

“Systematic Risk Cannot Be Controlled but Unsystematic Risk Can Be Reduced” — Discuss

Risk in investment refers to the possibility that actual returns may differ from expected returns. In finance, risk is broadly classified into **systematic risk** and **unsystematic risk**. The statement “*systematic risk cannot be controlled but unsystematic risk can be reduced*” is widely accepted in financial theory and practice. This can be clearly understood by examining the nature, causes, and management of both types of risk.

1. Meaning of Systematic Risk

Systematic risk, also known as **market risk** or **non-diversifiable risk**, is the risk that affects the entire market or economy.

Causes of Systematic Risk

Systematic risk arises due to **macro-economic factors** that are beyond the control of individual firms or investors, such as:

- Changes in interest rates
- Inflation
- Economic recession or depression
- Political instability
- Changes in government policies
- Natural disasters
- Global events (wars, pandemics)

Why Systematic Risk Cannot Be Controlled

- These factors affect **all firms and industries** simultaneously.
- No individual company or investor can prevent or avoid these risks.
- Even a well-diversified portfolio is affected by market-wide fluctuations.

Examples of Systematic Risk

- Fall in stock prices during a recession
- Decline in bond values due to rising interest rates
- Impact of inflation on purchasing power of returns

Thus, systematic risk **cannot be eliminated or controlled**, only managed to some extent through strategies like asset allocation and hedging.

2. Meaning of Unsystematic Risk

Unsystematic risk, also called **specific risk** or **diversifiable risk**, is the risk that is unique to a particular company or industry.

Causes of Unsystematic Risk

- Poor management decisions
- Labour strikes
- Change in consumer preferences
- Failure of a new product
- Financial mismanagement
- Company-specific legal issues

Why Unsystematic Risk Can Be Reduced

- This risk affects **only a particular firm or industry**, not the entire market.
- By investing in different companies and industries, losses in one investment can be offset by gains in others.

Examples of Unsystematic Risk

- Losses due to a factory fire
- Decline in sales of a specific company
- Bankruptcy of a single firm

3. Role of Diversification in Reducing Unsystematic Risk

Diversification means spreading investments across different securities, industries, and sectors.

- It reduces company-specific risk.
- When one company performs poorly, others may perform well.
- As the number of securities in a portfolio increases, unsystematic risk approaches zero.

However, diversification **cannot reduce systematic risk**, as market-wide factors affect all securities.

4. Comparison between Systematic and Unsystematic Risk

Basis	Systematic Risk	Unsystematic Risk
Nature	Market-wide risk	Company-specific risk
Control	Cannot be controlled	Can be reduced
Diversification	Not helpful	Very effective

Basis	Systematic Risk	Unsystematic Risk
Scope	Affects entire economy	Affects individual firms
Examples	Inflation, interest rate changes	Strikes, mismanagement

5. Practical Implications for Investors

- Investors must accept systematic risk as unavoidable.
 - They should focus on reducing unsystematic risk through:
 - Proper diversification
 - Careful selection of securities
 - Regular portfolio review
 - Investors are rewarded only for taking **systematic risk**, not unsystematic risk.
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Conclusion

The statement “*systematic risk cannot be controlled but unsystematic risk can be reduced*” is true and justified. Systematic risk arises from macro-economic forces that affect the entire market and are beyond individual control. On the other hand, unsystematic risk is specific to a company or industry and can be significantly reduced through diversification and sound investment decisions. Therefore, effective risk management focuses on minimizing unsystematic risk while carefully managing exposure to systematic risk