Risk, return, trade off, portflio and diversification

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RISK, RETURN, TRADE OFF, PORTFLIO AND DIVERSIFICATION:

The paper gives a through idea to the reader regarding the two main concepts of finance and it will also elaborate the way one can mitigate the vulnerabilities from investment. The return of an investment and the risk associated with it are the two basic concepts of finance. Return on an investment is the financial outcome for the investor. Risk is present whenever investors are not certain about the outcomes an investment will produce (Vernimmen, 2000). We know that the stock market is totally a risk based market in which every investor enters with a clear state of mind that he has to bear the risk associated with the investment. We often hear a proverb that " Quality Never Cheeps"; same applies here that an investment with a low risk profile has a low investment return capacity as compared to an investment with a high profile of risk. Most of the investors are risk averse, but they are unaware of the fact that, while investing they have to indulge themselves into a number of risks, which they don't think; like interest rate risk, country risk, hazard risk and bankruptcy risk. This happens because the investor merely focuses on the financial risk and concern about the volatility among the prices of the asset or security, he have. It's a psyche of a person that, if we offer two investments offering the same expected return, but differing in risk, then a risk-averse investor will prefer the less risky investment. Most people invest in a number of assets or hold shares of a number of companies in order to diversify the risk. More precisely we can say that, people typically invest their wealth in a portfolio of assets and will be concerned about the risk of their overall portfolio. Portfolio theory is used to diversify the risk of an investment; the theory was initially adopted by Markowitz in 1952 as a normative approach to investment choice under uncertainty. As per the risk trade off, those assets that produce the highest average returns also have the highest standard deviation (risk) and the widest ranges of returns (Vernimmen, 2000).

Here we select 4 companies which are indulged in diversified businesses. We choose Microsoft, General Electric, Pfizer and Coca Cola. Microsoft, which is a multinational United States based computer Technology Corporation earned a net profit of US$17. 681 billion in the year 2008, which is a great achievement in the presence of a severe financial turmoil.

General electric is one of the most top notch companies in the world, which is also an US-based multinational technology and Services Company and enjoyed a net income of US$ 17. 410 billion in 2008. Pfizer which is the top ranked pharmaceutical company in the world is also an American based multinational organization which had a net income of $8. 144 billion in the year 2008.

Coca Cola is the largest beverage company in the world which earned a net profit of US$5. 981 in the year 2008. Suppose, we want to invest in the above mentioned companies and we have US4 million. We have the beta (risk) associated with each stock and its expected return, now we are analyzing weather we have to invest in a portfolio of these 4 stocks or invest individually.

CALCULATON OF EXPECTED PORFOLO RETURN AND PORTFOLIO BETA:

Stock

Investment

Beta

Expected Return

Weight

$

$

%

Microsoft

400, 000

1. 5

18%

0. 1

General Electric

600, 000

-0. 5

2

0. 15

Pfizer

1, 000, 000

1. 25

16

0. 25

Coca Cola

2, 000, 000

0. 77

12

0. 5

Total

4, 000, 000

1

Portfolio Beta

0. 7625

Expected Return

14%

We can see that investing in the portfolio, condenses the risk up to a satisfactory level. We can see that the portfolio beta is the lowest as compared to the beta of individual stocks.

CALCULATION OF RETURN IN EQUITY (ROE):

Stock

Net Income

Equity

Return on Equity

$ Billion

$ Billion

%

Microsoft

17. 681

36. 28

48. 73

General Electric

17. 41

14. 665

118. 72

Pfizer

8. 144

17. 254

47. 20

Coca Cola

5. 981

21. 744

27. 51

Return on Equity (ROE) measures the company performance that how a company earns over its equity or investment. ROE is the best tool available for the shareholder or a new investor, who wishes to evaluate the performance of the company. As per the calculated results, General Electric is the most profitable company among the others; however, all the companies have a remarkable ROE. Mostly investors and analyst choose the companies to invest which have a ROE of above or at least 15 percent.

CONCLUSION:

It is observed that investment in a diversified number of assets or shares are worthwhile rather than emphasizing on one. It is also computed that individual securities have a higher number of beta (risk) but its beta mitigates when an appropriate portfolio is maintained. Thus, we can say that the investors who are risk averse and want to take a limited risk then they should invest in the portfolio.

REFERENCES:

Vernimmen, P (2000), Corporate Finance Theory and Practice, British Library Publications.