

Investors and managers demonstrates risk aversion in different ways



People try to avoid risk






Why managers invest in risky projects?

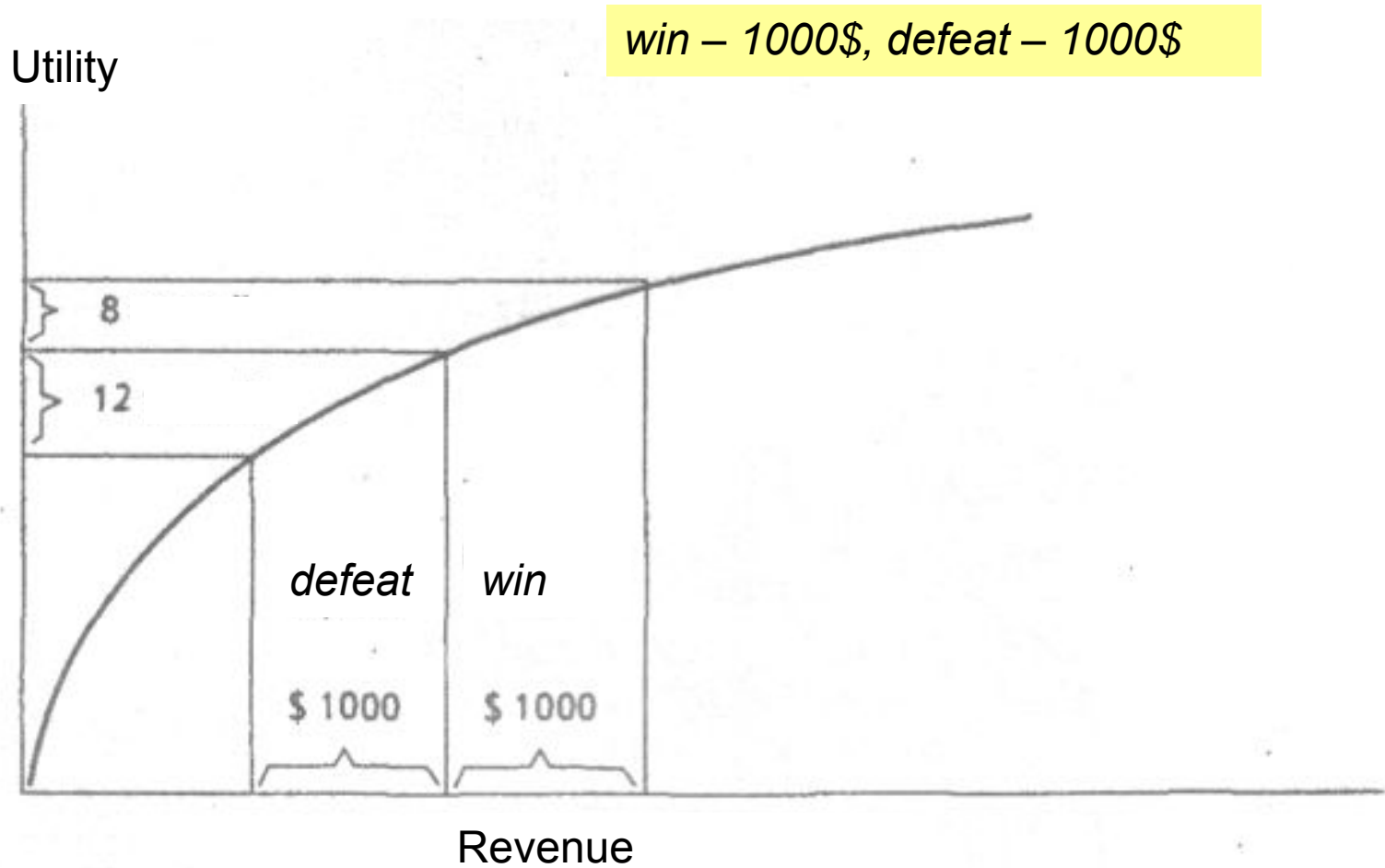


RISK PREMIUM

A young child with blonde hair, dressed in a grey business suit, white shirt, and patterned tie, is sitting and talking on a black mobile phone. The child is looking slightly to the right with a thoughtful expression. The background is a blurred office setting with a window.

I want to have a compensation not only for the use of my money, but for the risk to remain without them!

... a higher rate of profit, if there is a risk...

