RISK AND RETURN

Basics

By assuming only low levels of risk potential returns tend to be low as well. On the other hand, high levels of risk are usually linked with high potential returns. Clearly, by making a risky investment one is more likely of losing everything; but, the potential gains are much higher.

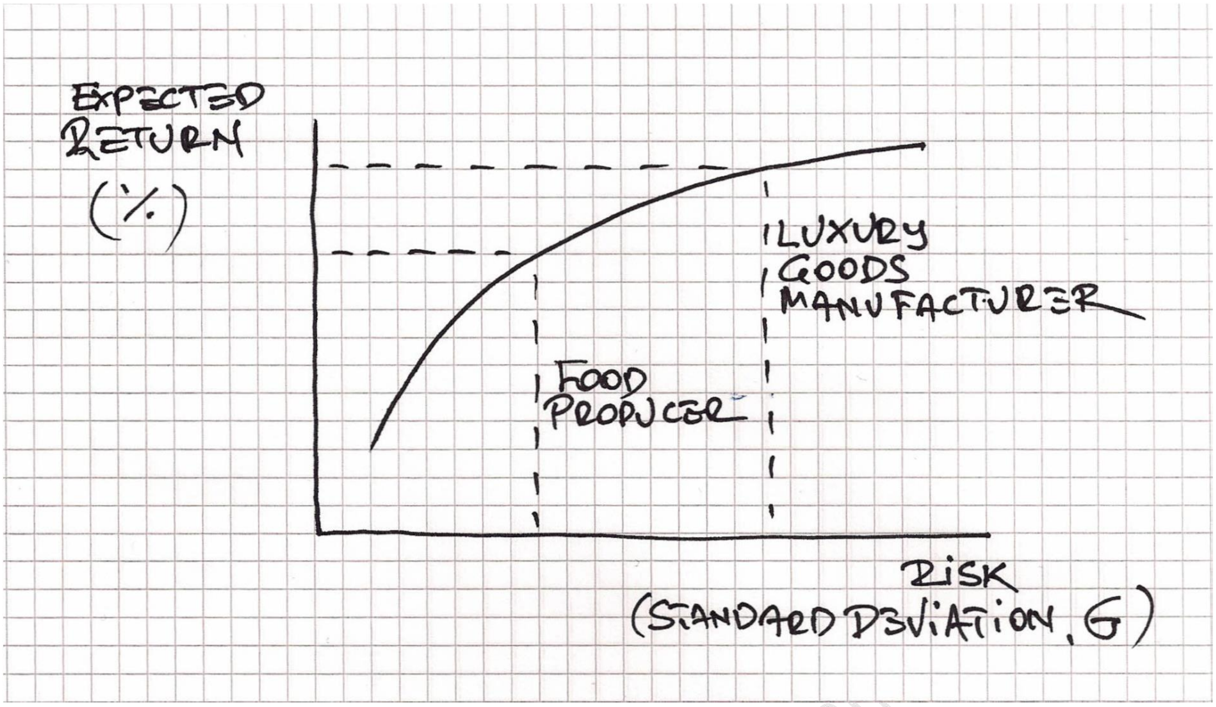
If – let´s say - you decided to invest in a stock, then you will also have some expectations: For example, how much you want to get back from your investment, what the expected return should be. In the case of a stock, this expected return will probably consist of a combination of an increase in the share price as well as dividend payments.

The distribution of the relative periodic changes of returns in an investment – by times higher, then lower - fluctuates more or less widely around the center of a bell-shaped curve, the average historical return. And, this average historical return usually also serves as the assumed basis for the – though, unguaranteed - expected future return of the investment. The disparity between the historical (or expected) average returns and actual returns – alas: the gap and its width - is in a Corporate Finance context usually expressed in the form of the standard deviation: The wider this disparity, the flatter the bell-shaped curve. And, the higher the standard deviation, the higher the volatility of the investment, the higher the financial risk assumed by the investor.

Previously, we have contrasted a mature, stable food manufacturer with a rather cyclically performing luxury goods company to illustrate the concept of volatility. But there are actually many more risk aspects one could or actually should look into: For example, an investment in a mature company will probably be less risky than such in a start-up firm which has yet to prove the viability of its – possibly yet untested – products. Or, an investment in a packaging company - with high order volumes in a booming economy and few or no orders in an economic downturn - will have a higher performance and return volatility than a specialist manufacturer for toilet paper only (or one may assume so …).

Therefore, the following reasoning seems only logical: The higher the assumed risk, the higher the yield or return an investor deserves.

To close in on the issue of precisely how much yield or return may be justified for a certain investment, benchmarking with other similar investment propositions seems like a good start: In regards to stocks, for example, one could look into the returns of similar companies in the same industry with a focus on more or less the same product or geography. It seems only logical that for a certain investment one wishes to achieve as much yield as for a comparable investment opportunity with a similar risk profile: This means, with a similar volatility profile, or standard deviation.


EXPECTED
RETURN
(%)
LUXURY
GOODS
MANUFACTURER
FOOD
PRODUCER
RISK
(STANDARD DEVIATION, σ)