

## Expected Return

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Any investor should have a clear understanding of the expected return (interest or profit) before his/her investment action. Expected return is determined by several factors such as expected inflation, risk free rate and the risk premium.

### Expected Inflation

Prices of goods and services generally increase over time (inflation), and therefore the value you could get out of your money (purchasing power) decreases over time. For example, if you had Rs. 10,000 and general price levels go up by 5% over a period of one year, the amount of goods and services that you could purchase using the Rs 10,000 would have reduced during that year.

### Real Risk-Free Rate

The risk free rate of return is the rate of return that could be achieved by taking the least amount of risk. In any economy the least risky (risk free) investments are treasury securities because a sovereign government is expected to service its debt obligations without failing.

However, the real risk free rate is the risk free rate minus the expected inflation. For an investor to increase his/her wealth, the risk free rate should be higher than the expected rate of inflation. If not the real risk free rate would be negative, thus eroding the purchasing power of investors' money.

When an investor invests money he/she loses the opportunity of utilizing the money for immediate consumption of goods and services. Therefore when an investor defers current consumption and invests, he/she expects to earn the ability of consuming a greater amount of goods and services in the future. For example, when an investor chooses to invest in the stock market, he will lose the opportunity to use that money on a vacation. He/she may expect to purchase a vehicle by using the return from his investment in the future.

Therefore when investments are made it is important to ensure that the return earned, exceeds the expected rate of inflation, or in other words the real risk free rate should be positive.

### Risk Premium

Most investment options are more risky than low risk assets such as treasury securities. That is they may not guarantee a return and even the capital (investor may not even get his/her initial investment back). Therefore investors should require a higher return for taking up the risk of uncertainty of future income. This extra return required is called the "risk premium". Higher the risk involved in the particular investment option, higher the "risk premium". If the investment option is not capable of providing the return expected, it is not an attractive investment option.

$$\text{Expected Return} = \text{Real Risk-Free Rate} + \text{Expected Inflation} + \text{Risk Premium}$$

For example, if the one year Treasury bill rate is 12%, the expected rate of inflation is 6% and the risk premium of a high risk share is 10%. Then by investing in the share:

$$\text{Expected Return} = 12\% + 6\% + 10\% = 28\%$$