Investment & Risk Premium

CHAPTER 6

Introduction

Investment
&
Risk premium

Types of
Leverage

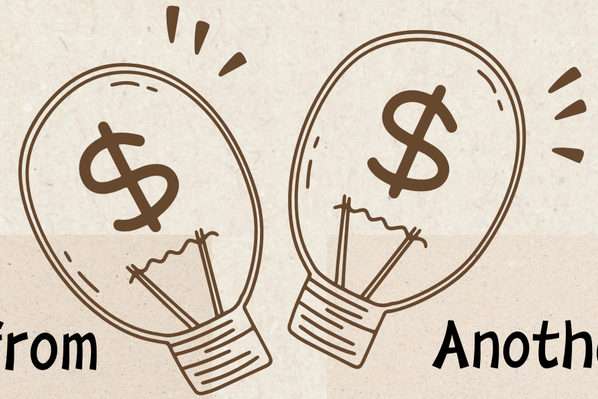
International
&
Other type of risk

Introduction of Investment & Risk Premium

Money committed with an intention to earn a return over a period of time may be considered an investment.

As explained in earlier chapter, companies and individuals have various uses of funds (e.g., working capital needs, capital expenditures, dividend payments, loan payments). To meet these various needs, companies and individuals generate the necessary funds from various sources

Investment and Risk Premium



For companies, collections from customers and clients are the primary source of funds.
For individuals, funds primarily come from compensation income (for those employed) and business income (for entrepreneurs).

Another possible source of funds for companies and individuals could come from their investment portfolio. Their investments could generate various types of income, such as dividends, capital gains, and interest, among others.

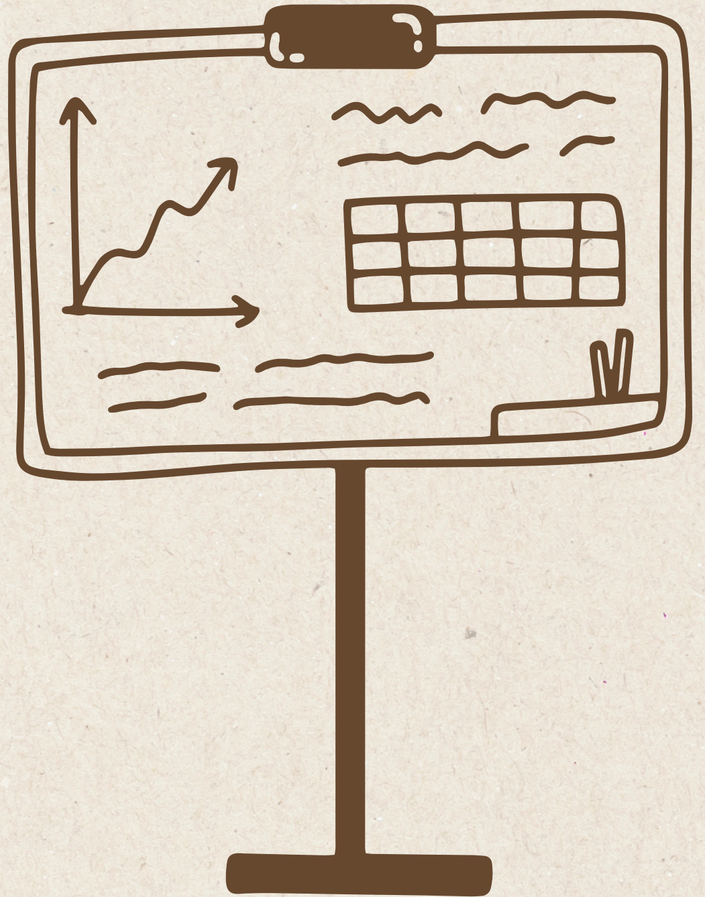
The required return of any investment is dependent on the risks faced by the investor, as the risk-return trade-off suggests. The riskier the investment, the higher is the required rate of return by the investor.

The required return is computed as follows:

Required Return of Any Investment =
Real Risk-Free Rate + Expected Rate of Inflation +Risk Premium

This means that all investments face with the same nominal risk-free rate consisting of the real risk-free rate (time value of money) and the same expected inflation rate

Investment Risk Premium



The required rates of return of various investment instruments differ because of their risk premium. The riskier the investment, the greater the risk premium added to the nominal risk-free rate to determine the required rate of return.

