Financial Management

MS109

UNIT 3 RISK AND RETURN

MBA Second Semester

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Risk and Return

Return - Return is nothing but the reward for undertaking investment.

Assessment of historical returns is must to know the performance of the fund manager.

This also helps as an important input to estimate future returns.

It has two components;

Current return – It is the periodic cash flow in the form of interest or dividend

Capital return - It represents change in the price of asset.

Thus Total Return = Current Return + Capital Return

O The current return can be zero or positive, whereas capital return can be zero, positive or negative.

Risk in Investment

O Risk is nothing but the possibility that actual outcome of investment will differ from expected outcome of investment.

❑ Risk can be broadly classified in to two types;

Systematic Risk

Unsystematic Risk

Systematic Risk

O The risk inherent to the entire market or entire market segments is known as systematic risk. This is also known as "un-diversifiable risk" or "market risk".

Systematic risk covers:

- Market risk
- Interest rate risk
- Purchasing Power risk
- Political risk

Beta values are fairly easy to interpret.

o If the stock's price experiences movements that are greater or more volatile than the stock market, then the beta value will be greater than 1.

o If a stock's price movements, or swings, are less than those of the market then the beta value will be less than 1. Since increased volatility of stock price means more risk to the investor, we'd also expect greater returns from stocks with betas over 1.

o The reverse is true of a stock's beta is less than 1 - we'd expect less volatility, lower risk, and therefore lower overall returns.

Security Market Line

O The Security Market Line represents the average or normal, trade-off between risk and return for a group of securities – where risk is measured typically, in terms of Beta value of the securities.

O E (R i) = R f + [E (R M) – R f] β i
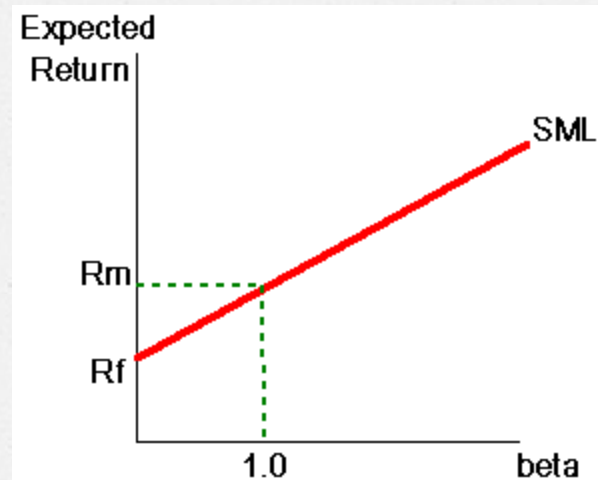
References

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