risk. Debt financing increases the risk of

Chapters 3 and 4.

Risk-Return Trade off : The required rate of return from an investment is associated with the degree of risk attached to it. Investors assume risk and is not irrational to incur even higher degree of risk if the investor expects to be compensated for it. Investors select the level of risk they are ready to assume. Some investors are unwilling to undertake much risk and they need not expect to earn higher returns. Some investors are ready to take even higher risk but only with the expectation of higher returns. In fact, investors cannot expect to earn higher returns without undertaking larger risk. If higher expected return can be earned without bearing extra risk, every investor would be rushing towards to buy the higher return assets only. This would result in driving up their prices. At higher prices, the higher return assets may become unattractive. The reason being that higher the price, lower would be the percentage rate of return and *vice versa.*

The investors always like to maximise returns. But would they select investments to minimise the risk? No, because there is also a cost of minimising the risk and that is the lower expected return. The minimization or risk would result in every investor holding only risk-free investments. So, maximisation of returns and minimization of risk are two opposite forces working in the investment decisions. This gives risk to what is known as the risk-return trade-off.

The expected return of an investment should be commensurate with the level of risk attached therewith. At this level, investors anticipate a fair return relative to the risk of the investment. If returns are independent of the risk, there will be a rush to sell high risk securities and to buy lower risk securities. This will make their prices to adjust and the expected rate of return will rise or fall until the securities eventually become attractive to be bought or held by an investor. So, there would be a risk-return trade-off with higher risk assets priced lower than lower-risk assets. An investor should think in terms of the expected risk return trade-off that results from the relationship between the expected return and the risk of the investment. This risk-return trade-off has been shown in Figure 2.3.

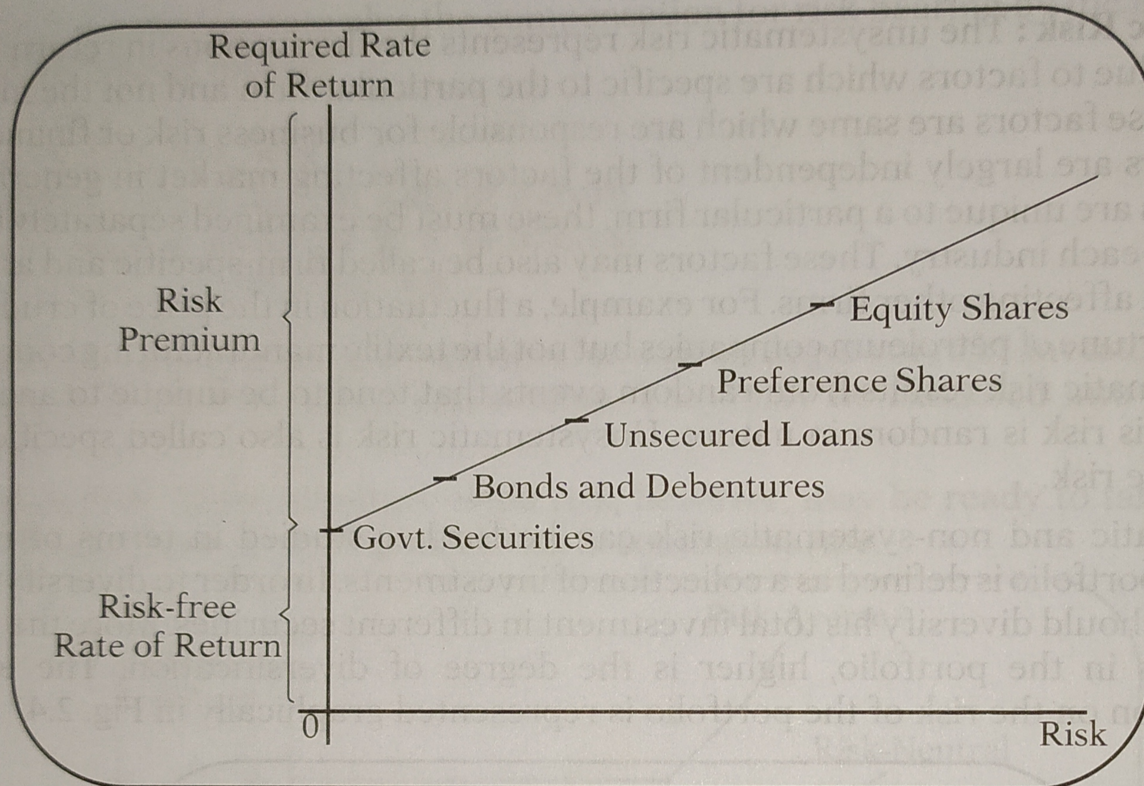

FIG. 2.3 : RISK-RETURN RELATIONSHIP OF DIFFERENT INVESTMENTS

Figure 2.3 shows that different types of investments have different degrees of risk and the required rate of return. The Government securities have rate of return equal to the risk-free rate. As the risk increases, the required rate of return also increases. Equity shares have maximum risk (with reference to revenue return as well as the capital gain/loss), so the required rate of return is also highest. Risk-Return line in Figure 2.3 shows that higher the risk, more is the required rate of return of the investment. The risk-return line also explains that the required return is comprising of two elements : (*i*) Minimum Return in terms of risk-free rate of return, and (*ii*) Risk-premium depending upon the degree of risk attached with the investment.