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Risk and Return: A New Look

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One of the best documented propositions in the field of finance is that, on average, investors have received higher rates of return on investment securities for bearing greater risk. This paper looks at the historical evidence regarding risk and return, explains the fundamentals of portfolio and asset pricing theory, and then goes on to take a new look at the relationship between risk and return using some unexplored risk measures that seem to capture quite closely the actual risks being valued in the market. The paper concludes that the best single risk proxy is not the traditional beta calculation but rather the dispersion of analysts' forecasts. Companies for which there is broad consensus with respect to future earnings and dividends seem to be less risky (and hence have lower expected returns) than companies for which there is little agreement among security analysts. It is possible to interpret this result as contradicting modern asset pricing theory, which suggests that total variability per se will not be relevant for valuation. As is shown in the paper, however, this dispersion of forecasts could well result from different companies being particularly susceptible to systematic risk elements and thus the dispersion measure may be the best individual proxy available to capture the variety of systematic risk elements to which securities are subject.

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