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Risk and Return

A key idea in finance is that investors (all people, actually) are risk averse, and their decisions reflect the trait of *risk aversion*. Risk aversion means that, other things being the same, investors shun risky alternatives in favor of risk-free ones. To make risky alternatives attractive to the investors other things have to be different. Specifically, risky alternatives have to offer higher *expected* return than risk-free venture.

Historical performance of investments reflects this relationship: common stocks offer higher returns on an average than bank accounts. This observation has led to the colloquial refrain of "the higher the risk, the higher the return." To be semantically correct, we should say "the higher the risk, the higher the *expected* return." If, as per the colloquial refrain, higher risk alternative has a higher return then where is the risk?

The difference between the expected return from a risky investmen and the return on a risk-free investment is known as *risk premium*:

$$\text{Risk premium} = E(r) - r_f$$

where $E(r)$ is the expected return on the risky venture and r_f is the return on the risk-free investment.

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