risk for the next day*

Commodity - Sugar

Managing Risk through Price / Value Limits – again a flawed approach



** Risk is the estimated Value-at-Risk for the next day*

Commodity - Soybean

Quantity Limits – A Flawed approach to managing Risk

** Risk is the estimated Value-at-Risk for the next day*

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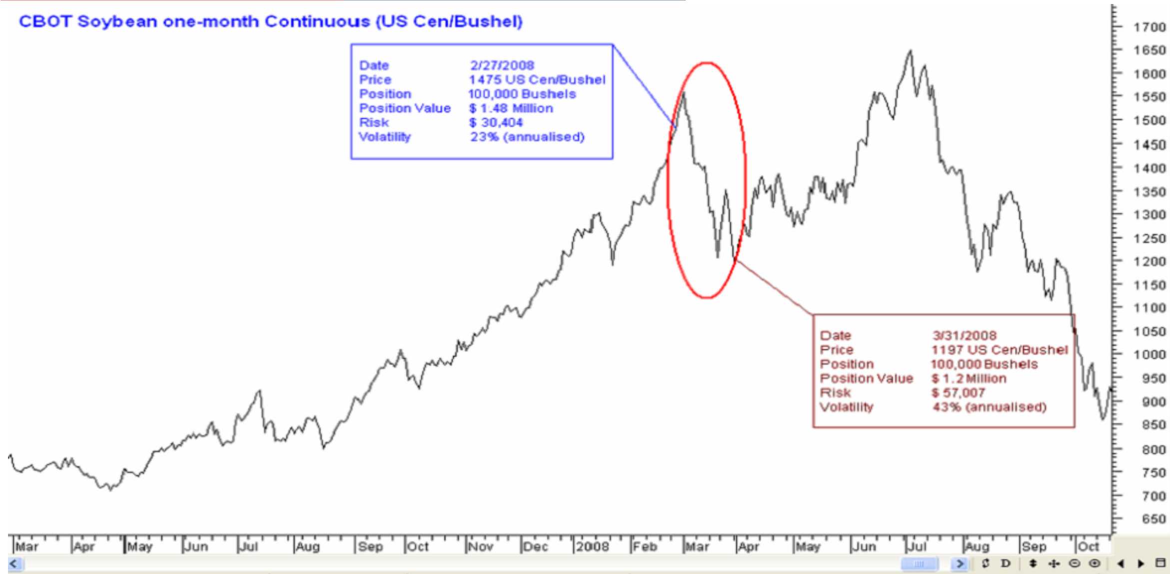

** Risk is the estimated Value-at-Risk for the next day*

Commodity – Palm Oil

Quantity Limits – A Flawed approach to managing Risk

** Risk is the estimated Value-at-Risk for the next day*

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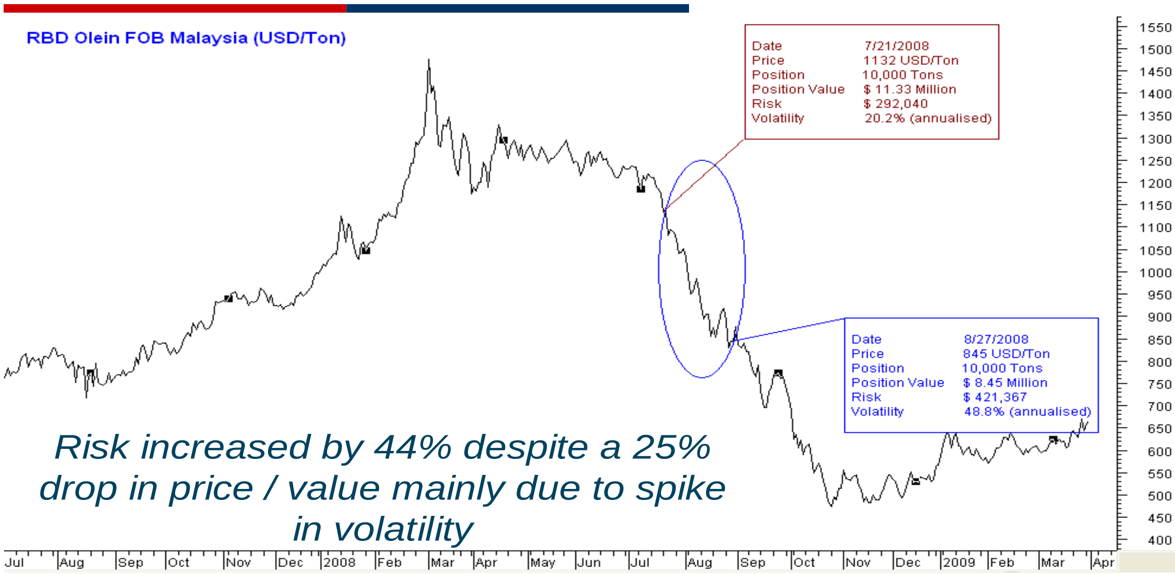

** Risk is the estimated Value-at-Risk for the next day*

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<u>Measures For Overcoming Misconceptions</u>

- **Manage Risk through forward looking approaches:** Measuring Risk in Quantity / Cash Loss terms is akin to doing "post-mortem" analysis as such limits generate alerts only **AFTER** the risk / loss is realized. Value-at-Risk is a forward looking approach which estimates the potential loss that can happen tomorrow and thus, VaR-based limits have proven to be far more effective as a Risk Management Tool.

- **Consider Currency and basis risk while calculating total risk:** Basis risk due to fluctuations of spread (spot-futures) and currency risk due to high price volatility in currencies should be taken into consideration while calculating the overall portfolio risk and appropriate tools like hedge ratio have to be employed.

- **Have an Objective Risk Management Policy (RMP):** An RMP with well-defined limits on Traders, commodities, markets and instruments will go a long way in avoiding huge one-time losses which can potentially wipe out a huge part of the organizations' net worth and thereby, its share holder value.

- **Focus on a good Return v/s Risk trade-off:** Traders should be rewarded on the basis of not only the return they have delivered, but also the amount of risk they have taken to generate those returns.

- **Keep an eye on trend:** Senior Management and risk managers will be able to make better decisions in a dynamic market if they are aided by Trend reports on a regular basis rather than periodically.

- **Put a hierarchical structure to good use:** The hierarchical structure of operational team should facilitate and not hinder the risk taking nature of the organization. This can be achieved by managing risks at each level of the hierarchy, while simultaneously achieving the benefits of lower risk due to greater diversification at each higher level.

- **Innovate a self adjusting risk management and trade guidance tool:** Have a self adjusting tool / process that guides in increasing / decreasing the exposures based on the risks and P&L of the organization.

Summary

- For making a trading decision, consider not just the price outlook, but also the potential risks involved.

- Have an objective, enterprise-wide Risk Management Policy.

- Implement Risk Management Process and best – practices in the organization.

- Have a solution to measure, simulate, and monitor Risks arising from various sources.

- Compliance of Risk Management Process will surely enhance shareholder value and ensure long-term sustainability of the organization.

Contact us:
TransGraph Consulting Pvt. Ltd.
6-3-655/2/1, AP Civil Supplies Bhavan Lane,
Somajiguda, Hyderabad – 500 082
Ph: +91-40-3340 4000, Fax: +91-40-30685002.
E-mail: mktg@transgraph.com, demo@transgraph.com
Website: www.transgraph.com