Which Return Dominates? — Financial Instruments

Every investment pays through price return, capital distribution return, or both. Know which one dominates for each instrument, whether the income is fixed or variable, and what moves its value.

Instrument	Investor's role	Dominant return	Capital distribution	What moves the value	Remember for the exam
Equity (stocks / shares)	Owner — a stake in the company	**Price return** (capital appreciation)	**Variable** — discretionary dividends decided by the board	Earnings outlook: company-specific (new product) and market-wide (economic growth, rates)	Dividends are never a fixed distribution. Buybacks shift return from dividends to price.
Fixed-coupon bond	Lender to the issuer	**Distribution return** (coupon)	**Fixed** — coupon set at issue; principal (par / face value) repaid at maturity	Interest rates ↑ → price ↓; issuer default risk ↑ → price ↓	Still has price return. Longer maturity = bigger price change for the same rate move.
Floating-rate bond (FRN)	Lender to the issuer	**Distribution return** (coupon)	**Variable** — coupon resets with prevailing interest rates	Credit quality of the issuer; much less sensitive to rate changes	Proof that "fixed income" does not always mean fixed distributions.
Treasury bill (T-bill)	Lender to the government	**Price return only**	**None** — issued at a discount, pays face value at maturity	Short-term rates (very small price effect)	Its return is the risk-free rate: free of credit risk, not of inflation risk. Income = 0.
Corporate bond vs government bond	Lender	Distribution return	Fixed (usually)	Corporate: default risk is higher, so price reacts to issuer news	Corporate bonds pay a **credit spread** over government bonds.
Derivative	Party to a contract	Value change of the contract	None in itself	Price of the reference (underlying) asset, e.g. gold	One party's gain = the other party's loss.
Cash	Holder	**No return**	None (notes, coins, non-interest-bearing deposits)	Nothing nominally; inflation erodes purchasing power	Held for liquidity. Real return is negative when inflation is positive.
Hybrid (e.g. convertible bond)	Lender with an option to become owner	Blend of both	Fixed coupons while held as a bond	Both rates/credit (debt side) and share price (equity side)	Risk and return are a blend of equity and debt.

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Financial Indicators — They Move Returns but Pay Nothing

Indicators generate no cash flows themselves. They change the returns of the instruments above.

Indicator	What it is	How it affects returns	Formula / rule	Exam pointer
Interest rates	Return paid to savers for lending; seen in deposit rates and fixed-income yields	Rates ↑ → bond prices ↓ (negative price return). Also hurt equities: higher financing costs, lower PV of future cash flows	Price = Face / $(1 + r_{period})$	Short-term developed-market government rate = risk-free rate.
Foreign exchange rates	Value of one currency in terms of another (e.g. 1 GBP = 1.35 USD)	Foreign currency strengthens → domestic return ↑; weakens → domestic return ↓. Affects both price and income returns	$R_{DC} = (1 + R_{FC})(1 + R_{FX}) - 1$	Multiply, never add the two returns.
Market indexes	Average performance of a group of investments (S&P 500, Nifty 50, Bloomberg Global Agg)	More diversified → lower volatility → better compound (geometric) returns over multiple periods	Geometric ≤ arithmetic; gap grows with volatility	Volatile stock can have higher arithmetic but lower geometric return.

Module 2.2 — Asset Classes Ranked by Risk and Expected Return

Risk-return tradeoff: over the long term, rational investors demand higher returns from riskier assets. Listed roughly from highest to lowest expected return.

Asset class	Why it is risky (or not)	Expected long-term return	Typical portfolio role	Exam pointer
Small-cap equities	Highest volatility; less established businesses	Highest	Long-horizon growth	Curriculum data showed large-caps ahead — an artifact of the period, not a rule.
Large-cap equities	High volatility of prices; market and issuer risk	High	Growth (capital appreciation)	Equities earned higher long-term returns and risk premiums than bonds.
Corporate bonds	Default (credit) risk on top of rate risk	Above government bonds	Income with some extra yield	Earn a credit spread over government bonds.
Long-term government bonds	Interest rate and inflation risk from locking in a rate for long	Above short-term bonds	Income; low default risk	Longer-term fixed income outperformed shorter-term bonds historically.
Short-term T-bills / cash	Almost no credit or price risk	Lowest (near-zero real return)	Liquidity, safety	US 30-day T-bill showed little return above inflation.

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