UNIT-1

INVESTMENT SETTING

1.8 THE CONCEPT OF RETURN IN INVESTMENT

1. Introduction to Investment Returns:

- **Definition:**
  - Investment return refers to the gain or loss made on an investment relative to the amount invested.
  - It is a key metric for assessing the profitability and performance of an investment.
- **Components of Investment Return:**
  - **Capital Gain:**
    - Profit from an increase in the value of an investment.
  - **Income (Yield):**
    - Earnings generated from an investment, such as interest, dividends, or rental income.

2. Types of Investment Returns:

- **Total Return:**
  - Combines both capital gains and income.
  - Provides a comprehensive view of the overall return on investment.
- **Nominal Return:**
  - The actual monetary gain or loss on an investment.
  - Excludes the impact of inflation.
- **Real Return:**
  - Adjusts nominal return for inflation.
  - Reflects the actual purchasing power gained or lost.

3. Measuring Investment Returns:

- **Return on Investment (ROI):**
  - Calculates the return as a percentage of the initial investment.

- **Formula:** $ROI = (Current\ Value - Initial\ Investment) / Initial\ Investment \times 100$

- **Compound Annual Growth Rate (CAGR):**
  - Represents the geometric progression ratio that provides a constant rate of return over a specified time period.
  - Smooths out the impact of volatility.
  - Useful for evaluating the performance of investments over multiple years.

4. Risk-Return Tradeoff:

- **Higher Risk, Higher Potential Return:**
  - Investments with higher risk tend to have the potential for higher returns.
  - Investors must assess their risk tolerance and investment goals.
- **Diversification:**
  - Spreading investments across different asset classes to balance risk and return.
  - Aims to maximize return for a given level of risk.

5. Time Value of Money:

- **Present Value and Future Value:**
  - The concept that money today is worth more than the same amount in the future.
  - Present value discounts future cash flows, while future value calculates the future worth of an investment.
- **Discounted Cash Flow (DCF):**
  - Technique to estimate the value of an investment based on its expected future cash flows.
  - Accounts for the time value of money.

6. Types of Investment Vehicles:

- **Equities (Stocks):**
  - Returns from capital appreciation and dividends.
  - Potentially higher returns but with higher volatility.

- **Bonds:**
  - Generate returns through interest payments and capital appreciation.
  - Generally lower risk compared to equities.
- **Real Estate:**
  - Returns from rental income and property appreciation.
  - Combines income and capital gains.
- **Mutual Funds:**
  - Returns derived from the underlying assets (stocks, bonds, etc.).
  - Diversification and professional management may impact returns.
- **Savings Accounts and Fixed Deposits:**
  - Earn interest income.
  - Generally considered lower-risk, lower-return investments.

7. Impact of Costs and Taxes:

- **Fees and Expenses:**
  - Costs associated with managing and maintaining an investment.
  - Impact overall returns.
- **Taxation:**
  - Taxes on investment gains can reduce net returns.
  - Different investments may have varied tax implications.

8. Behavioral Aspects of Returns:

- **Loss Aversion:**
  - Investors may be more sensitive to losses than gains.
  - Influences decision-making and risk tolerance.
- **Recency Bias:**
  - Tendency to extrapolate recent returns into the future.
  - Can lead to unrealistic expectations.

9. Conclusion:

Understanding the concept of return is fundamental to making informed investment decisions. Investors should consider the different types of returns, measure performance using appropriate metrics, and evaluate the risk-return trade-off. Additionally, taking into account the impact of costs, taxes, and behavioural factors contributes to a holistic understanding of investment returns. By aligning expectations with investment goals and risk tolerance, investors can navigate the complex landscape of financial markets more effectively.