Basics

Taking on a low level of risk tends to result in relatively modest, lower returns. - Assuming higher risk, on the other hand, deserves significantly higher returns, with the likelihood increasing, though, potentially losing everything.

If – for example – one decided to invest in a stock, then such an engagement will come with expectations, not least, how much one wants to get out of that investment, or what the yield should be. - In the case of a stock, the expected return will probably consist of a combination of an increase in the share price as well as dividend payments.

In many cases, not always, though, the distribution of the relative periodic changes of returns in an investment – sometimes higher, then lower - fluctuates more or less widely around the center of a bell-shaped curve, the investment´s average return. Whereby average historical returns frequently serve as the basis for – though, unguaranteed - future expected returns.

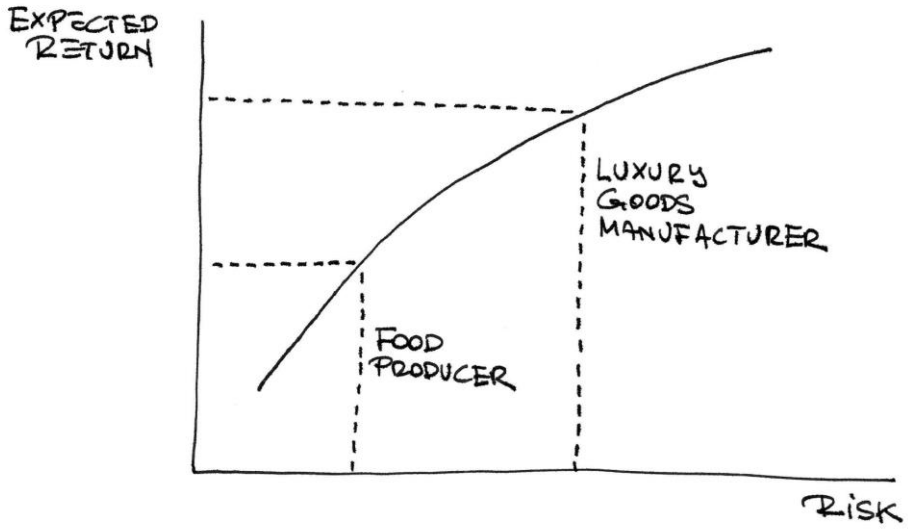
A major hypothesis in the financial discipline is that variables, such as the return of a stock, are normally distributed. However, this has often been rejected in both, theoretical studies and certain specific cases. In the "real" world of financial investors — where risk averse investors mainly hold government bonds, a few equities and do not hold derivatives — the normal distribution still plays a lead role, though.

Now, in a Corporate Finance context, the disparity (gap) between historical (or expected future) average returns and actual returns is most commonly expressed in mathematical terms, in form of the standard deviation: The wider this disparity, the flatter the normally distributed, bell-shaped curve. And, the higher the standard deviation, the higher the volatility of the investment, the higher the instrument´s financial risk.

The previous example used for comparing the expected share price performance of a mature, reasonably stable food producer with that of a rather cyclical luxury goods manufacturer illustrates the concept of volatility.

However, there are a wide range of additional risk aspects to consider prior to assuming an investment: For instance, an investment in an established, mature company will be less risky than such in an early-stage startup which has yet to prove the viability of its –perhaps yet untested – products. Or, an investment in a packaging company – benefitting from high order volumes in a booming economy and few or no orders in an economic downturn - will assumedly have a higher performance- and return-related volatility than a specialist manufacturer for toilet paper.

Therefore, the higher the assumed risk, the higher the yield or return an investor may expect, also deserve. - The question remains, though: Precisely how much yield or return may be expected, should be demanded or could be justified for a certain investment. - Benchmarking with similar investment propositions seems like a good start: In regards to stocks, for instance, one could compare the returns of a firm´s peers (i.e. similar companies in the same industry with a focus on more or less the same product or geography). As for making a specific investment, one certainly wishes to achieve as much yield as would be achievable with a comparable investment with a similar risk profile (i.e. similar volatility profile or standard deviation). – As will be outlined in the following sections, Corporate Finance tools can help transforming risk-return expectations into quantitative benchmarks.



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