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**Estimating Risk and Return**

**1**. Solution

Expected return is the anticipated loss or profit as a consequence of a particular investment. When added to the unexpected returns, the net return of an investment is calculated. Essentially, it proves dangerous to make critical investment decisions based on the expected returns as the only factor. Expected return is deemed forward-looking as it represents the return investors generally expect to receive in the future. It is the compensation for the market risk they took in their venture. The prominent challenge that is likely to occur is the process of strategizing that the investment will respond in a specific manner(Chen, n.d.). For instance, there exist a wide range of aspects that practitioners utilize to formulate critical strategies. General demand for the business services/products, external economic conditions, internal corporation’s policies and the business projects are some of the common examples. Before making buying decisions, investors ought to review the risk characteristics of the investment opportunities to identify the investments aligned with the portfolio goals. Besides, the most daunting task is the unknown nature of the economic dimensions as a part of the equation(Kenton, n.d.). A practitioner can utilize the probability distribution as a potential means to identify the likelihood of probability there exists in the economy acting in a specific manner to determine the risk.

**2**. Solution

To decide the market risk, an investor ought to decide how much of their portfolio should be invested in the market (beta= 1) and in risk-free securities (beta=0). For instance, a risk averse person will prefer to invest 70% in the risk free market and 30% in the stock market(“What is CAPM - Capital Asset Pricing Model - Formula, Example,” n.d.). The allocation would have a beta=.30. However, a less risk averse person may prefer to have the allocations on the opposite order, 70% stock market and 30% risk free, that equals a beta of 0.70. An investor can further vary the amount of the assumed risk by changing the amount of allocation between the market portfolio and risk free market(“Market Risk Premium - Definition, Formula and Explanation,” n.d.).

**3**. Solution

Expected return= probability of that return x sum of each return

Expected return = (p1x return) + (p2 x return) + (p3 x return)

(.3 x 40%) + (.5 x 10%) + (.2 x -25%) = 12%

Provided the change in the forecast for the economic probability where the economy was expected to experience slow growth and utilizing the following set of values:

Slow 70%, fast 20% and recession 10%

The expected return will change to 12.5%

**4**. Solution

Risk Premium= 4%

Risk Free Rate= 7%

Required return= 4%+7%= 11%

**5**. Solution

T-Bill return = 5.6%

Index Return= 14.8%

Market Risk Premium= 14.8%-5.6% = 9.20%

**6**. Solution

Market Return= 12%

Beta= 0.32%

Risk Free Return= 5%

Conglomco’s Required Return= 5%+ 0.32\* (12%-5%) = 7.24%

**7**. Solution

* Conglomco stock that has a beta of 3.9 and constitutes 35 % of the portfolio.
* Megaorg stock that has a beta of 0.3 and constitutes 40 % of the portfolio.
* Supercorp stock that has a beta of 1.7 and constitutes 25 % of the portfolio.

The following formula is used to reach the final sum of beta:

Beta of Conglomco= 3.9

Conglomco weight= 0.35

Megaorg weight=0.40

Beta of Megaorg= 0.3

Supercorp Weight= 0.25

Beta of Supercorp= 1.7

Portfolio Return= 3.9\* 0.35 + 0.25\*1.7 + 0.40 \* 0.3= 1.91

References

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