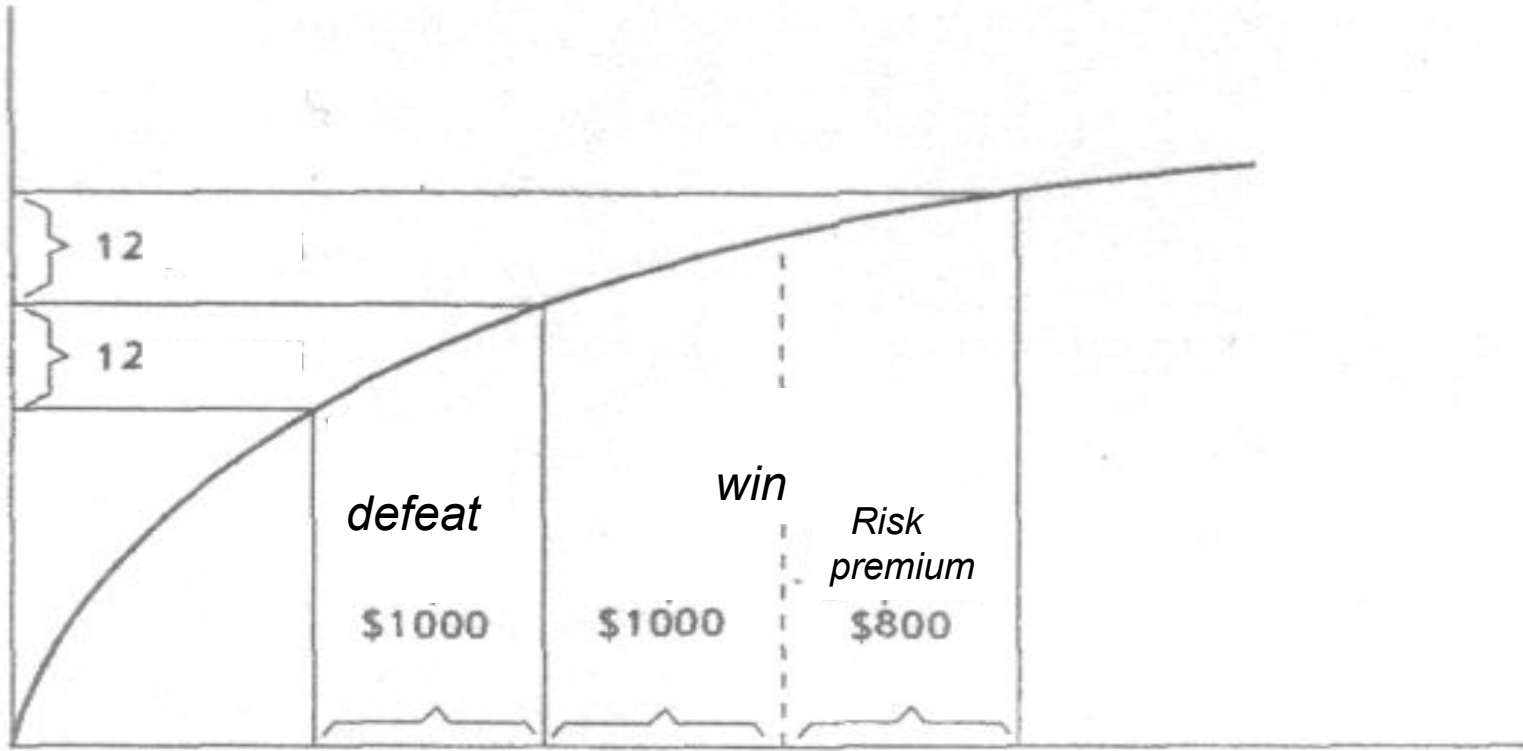


Negative expected value => investor will not bet

Utility of revenue

win – 1800\$, defeat – 1000\$

Utility



Revenue

Utility of revenue



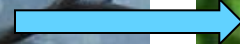
Business risk associated with a firm decision about investment

Business risk is always there - no business does not guarantee success




"We've considered every potential risk except the risks of avoiding all risks."

Within one business direction, the investor usually faced with higher business risk in the newly created company



On the other hand, the "old" company, products or methods of entrepreneurship which are outdated, can have high enough degree of business risk





Financial risk is determined by the financial decisions of the firm (the risk of possible insolvency)



