

7.12: Key Takeaways

Learning Objectives

The relationship between risk and return is an essential element of financial analysis. Because investors tend to behave in a risk-averse manner, we anticipate that higher risk investments should have higher expected returns. In this chapter, we formalize that analysis by introducing measures of risk (standard deviation and beta) and expected return. Standard deviation captures the dispersion of possible returns (total risk) and is best used when evaluating individual investments in isolation or poorly diversified portfolios. Beta captures the risk of securities relative to the overall market (market risk) and is best used when evaluating individual investments within a portfolio. A portfolio represents a collection of securities held together and is an essential tool for diversifying away firm-specific risk. The lower the correlation between a pair of securities, the more potential diversification benefits there are. This is reminiscent of the “don’t put all your eggs in one basket” cliché. While diversification can virtually eliminate the impact of firm-specific risk, it cannot eliminate market risk. Therefore, investors should be compensated for the degree of market risk that they are exposed to in their investments. The Security Market Line (SML) formalizes the risk-return tradeoff with respect to beta, the risk-free rate, and the market risk premium. It hypothesizes that higher beta stocks should generate higher returns and beta should be the only factor that systematically differentiates returns. Unfortunately, the SML has not held up well to empirical testing which has led to the introduction of newer attempts to formalize the relationship between risk and return. While the specific nature of risk and return is not finalized, it is safe to say that, in general, higher risk should be rewarded with higher expected returns. However, it is important to remember that expected returns are not the same as realized returns due to the nature of risk.

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