

Wk4 discussions

Finance



Cost of capital and market risks Discussion Market risks question to Mr. Peter Lynch)

My question Peter Lynch concerns market risks. It is known there is no investment you can invest that does not have any risk be it shares or bonds. All of us including you need to have good returns from their investment. Help me and other investor watching what should we consider before investing and how can minimize if at we cannot avoid the market risks?

My question to Mr. Lynch is essential in the sense that many people fear in investing in stock or bonds. Investors shy off from investing in securities but rather prefer investing in other forms of investment like transport, real estate. Some of them might not be conscious of the dynamics involved in the investment of securities. Others might be conscious of the securities investment but do not understand which security will give a better return than the other. If Mr. Lynch answers this question, more investors from other industries will be interest on security investment.

Mr. Lynch can let us know how to minimize market risks since avoiding it by diversification is impossible. He will suggest other avenues investors can use to minimize the risks associated with the type of security they have invested. Expectations of investors are high return, but market risk being included in the equation then the possibility of high return becomes slim. If investors have been armed with that kind of information regarding securities investment, we can be rest assured the number of investors in securities will increase. This will be a boost to our nation's economy.

Discussion 2 (Cost of capital)

Weighted average cost of capital (WACC) is a company's average after-tax cost of the different sources of capital (Ffler, 2001). WACC is calculated using <https://assignbuster.com/wk4-discussions/>

the formula below

$$WACC = ((E / V) * Re) + ((D / V) * Rd) (1 - T) \text{ where } v; (E + D)$$

For instance a company x has equity; \$10, 000, debt; 3, 500, Re; 13%, Rd; 5%, Tax rate; 30%

$$WACC = ((10, 000 / 13, 500) * 0.13) + ((3, 500 / 13, 500) * 0.05) (1 - 0.3)$$

$$0.1 + 0.0091 = 0.1091, WACC = 10.91\%$$

To calculate the cost of equity division of cost of structure will need the use of Capital Asset Pricing Model (CAPM) or by Dividend Growth Model (DGM).

The cost of debt can be calculated by use of historical (coupon) interest rate or market based interest rate

The riskier division would get the greater share of capital than conservative. Reason for this is; that the rate of return for the riskier division would surpass that of the hurdle rate.

The techniques used to calculate the estimate of divisional cost of capital are referred to as pure play approach. This technique is used to calculate riskier division is the security market line (SML) while for conservation division subjective approach technique would be used to estimate the cost of capital.

The main challenge experienced during the estimation of the cost of capital for a division is that it hardly has securities for to trade in the market, so it is a problem to notice the risk of division in the markets' valuation.

References

Ffller, A. (2001). Miles-Ezzells WACC approach yields arbitrage. Hannover: Fachbereich Wirtschaftswiss., Univ.