Investors Demand Different Returns

By solving for expected returns directly, investors can more precisely target the tradeoff between expected returns and the associated risks.

Not every investment is the same. Savvy investors demand different returns from different investments based on the level of risk of that investment and their own tastes and preferences. If Bill Gates lost his wallet and asked you for a $10,000 loan to help him refuel his private jet to get home, you probably would not charge him a very high interest rate for that investment. He is a wealthy man, cares about his reputation, and has a high likelihood of paying you back. The rate would match the risk.

However, if your deadbeat uncle asked you for a $10,000 loan to start an ice cream truck business in Northern Canada, you might charge him a very high interest rate for that loan. The odds of you getting your money back are much lower, and you want to be compensated for the additional risk that you are taking. Cousin Eddie would pay more interest than Bill Gates.

Investors in the stock market assess risk the same way. They demand a different return for holding different stocks. If you invest in the stocks where investors are demanding a higher return, you can increase your expected return, albeit by increasing your risk as well. Risk and reward are related.

Unfortunately, stocks don't go around advertising the return investors demand for them. It is an unknown number that is constantly changing as risks, news, and economic conditions evolve. Fortunately, we can use security prices and fundamental data to help us narrow in on this return.

Solving for Expected Return

A traditional valuation equation says that a company is worth the summation of its future profits discounted to today.

$$Price = \frac{Future\ Profits}{(1 + Discount\ Rate)}$$

The discount rate you apply to this equation is your expected return as an investor. If you pay $10 today and expect to receive $15 in the future, your return is 50%. We can see this if we solve for the discount rate in the equation above:

$$\textit{Expected Return} = \textit{Discount Rate} = \frac{\textit{Future Profits}}{\textit{Price}} - 1 = \frac{\$15}{\$10} - 1 = 50\%$$

Using prices and fundamentals, we can "solve" for and approximate the expected return the market demands for holding a given stock.

$$\textit{Expected Return} = \frac{\textit{Future Profits}}{\textit{Price}} - 1 \approx \frac{\textit{Profits/Book}}{\textit{Price/Book}} - 1 = \frac{\textit{Profitability}}{\textit{Value}} - 1$$

You can see that we end up with established evidence-based factors driving the expected returns. The ratio of profitability to value determines the expected return for each security. By solving for expected return in this way, we can more precisely and accurately target securities with higher expected returns.

The price you pay for risk today shapes the returns you might see tomorrow. At Longview Research Partners we aim to maximize that tradeoff between risk and return via portfolio construction and solving for the expected return.

info@longviewresearchpartners.com
longviewresearchpartners.com