Reading 2 Concept Map

How Modules 2.1 & 2.2 Connect

MODULE 2.1 · FINANCIAL ASSETS, INSTRUMENTS & INDICATORS

Total Return = Price Return + Capital Distribution Return

Capital distribution is **fixed** (bond coupon) or **variable** (dividend, floating-rate coupon)

FINANCIAL INSTRUMENTS — earn returns

- **Equity** (owner): mostly **price return**; dividends are variable
- **Bonds** (lender): mostly **fixed coupon**; some price return; principal repaid at maturity
- **Derivatives**: value derived from an underlying asset; one side's gain is the other's loss
- **Cash**: no return; held for liquidity
- **Hybrids**: blend of debt and equity, e.g. convertible bond

FINANCIAL INDICATORS — move returns

- **Interest rates**: rates ↑ → bond prices ↓; longer bonds fall more
- **Risk-free rate**: short-term government bills, free of credit risk
- **Creditworthiness**: default risk ↑ → bond price ↓
- **Exchange rates**: foreign currency ↑ → domestic return ↑; weakens → ↓
- **Market indexes**: diversified → lower volatility → better compound returns

Indicators generate no cash flows themselves.

MEASURING RETURNS — the maths

- HPR = $(P_1 - P_0 + \text{Income}) / P_0$
- Annualize: $(1 + r)^{365/t} - 1$
- Domestic return: $(1 + R_{FC})(1 + R_{FX}) - 1$
- Arithmetic vs geometric mean: volatility drag
- Outperformance: $(1 + R_A) / (1 + R_B) - 1$

Common thread: when returns stack, compound them. Never add.

MODULE 2.2 · LONG-TERM RETURNS, RISK & ASSET ALLOCATION

Now ask: how much should each asset earn, and how do we choose the mix?

1 RISK-RETURN TRADEOFF

Riskier assets → higher expected long-term return

Small-cap > large-cap; corporate > government (credit spread)

History: equities > bonds; long bonds > short; T-bills ≈ zero real return

→

2 RISK

Chance of a return different from expected

Systematic (macro): inflation, interest rate, market — not diversifiable

Unsystematic (micro): issuer, sector — diversifiable

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3 RISK PREMIUM

Extra return demanded for bearing extra risk

Measure risk by variability, e.g. range = highest - lowest

Equities earn higher premiums than fixed income

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4 ASSET ALLOCATION

Match the client's objectives and constraints

Growth → equity; income + low risk tolerance → fixed income; both → balanced

Portfolio return = weighted average

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