The Return Investors Demand

Investors demand different returns from different investments based on risk, tastes, and preferences. Simply, the expected return of any investment is the difference between what an investor pays and what they expect to receive. That return is not printed anywhere, but it can be estimated using market prices and company fundamentals.

Why It Matters

A cheap stock may be cheap for a reason, while a highly profitable company may be priced so richly that little return remains.

Moving beyond the style box and simple factor sorts to solve directly for expected return helps identify the companies offering the most favorable balance between what investors pay and what they expect to receive.

Start with the Dividend Discount Model

The dividend discount model begins with a simple idea: a stock's price equals the summation of all profits investors expect it to generate in the future, discounted to its value today.

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

Rather than predicting future information and solving for price, we trust the information already reflected in market prices and solve for the expected return investors are demanding. The discount rate is the expected return required to make those future profits consistent with today's market price.

Rearrange the Equation to Solve for Expected Return

$$\text{Expected Return} = \text{Discount Rate} = \frac{\sum \text{Expected Future Profits}}{\text{Price}} - 1 \approx \frac{\text{Profitability}}{\text{Value}}$$

Here, value is measured as price-to-book. A lower ratio means investors are paying less relative to fundamentals.

Price and Profits Must be Evaluated Together

Higher expected returns come from a favorable combination of paying less and receiving more.

	LOWER PROFITABILITY	HIGHER PROFITABILITY
LOWER PRICE relative to fundamentals	**PAY LESS** Lower price, but weaker profits	**HIGHER EXPECTED RETURN** Pay less and receive more
HIGHER PRICE relative to fundamentals	**LOWER EXPECTED RETURN** Pay more and receive less	**RECEIVE MORE** Stronger profits, but higher price

Expected return is an estimate, not a promise. Higher expected returns involve greater risk, and realized returns may differ materially from expectations.

Source: Longview Research Partners.

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