As discussed in various sections of this chapter, the risk is measured and associated with variability and leverage. The two main sources of risk of a company, business risk (or operating risk) and financial risk, are related to the two types of leverage-operating and financial leverage.

Two Types of Leverage

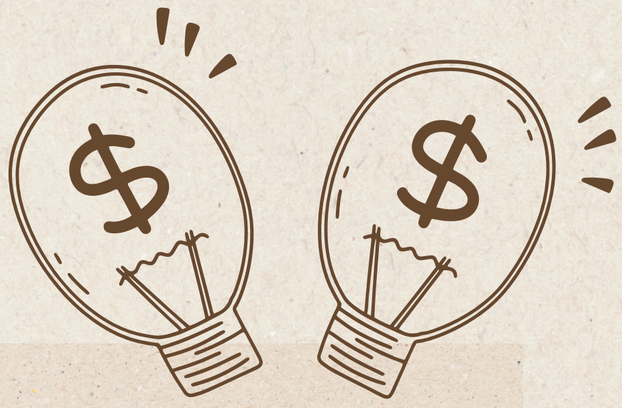
1. Business Risk

Business risk (or operating risk) is related to the nature of the company's products and its operating strategy. Companies with stable sources of sales and earnings have relatively low business risks. These companies' products are patronized even during times of recession.

Business risk is also associated with the cost structure of the issuing company. Suppose the issuing company chooses to incur higher fixed operating costs, then its business risk increases. Higher fixed operating costs result in greater variability in the operating income (loss) as the company sales fluctuate. Business risk is usually measured by the degree of operating leverage.

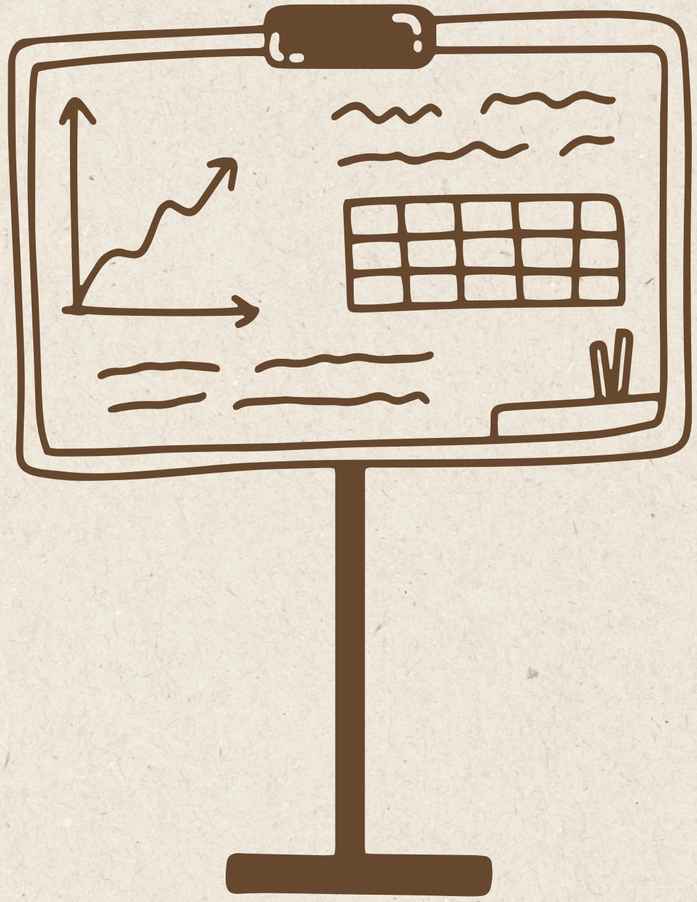
2. Financial Risk

Financial risk refers to the risk created by the choice of capital structure- the financing mix of the issuing company. A company usually funds its operation through debt and equity financing. As the debt portion increases, financial risk increases. Incurring debt creates a fixed financial obligation. Like fixed operating costs, these fixed financial costs create more variability in the returns of the issuing company. Financial risk is usually measured by the degree of financial leverage.



