Quadrant II - Notes

Paper Code:DSE-05

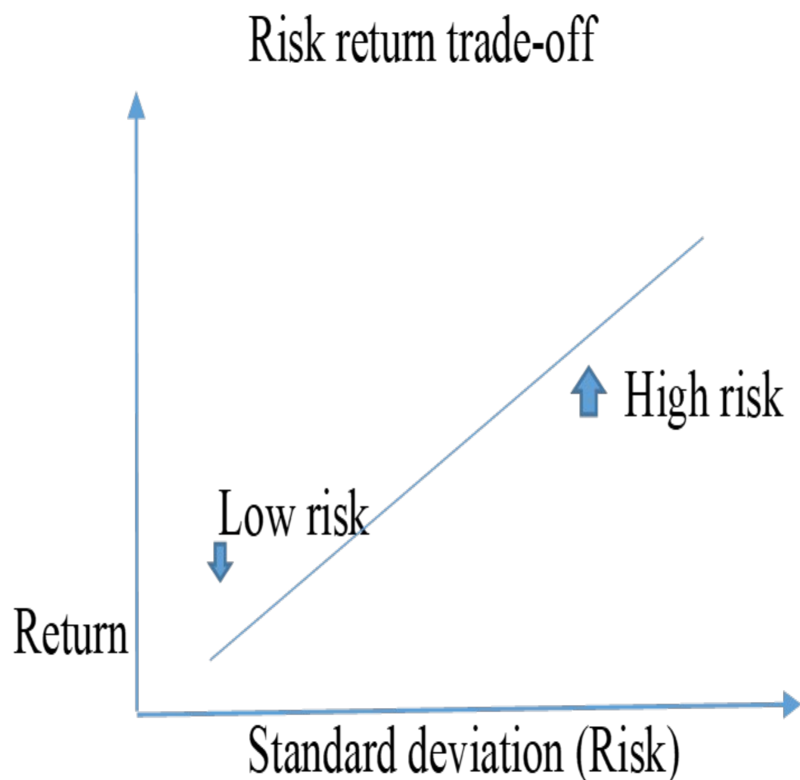
Module Name: Risk-Return Tradeoff

What is Risk-Return Trade-off?

The risk-return trade-off states that the potential return rises with an increase in risk. Using this principle, individuals associate low levels of uncertainty with low potential returns, and high levels of uncertainty or risk with high potential returns. According to the risk-return trade-off, invested money can render higher profits only if the investor will accept a higher possibility of losses.

Understanding Risk-Return Trade-off

The risk-return trade-off is the trading principle that links high risk with high reward.



The appropriate risk-return tradeoff depends on a variety of factors including an investor's risk tolerance, the investor's years to retirement and the potential to replace lost funds. Time also plays an essential role in determining a portfolio with the appropriate levels of risk and reward. For example, if an investor has the ability to invest in equities over the long term, that provides the investor with the potential

to recover from the risks of bear markets and participate in bull markets, while if an investor can only invest in a short time frame, the same equities have a higher risk proposition.

Investors use the risk-return tradeoff as one of the essential components of each investment decision, as well as to assess their portfolios as a whole. At the portfolio level, the risk-return tradeoff can include assessments of the concentration or the diversity of holdings and whether the mix presents too much risk or a lower-than-desired potential for returns.

KEY TAKEAWAYS

- The risk-return tradeoff is an investment principle that indicates that the higher the risk, the higher the potential reward.
- To calculate an appropriate risk-return tradeoff, investors must consider many factors, including overall risk tolerance, the potential to replace lost funds and more.
- Investors consider the risk-return tradeoff on individual investments and across portfolios when making investment decisions.

The risk-return trade-off states that the level of return to be earned from an investment should increase as the level of risk goes up. Conversely, this means that investors will be less likely to pay a high price for investments that have a low risk level, such as high-grade corporate or government bonds. Different investors will have different tolerances for the level of risk they are willing to accept, so that some will readily invest in low-return investments because there is a low risk of losing the investment. Others have a higher risk tolerance and so will buy riskier investments in pursuit of a higher return, despite the risk of losing their investments. Some investors develop a portfolio of low-risk, low-return investments and higher-risk, higher-return investments in hopes of achieving a more balanced risk-return trade-off.

A canny investor delves into the fundamentals of a prospective investment to gain insights into the actual amount of risk associated with it. If this investor perceives that the actual risk level differs from the general perception, then this difference can be exploited to achieve above-average returns.