

Financing new ventures

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Capital Asset Pricing Model According to capital asset pricing model the return expected from securities should be equivalent to the rate of risk-free security. A free-risk-security is one which has a guaranteed returned either from insurance or government pays the investor in case of security fails to meet the agreed return.

Importance of capital asset pricing model (CAPM)

This model considers systematic risks, this are the risks that are do occur on daily basis and are normally referred to as unknown risks. This is a reality since, investors will never invest to any business that he/she has doubt that returns from his investment will not be realized. This has paved way for diversification in investment According to (Harrington, 1987) it allows the investor to avoid unsystematic risks such as poor management of the company which will automatically lead to returns not being realized. From this model a linear relationship has been developed to show the relationship between systematic risk and the expected return.

As compared to weighted average cost of capital (WACC) this model gives a robust discount rate that can be used for assessing the investment. Using WACC a project can be turned down when its internal rate of return is less that of WACC. This is because WACC is based on the assumption that any investment doesn't have an effect to financial and business risk. Using CAPM, gives internal rate of return that is higher than the security market line and a return that can minimize or eliminate system risk.

CAPM is considered as the best tool to calculate the cost of equity as compared Dividend Growth Model (DGM). This is because it takes into account the systematic risk level of the business relative to stock market.

Portfolio effect and individual security

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Portfolio effect refers to the addition of other investment into the portfolio with aim of reducing risk. This can be termed as diversification of portfolio such that change in the value of one investment e. g. bond in the portfolio there will be a response to change in the value of other assets in the portfolio.

Portfolio effect has the ability to minimize a specific risk attached to an asset in a given portfolio, but this depends or lies on the degree of correlation of assets held in the portfolio (Hirt & Block, 1990). Diversifying portfolio can be achieved in either horizontal or vertical diversification both will help to reduce the risk associated to a given asset, vertical diversification occurs when an investor decides to add different form of assets or securities in his portfolio e. g. cash, corporate bonds, and building. This is advisable since whenever a different sector is affected by inflation or other macroeconomic effect the other sector will be bail out the investor from losses he would have incurred if he had invested in one sector.

Horizontal diversification is where an investor holds one type of asset or security in his portfolio but checks its performance and keeps on changing to reduce the possible risk that will be associated to asset if he hadn't change the asset in the portfolio. For instance an investor might have shares in his portfolio of different companies. He will keep track on the performance of each company's shares and make a wise decision which share are risky. Since not all shares can suffer low price index or decreasing stock price, he will get returns from other shares he has invested to the other companies it is advisable the companies ought to be of different industry.

References

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