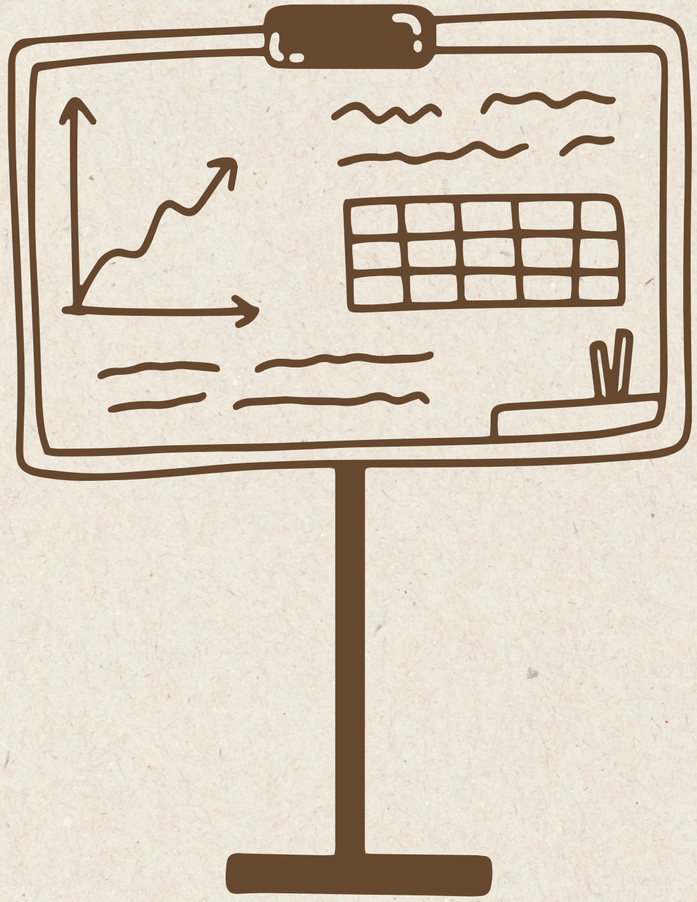
Brown and Reilly (2014) identified the major sources of risk as business risk, financial risk, exchange rate risk, country risk, and liquidity risk. Brealey et al. (2011) classified currency risk and political risk as international maks

International Risks



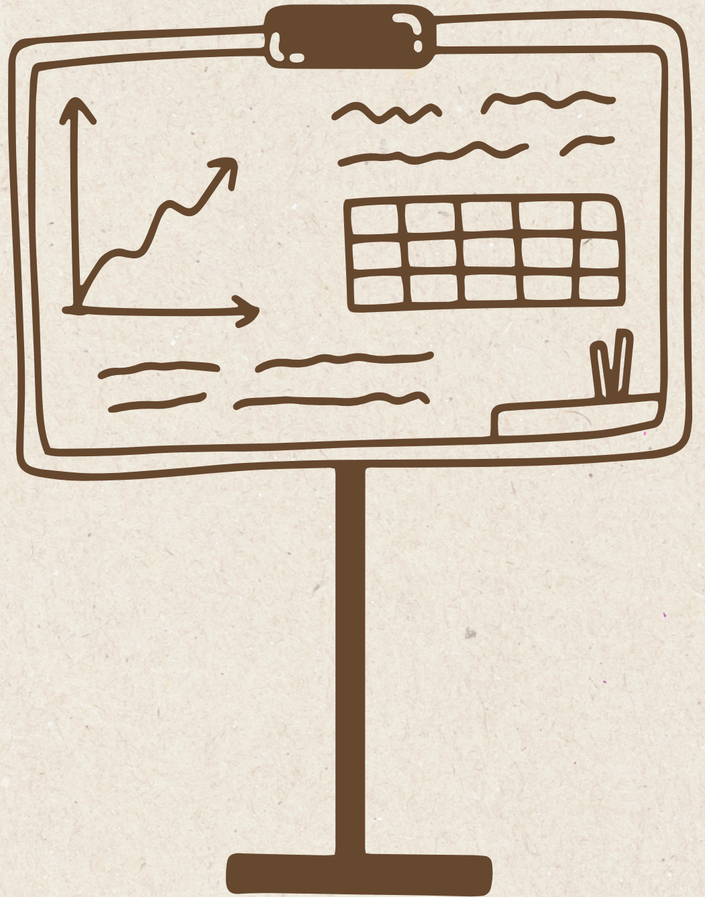
Currency or exchange rate risk affects the cash flows, operating results, financial position, and value of firms that engaged in foreign-currency-denominated transactions and more so those companies that have fully established subsidiaries in international markets.

