

Finance and accounting

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Identify the Components of a Stock's Realized Return

The realized return of a stock consists of two major components which are i) dividend and ii) capital gain or loss (Navarro, 2005). The dividend is referred to a portion of the earnings of a company. It is usually distributed to the shareholders as per the direction that is given by the board of directors of the company. On the other side, capital gain or loss refers to the increase or decrease in the value of the stock with respect to the price at which it was purchased.

Contrast Systematic and Unsystematic Risk

Systematic risks are the risks which are generated by various market factors. Usually, investors do not possess any control over these factors. Such risks are non-diversifiable in nature. They may happen due to some 'non-probabilistic events' (Condamin, Louisot & Naïm, 2006). Interest rates, wars, and recession are some of the important sources of this kind of risk as they are capable of affecting the whole market. In general, systematic risks cannot be insured.

On the other hand, unsystematic risk is the risk that is found to be in association with the organizations' operations and their ways of running the business. Since such risk is industry or company specific, it can be reduced by proper diversification. In other words, such risk is diversifiable in nature (Condamin, Louisot & Naïm, 2006).

Explain why the total risk of a portfolio is not simply equal to the weighted average of the risks of the securities in the portfolio

The total risk of a particular portfolio can be measured as the variance of the
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return of that portfolio. A portfolio's risk is not equal to the weighted average of the risks of each and every security rather it is the combination of the weighted average of the risks of each and every securities and the weighted average of risks that are market-related (Kevin, 2006). It can be expressed by the following equation

[Source: Kevin, S. 2006]

The first term represents the risks that are market-related with respect to individual securities, whereas the second part represents the weighted average of risks of the specific securities (Kevin, 2006).

State what beta measures and its uses

In simple words, the beta of a stock is referred to the ratio of systematic risk of that stock to the market's systematic risk (McInish, 2000). It measures the volatility of a portfolio or a security with respect to the market. It can be calculated by using regression analysis. One can see beta as the propensity of the return of a stock while responding to the swings or movements of the market. When the beta is equal to one it means that the price of the stock is likely to move along with the market. Beta, when less than one, it is expected that the stock would be less volatile or sensitive as compared to the volatility of the market. Sometimes, beta is found to be greater than one and it indicates that the volatility of the price of the stock is likely to be more than the volatility of the market.

Beta is used as one of the most important components in the CAPM i. e. Capital Asset Pricing Model. CAPM is actually used in calculating the cost of equity. Beta represents the price volatility of a stock and this volatility is a crucial factor in the process of determining the risk. In other words, it can
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also be said that since beta assists in measuring the risk, it should also be immensely helpful in making more effective decisions regarding investments.

State what WACC measures and explain the WACC assumptions used to value a project

WACC refers to Weighted Average Cost of Capital. In the calculation of WACC, each and every type of capital is appropriately weighted. Securities analysts use WACC in the process of selecting any investment. It is used as a tool to make decisions regarding investment. It may be used as a discount rate that is applicable to cash flows which are used in determining the 'net present value' of a business. It is also used in the calculation of EVA (Economic Value Added).

The calculation of WACC includes all types of sources of capital in the form of debt and equity. The process involves summation of the cost of every component of capital which is multiplied by their proportional weight.

References

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