The income of the company must first of all go to debt service



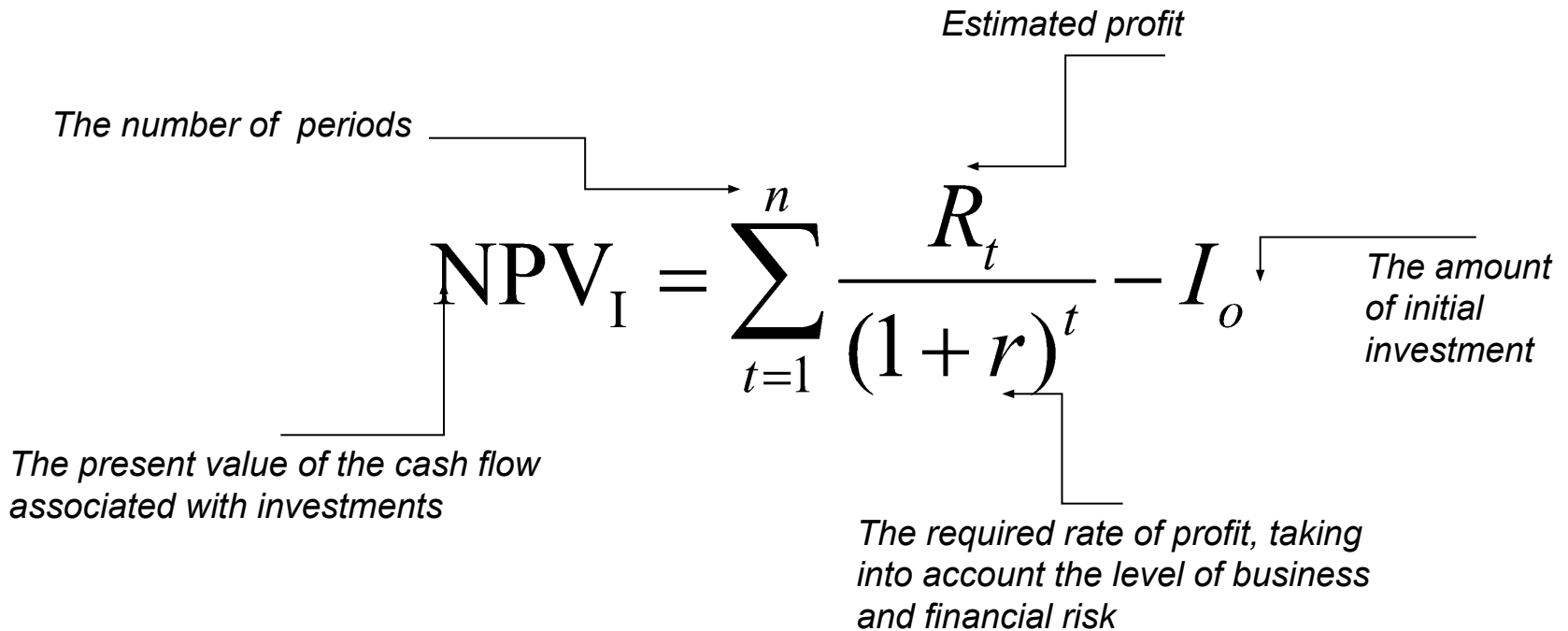
Adjustment of risk



Discounted value of future profit

Degree of risk

Valuation model:



Methods of risk account :

✓ *The rate method, corrected for risk*

✓ *Method of certainty equivalent*



✓ The rate method, corrected for risk

The rate, corrected for risk

-the required rate of profit from prospective investments after due consideration of the existing risk

Ex:



✓ **Method of certainty equivalent**

The diagram illustrates the formula for the Net Present Value (NPV) of an investment using the certainty equivalent method. The formula is:

$$NPV_I = \sum_{t=1}^n \frac{\alpha_t R_t}{(1+i)^t} - I_o = \sum_{t=1}^n \frac{R_t^*}{(1+i)^t}$$

The components of the formula are explained by the following labels and arrows:

- The number of periods:** Points to the upper limit n of the summation.
- The coefficient of certainty equivalent for period t :** Points to α_t .
- The expected cash flow in the period t at risk:** Points to R_t .
- Free from the risk equivalent amount of cash in the period t :** Points to R_t^* .
- The present value of the cash flow associated with investments:** Points to the entire summation term $\sum_{t=1}^n \frac{\alpha_t R_t}{(1+i)^t}$.
- Risk-free rate of profit or the interest rate for calculating the value of money:** Points to the denominator $(1+i)^t$.
- The amount of initial investment:** Points to I_o .

The coefficient of certainty equivalent α is a number between 0 and 1, which reflects the function of risk of the decision maker.

Ex:

$$\alpha_t = \frac{\text{Free from the risk equivalent amount of cash in the period } t}{\text{The expected cash flow in the period } t \text{ at risk}}$$

*It varies inversely with the degree of risk
(the higher the risk, the lower should be the factor)*

$\alpha = 1$ –the project is risk free

$\alpha = 0$ – the project is too risky

to expect profit



Risk is anyway evaluated by one Manager or team of experts

And most often for any specific period:

$$\frac{\alpha_t R_t}{(1+i)^t} = \frac{R_t}{(1+r)^t}$$

$$\alpha_t = \frac{(1+i)^t}{(1+r)^t}$$



East-West Trading Company