International Risks



From the investor's perspective, exchange rate risk exists if the investment is denominated in another currency different from the investor's local currency. Additional uncertainty exists if the investor would need to liquidate the foreign-currency-denominated investment and convert it to Philippine peso, for example. The investor then must consider the direction and variability of the exchange rate between the local currency and the various foreign currencies.

International Risks



Country or political risk is associated with the political and economic uncertainty of a particular business environment. You can only entice investors to invest in countries with political instability if a higher rate of return is expected. Country risk also increases if natural disturbances usually occur, such as typhoons and earthquakes. Investments in countries prone to changes in government through coup d'etat, rebellion, or revolutions have a higher country risk premium.

Other Types of Risks

Assuming the normal scenario that the yield curve is upward sloping, an instrument with longer maturity is associated with a higher maturity risk premium. It takes the investor a longer time to receive the cash flows related to their investment, then the required rate of return should be higher.

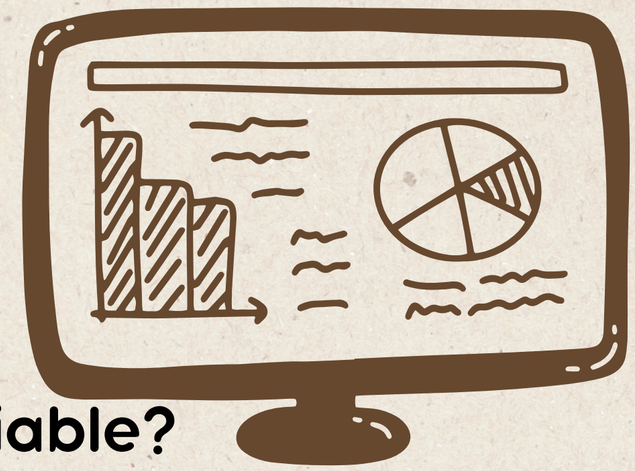
Liquidity Risk

Liquidity risk is the uncertainty that an investment can be converted to cash at a known price. The existence of exchanges facilitates ease in liquidating an investment. If there is no ready market for the investment, it is considered illiquid, and investors require a higher liquidity premium. The presence of many ready buyers and sellers reduces liquidity risk.

Other types of risk affect the required rate of return of investments. These risks are discussed in more advanced finance courses.

Types of Investments and the Related Risks

We describe the basic types of investments and identify the related risks by asking the following questions:



1. Who is the issuer of the investment instrument or security?
2. Is the return provided by the investment fixed or variable?
3. How long is the term to maturity of the investment?
4. Can the investment be liquidated immediately at a known price?

These questions represent the various risks involved with each type of investment.

A depositor with a checking account does not earn interest, but now most banks, if not all, provide a rate of return although the fixed rate is very low. The depositor can issue checks from their account to pay for various expenditures instead of delivering bills or coins as payment. Banks charge a certain fee for the printing costs of check booklets. Checks issued are subject to a clearing float (usually three days) when deposited by the payee.

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Financial institutions, mostly banks, provide deposit instruments. The primary deposit instruments include the following:

1.) savings account
2.) checking account and
3.) time deposit account

A typical savings account provides a low fixed rate of return but provides the convenience of availability. The depositor can easily deposit and withdraw from the account on any banking day.

Time Deposit Account

usually requires a minimum amount of deposit with a fixed term to maturity. This type of account provides a higher fixed rate of return compared to a savings and checking account. The depositor cannot withdraw from their account before the fixed maturity date.

Although banks are monitored by the Bangko Sentral ng Pilipinas (BSP), there is the possibility that these financial institutions may face the risk of bankruptcy. If this scenario arises, the bank would not be able to pay for all of its deposit liabilities. Deposits with banks are insured with the Philippine Deposit Insurance Corporation (PDIC) up to ₱500,000 per depositor for every bank.

Depositors need to determine the bank ' s overall financial position and performance before transacting with them. A comprehensive rating system is being used in assessing the overall condition of banks. Currently, most countries used rating systems similar to the CAMELS rating system, although central banks, including the BSP, continue to refine and improve their rating systems.

The CAMELS rating is based on the following components:

1. capital adequacy;
2. asset quality;
3. management indicators;
4. earnings quality;
5. liquidity; and
6. sensitivity to risk factors.

A bank may be graded with a CAMELS rating from 1 to 5. Some countries assign 5 as the highest rating, while other countries consider an opposite scale.

Stability is usually associated with the largest banks in the Philippines. The BSP provides a ranking of universal and commercial banks in the Philippines based on total assets.

Thank You